2017

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

February 16, 2018

AIR CANADA

A STAR ALLIANCE MEMBER

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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)	Fourth Quarter 2017	Fourth Quarter 2016	Fourth Quarter $ Change	Full Year 2017	Full Year 2016	Full Year $ Change
Financial Performance Metrics						
Operating revenues	3,820	3,425	395	16,252	14,677	1,575
Operating income	133	18	115	1,364	1,345	19
Income (loss) before income taxes	20	(178)	198	1,279	877	402
Net income (loss)	8	(179)	187	2,038	876	1,162
Adjusted pre-tax income (1)	77	39	38	1,158	1,148	10
Adjusted net income (1) (2)	61	38	23	1,142	1,147	(5)
Operating margin %	3.5%	0.5%	3.0 pp	8.4%	9.2%	(0.8) pp
EBITDAR (excluding special items) (1)	521	455	66	2,921	2,768	153
EBITDAR margin (excluding special items) % (1)	13.6%	13.3%	0.3 pp	18.0%	18.9%	(0.9) pp
Unrestricted liquidity (3)	4,181	3,388	793	4,181	3,388	793
Net cash flows from operating activities	389	351	38	2,738	2,421	317
Free cash flow (1)	(43)	121	(164)	1,056	(149)	1,205
Adjusted net debt (1)	6,116	7,090	(974)	6,116	7,090	(974)
Return on invested capital ("ROIC") % (1)	13.9%	16.7%	(2.8) pp	13.9%	16.7%	(2.8) pp
Leverage ratio (1)	2.1	2.6	(0.5)	2.1	2.6	(0.5)
Diluted earnings (loss) per share	$ 0.02	$ (0.66)	$ 0.68	$ 7.34	$ 3.10	$ 4.24
Adjusted earnings per share – diluted (1)	$ 0.22	$ 0.14	$ 0.08	$ 4.11	$ 4.06	$ 0.05
Operating Statistics (4)			**% Change**			**% Change**
Revenue passenger miles ("RPM") (millions)	19,396	17,643	9.9	85,137	76,481	11.3
Available seat miles ("ASM") (millions)	24,191	22,091	9.5	103,492	92,726	11.6
Passenger load factor %	80.2%	79.9%	0.3 pp	82.3%	82.5%	(0.2) pp
Passenger revenue per RPM ("Yield") (cents)	17.1	16.9	1.4	16.7	16.8	(1.0)
Passenger revenue per ASM ("PRASM") (cents)	13.7	13.5	1.8	13.7	13.9	(1.3)
Operating revenue per ASM (cents)	15.8	15.5	1.9	15.7	15.8	(0.8)
Operating expense per ASM ("CASM") (cents)	15.2	15.4	(1.2)	14.4	14.4	0.1
Adjusted CASM (cents) (1)	11.3	11.4	(1.2)	10.6	10.9	(3.0)
Average number of full-time equivalent ("FTE") employees (thousands) (5)	28.3	26.2	8.0	27.8	26.1	6.7
Aircraft in operating fleet at period-end	395	381	3.7	395	381	3.7
Average fleet utilization (hours per day)	9.7	9.5	2.4	10.4	10.2	1.8
Seats dispatched (thousands)	14,522	13,873	4.7	60,820	57,135	6.4
Aircraft frequencies (thousands)	138.4	136.7	1.3	569.6	565.5	0.7
Average stage length (miles) (6)	1,666	1,592	4.6	1,702	1,623	4.8
Fuel cost per litre (cents)	67.5	59.4	13.8	62.6	53.9	16.2
Fuel litres (thousands)	1,254,111	1,160,404	8.1	5,331,888	4,837,159	10.2
Revenue passengers carried (thousands) (7)	11,314	10,719	5.6	48,126	44,849	7.3

(1) Adjusted pre-tax income, adjusted net income, adjusted earnings per share – diluted, EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent), EBITDAR margin, leverage ratio, 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 9 and 20 of this MD&A for descriptions of Air Canada's non-GAAP financial measures and additional GAAP measures. As referenced in the table above, special items are excluded from Air Canada's reported EBITDAR calculations. Refer to sections 6 and 7 of this MD&A for information on special items.

(2) Starting as of and including the fourth quarter of 2017, adjusted net income is determined net of tax and includes the income tax effect of adjustments included in the measurement of adjusted net income. Prior to the fourth quarter of 2017, there was no deferred income tax expense recorded because of significant unrecognized deferred tax assets. A tax expense of $16 million affected fourth quarter and full year 2017 adjusted net income results.

(3) Unrestricted liquidity refers to the sum of cash, cash equivalents, short-term investments and the amount of available credit under Air Canada's revolving credit facilities. At December 31, 2017, unrestricted liquidity was comprised of cash and short-term investments of $3,804 million and undrawn lines of credit of $377 million. At December 31, 2016, unrestricted liquidity was comprised of cash and short-term investments of $2,979 million and undrawn lines of credit of $409 million.

(4) 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 Limited ("EVAS")) operating under capacity purchase agreements with Air Canada.

(5) 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.

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

(7) Revenue passengers carried 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 fourth quarter and the full year of 2017. This MD&A should be read in conjunction with Air Canada's audited consolidated financial statements and notes for 2017. Except for non-GAAP measures and except where otherwise described in this MD&A, all financial information of Air Canada has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), as set out in the CPA Canada Handbook – Accounting ("CPA Handbook"), which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

Except as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 21 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of February 15, 2018. Certain comparative figures have been reclassified to conform to the financial statement presentation adopted for the current year.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 18 "Risk Factors" of this MD&A. Air Canada issued a news release dated February 16, 2018 reporting on its results for the fourth quarter and the full year of 2017. 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 forward-looking statements within the meaning of applicable securities laws. Such forward-looking 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 using 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, industry, market, credit, economic and geopolitical conditions, energy prices, currency exchange, competition, our dependence on technology, cybersecurity risks, our ability to pay our indebtedness and secure financing, our ability to successfully implement appropriate strategic initiatives or reduce operating costs, war, terrorist acts, epidemic diseases, airport user and related fees, high levels of fixed costs, liquidity, our dependence on key suppliers including regional carriers and Aimia Canada Inc., our success in transitioning from the Aeroplan program and launching our new loyalty program, casualty losses, employee and labour relations and costs, our ability to preserve and grow our brand, 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, our dependence on Star Alliance, interruptions of service, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties and our ability to attract and retain required personnel, as well as the factors identified in Air Canada's public disclosure file available at www.sedar.com and, in particular, those identified in section 18 "Risk Factors" of this MD&A. The forward-looking statements contained or incorporated by reference in this MD&A represent Air Canada's expectations as of the date of this MD&A (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 because 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 modest Canadian GDP growth for 2018 and 2019. Air Canada also expects that the Canadian dollar will trade, on average, at C$1.25 per U.S. dollar in the first quarter of 2018 and the full year 2018 and that the price of jet fuel will average 72 CAD cents per litre in the first quarter of 2018 and 70 CAD cents per litre for the full year 2018.

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.

This MD&A may also include trademarks, service marks or trade names of other parties. Air Canada's use or display of other parties' trademarks, service marks, trade names or products is not intended to, and does not imply a relationship with, or endorsement or sponsorship of Air Canada by, the trademark, service mark or trade name owners or licensees.

3. ABOUT AIR CANADA

Air Canada is the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market and in the international market to and from Canada. In 2017, Air Canada, together with Jazz Aviation LP ("Jazz"), Sky Regional Airlines Inc. ("Sky Regional") and other regional airlines operating flights on behalf of Air Canada under capacity purchase agreements, operated, on average, 1,602 daily scheduled flights to 217 direct destinations on six continents, comprised of 64 Canadian cities, 57 destinations in the United States and a total of 96 cities in Europe, Africa, the Middle East, Asia, Australia, the Caribbean, Mexico and South America. In 2017, Air Canada carried record 48.1 million passengers, an increase of 7.3% from 2016.

At December 31, 2017, Air Canada mainline operated a fleet of 175 aircraft, comprised of 75 Airbus narrow-body aircraft, 73 Boeing and Airbus wide-body aircraft, two Boeing narrow-body aircraft and 25 Embraer 190 regional jets, while Air Canada Rouge operated a fleet of 49 aircraft, comprised of 20 Airbus A319 aircraft, five Airbus A321 aircraft and 24 Boeing 767-300 aircraft, for a total fleet of 224 aircraft.

Air Canada enhances its domestic and transborder network through capacity purchase agreements ("CPAs") with regional airlines, namely Jazz, Sky Regional Airlines Inc. ("Sky Regional"), Air Georgian Limited ("Air Georgian") and Exploits Valley Air Services Limited ("EVAS"), each of which operates flights on behalf of Air Canada. These carriers form an integral part of the airline's international network strategy, providing valuable traffic feed to Air Canada and Air Canada Rouge routes. At December 31, 2017, the Air Canada Express fleet was comprised of 45 Bombardier regional jets, 86 Bombardier Dash-8 turboprop aircraft and 25 Embraer 175 aircraft for a total of 156 aircraft. Air Georgian and EVAS also operate a total of 15 18-passenger Beech 1900 aircraft on behalf of Air Canada.

Air Canada is a founding member of the Star Alliance® network. Through the 28-member airline network, Air Canada offers its customers access to approximately 1,300 destinations in 191 countries, as well as reciprocal participation in frequent flyer programs and the use of airport lounges and other common airport facilities.

Air Canada is able to build customer loyalty through Air Canada Altitude®, its frequent flyer program and through the Aeroplan® loyalty program operated by Aimia Canada Inc. (formerly Aeroplan Canada Inc. and referred to as "Aeroplan" in this MD&A). Air Canada Altitude® recognizes and rewards Aeroplan® members with a range of premium travel privileges and benefits corresponding to their travel activity, such as priority check-in, complimentary checked baggage and upgrades to Business Class, as well as opportunities to earn Aeroplan® Miles on Air Canada flights and those of the other 27 Star Alliance® member airlines. Aeroplan is also Air Canada's single largest customer, purchasing Air Canada seats to be provided to Aeroplan® members who choose to redeem their Aeroplan® Miles for travel on Air Canada. Aeroplan® members also have opportunities to redeem their Aeroplan® Miles for travel with Star Alliance® member airlines. In May 2017, Air Canada announced its decision to launch its own loyalty program in 2020 upon the expiry of its commercial agreement with Aimia Canada Inc.

Air Canada has been pursuing a comprehensive strategy to improve profitability and competitiveness in leisure markets. This strategy leverages the strengths of Air Canada, Air Canada Rouge, the airline's lower-cost leisure airline, and Air Canada Vacations. Through Air Canada Rouge, Air Canada is pursuing opportunities in leisure markets made viable by Air Canada Rouge's more competitive cost structure. Air Canada Vacations is a leading Canadian tour operator, developing, marketing and distributing vacation travel packages, operating in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, Central and South America, South Pacific, Australia and Asia), and the inbound leisure travel market to destinations within Canada, and also offering cruise packages in North America, Europe and the Caribbean.

Air Canada generates revenue from its cargo division, operating as Air Canada Cargo, Canada's largest provider of air cargo services as measured by cargo capacity. Air Canada Cargo provides direct cargo services to over 150 Canadian, U.S. transborder and international destinations and has sales representation in over 50 countries. Air cargo services are provided across the Air Canada network.

4. STRATEGY

Air Canada's principal objective is to become one of the world's best global airlines. In pursuing this goal, it seeks to continually improve customer experience and employee engagement, and create value for shareholders, by focusing on four core priorities:

- Identifying and implementing cost reduction and revenue enhancing initiatives;
- Pursuing profitable international growth opportunities and leveraging competitive attributes to appropriately expand margins, in large part by increasing connecting traffic through its strategic international gateways in Toronto, Vancouver and Montreal, and to grow and compete effectively in the leisure market to and from Canada;
- Engaging customers by continually enhancing their travel experience and providing a consistently high level of customer service, with additional emphasis on premium and business passengers and products; and
- Fostering positive culture change through employee engagement programs. This includes meaningful investments in training and other tools that support delivering exceptional customer experiences and that also promote improved collaboration and an appreciation of how the airline and its talented employees can better work together in a supportive and enriching environment.

Revenue enhancement and cost transformation

Margin improvement through the implementation of sustainable cost transformation and profitable revenue-generating initiatives is a key priority at Air Canada. Air Canada continues to seek and implement measures to reduce unit costs and expand margins, including through fleet modernization and greater fleet productivity. Additionally, Air Canada seeks to improve its ability to generate incremental passenger and ancillary revenue, including through its improved suite of branded fare products and investments in technology to generate incremental sales.

Key achievements in 2017

- Record operating revenue of $16,252 million, $1,575 million or 11% above 2016.
- Carried record 48.1 million passengers, 7.3% above 2016.
- EBITDAR margin of 18.0%, consistent with the 2017 EBITDAR margin of 17% to 19% forecast in Air Canada's news release dated October 25, 2017.
- CASM increased 0.1% from 2016. Adjusted CASM decreased 3.0% from 2016, in line with the 3.0% to 4.0% decrease forecasted in Air Canada's news release dated October 25, 2017.
- Continued to successfully expand Air Canada Rouge, the airline's leisure carrier, which operates at lower CASM when compared to the same aircraft in the mainline fleet.
- Added nine Boeing 787 aircraft into the mainline fleet, allowing the airline to serve new international destinations.
- Introduced its first two Boeing 737 MAX 8 aircraft into the mainline fleet, commencing the Air Canada's narrow-body renewal program which will allow the airline to further improve unit costs and provide greater deployment opportunities throughout the network.
- Reconfigured Airbus A330-300 aircraft into a more cost effective and competitive configuration.

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

Air Canada Rouge

Since its first flight in July 2013, Air Canada Rouge, Air Canada's leisure carrier, has been deployed to a growing number of Caribbean destinations and select leisure destinations in the U.S. and Canada, as well as in international leisure markets where demand is highly elastic and responds positively to lower priced, non-stop capacity. At December 31, 2017, Air Canada Rouge operated 49 aircraft (24 Boeing 767, 20 Airbus A319 and five Airbus A321 aircraft) and is planning to have a total of 53 aircraft in its fleet (25 Boeing 767, 22 Airbus A319 and six Airbus A321 aircraft) by the summer of 2018.

Air Canada Rouge provides Air Canada with the flexibility to swing capacity between markets as well as between seasons and effectively competes against lower-cost carriers. Air Canada Rouge offers competitive fares while leveraging the strengths of Air Canada, including its powerful brand, award-winning products and services, extensive network with enhanced connection options, distribution capability and operational expertise.

In September 2017, Air Canada concluded amendments to its long-term labour agreement with its pilots, represented by the Air Canada Pilots Association ("ACPA"). The amendments to the original 10-year agreement, reached in October 2014, further support Air Canada's strategic plan for profitable growth for both mainline and Air Canada Rouge in a proportionate manner based on overall growth. This provides Air Canada with abilities to grow its North American narrow-body fleet operated by Air Canada Rouge, enabling the airline to expand its presence in certain regional markets and to compete more effectively against emerging North American ultra-low-cost carriers. Air Canada will not expand into ultra-low-cost markets unless it determines it is appropriate to do so.

Air Canada plans to add one wide-body and three narrow-body aircraft to Air Canada Rouge's fleet in 2018. Refer to section 8 "Fleet" of this MD&A for additional information.

Continued introduction of fuel-efficient Boeing 787 aircraft

To date, Air Canada has taken delivery of 32 Boeing 787 Dreamliner aircraft of its firm order of 37 aircraft (comprised of eight 787-8 and 29 787-9 aircraft). Air Canada plans to take delivery of the remaining five Boeing 787-9 aircraft on firm order by the summer of 2019. The Boeing 787 Dreamliner is driving new opportunities for profitable growth by opening new international destinations made viable by its lower operating costs, mid-size capacity and longer range.

Narrow-body fleet renewal program

To date, Air Canada has taken delivery of four Boeing 737 MAX 8 aircraft of its firm order of 61 737 MAX aircraft (comprised of 50 Boeing 737 MAX 8 and 11 Boeing 737 MAX 9 aircraft). The Boeing 737 MAX aircraft are expected to replace the Airbus narrow-body aircraft in Air Canada's mainline fleet. Air Canada plans to take delivery of the remaining 57 Boeing 737 MAX aircraft on firm order by the end of 2021. Air Canada estimates that the Boeing 737 MAX 8 aircraft will deliver an 11% lower CASM when compared to its Airbus A320 aircraft, mainly driven by greater maintenance and fuel efficiencies. This aircraft will also offer greater deployment opportunities in the domestic, U.S. transborder and certain Atlantic markets.

In 2016, Air Canada and Bombardier Inc. ("Bombardier") finalized a purchase agreement for the acquisition of up to 75 Bombardier C-Series CS300 aircraft (45 firm orders plus options to purchase up to an additional 30 aircraft). Deliveries are scheduled to begin in late 2019 and extend to 2022. The first 25 aircraft on delivery are expected to replace the Embraer 190 aircraft in Air Canada's mainline fleet, with the incremental aircraft supporting Air Canada's hub and network growth. Air Canada estimates that the Bombardier C-Series CS300 aircraft will deliver a 12% lower CASM when compared to the Embraer 190 aircraft, mainly driven by greater maintenance and fuel efficiencies. This aircraft, with its longer range, will also offer greater deployment opportunities, enabling the airline to serve new markets that would not be as viable with its larger Boeing 737 MAX or Airbus A321 aircraft.

Other revenue optimization and cost reduction initiatives

Air Canada has created a culture of continuous cost transformation and revenue improvement across the organization, continually seeking productivity, process and other improvements. Initiatives may entail revising business and operational processes, including supply chain and maintenance operations, improving employee productivity and asset utilization, and promoting workplace policies to add revenue and lower costs. In 2017, through the execution of company-wide initiatives, Air Canada realized savings of approximately $90 million. In addition, through the implementation of sourcing best practices, Air Canada entered into agreements generating aggregate savings of $120 million over the life of the agreements.

Air Canada updated its suite of branded fare products to allow it to further segment its customer base and offer a variety of fare options and a customized on-board experience. These new re-bundled fares are designed to provide a wider range of choices and stimulate sales based on specific attributes, driving incremental revenue. The airline has also introduced a program entitled "AC Bid Upgrade" for eligible customers to bid on cabin class upgrades. Air Canada continues to increase its ancillary revenue through "à la carte" services, such as those related to baggage, ticket changes, seat selection, preferred seating and upgrades. Finally, Air Canada generates revenues from its onboard offerings, including food, beverage, duty-free shopping and onboard Wi-Fi Internet. To better monetize its ancillary offerings and increase related revenues, Air Canada intends to further develop its merchandising capabilities to customize, differentiate and combine its "*à la carte*" services.

Air Canada is also increasing revenues and reducing overall costs through sales and distribution initiatives. In 2017, in conjunction with a new agreement between Amadeus and Air Canada for the full Amadeus Altéa Suite passenger service system (PSS) (which is further described below under "Passenger Service System"), Air Canada renewed its multi-year distribution agreement with Amadeus on more favourable terms and conditions. This agreement supports Air Canada's business strategy for offering a more personalized travel experience across a wider range of sales channels. Amadeus users worldwide will be able to access Air Canada's customizable fare products and availability via the Amadeus global distribution system, as well as the airline's ancillary offerings. Air Canada has also introduced alternative forms of payment and payment wallets on aircanada.com, which have removed payment friction for customers within the channel and reduced transaction costs.

Air Canada continues to benefit from its amended and extended capacity purchase agreement with Jazz. The gains from this agreement primarily result from greater network flexibility, fleet economics (as the Jazz fleet transitions to more efficient and larger aircraft), and a pilot mobility agreement that provides Jazz pilots with access to pilot vacancies at Air Canada and reduces Jazz costs passed on to Air Canada. There will be further benefits beginning in 2021 when the compensation paid to Jazz decreases by approximately $55 million per year, bringing the cost of Jazz to Air Canada to a more competitive level in the regional sector.

Air Canada will be introducing a new fuel management system to better manage fuel inventories, optimize transportation logistics and improve the accuracy of fuel invoicing and reconciliation process.

Air Canada is also realizing incremental revenue through investments in digital channels. It is investing in web and mobile platforms, and as a result, saw a significant acceleration in direct channel share and core ancillary revenue sales in 2017. Air Canada continues to experiment and optimize its retail capabilities through new partnerships. For example, recent testing of AI-powered models to optimize customer fare sale and upgrade emails has led to a significant increase in customers engaging with their Air Canada emails, which would be expected to drive a higher volume of sales.

International growth

Air Canada remains focused on identifying new international growth opportunities to generate increased profit, diversify its network, and lower its risk profile. This includes the development of additional synergies offered by alliances with foreign carriers.

Key developments in 2017

- Introduced non-stop Air Canada service from Vancouver to Frankfurt, Melbourne, Taipei and Boston; from Montreal to Shanghai and Tel Aviv; from Toronto to Mumbai; from Calgary to San Jose del Cabo; and from Ottawa to Puerto Plata.

- Launched non-stop Air Canada Rouge service from Montreal to Algiers, Lima, Marseille and Reykjavik; from Toronto to Belize City, Berlin, Cartagena, Reykjavik, St. Vincent and the Grenadines; Calgary to Huatulco; and from Vancouver to London-Gatwick, Nagoya and Orlando.

- Started non-stop Air Canada Express service from Toronto to San Antonio, Memphis and Savannah; from Vancouver to Dallas-Fort Worth, Denver and Yellowknife; and from Montreal to Dallas-Fort Worth and Washington–Dulles.

- Converted Air Canada Rouge service between Montreal and Casablanca from a seasonal service to a year-round service.

- Expanded a codeshare agreement with Cathay Pacific, further widening the network by connecting Air Canada's services to Hong Kong to many Southeast Asian destinations, including the Philippines, Malaysia, Vietnam and Thailand. As a result, Air Canada now offers codeshare services to destinations such as Manila, Cebu, Kuala Lumpur, Ho Chi Minh City, Hanoi, Bangkok, Phuket and Chiang Mai.

- Implemented a new codeshare agreement with Virgin Australia, connecting Air Canada's services to Australia (Sydney, Brisbane and Melbourne) to destinations in Australia and New Zealand such as Adelaide, Canberra, Cairns, Gold Coast, Perth, Auckland, Christchurch and Wellington.

- Expanded existing codeshare agreements with Lufthansa Group, United Airlines, Croatia Airlines, Asiana Airlines, Thai Airways, Air India and Avianca Brazil.

- Increased sixth freedom traffic (international-to-international, including U.S.) connecting through Air Canada's major Canadian hubs by 20% when compared to 2016.

Air Canada has competitive strengths which allows it to profitably pursue international route opportunities. It has the ability to appreciably increase international-to-international traffic through its strategic international gateways in Toronto, Vancouver and Montreal, and is broadening its network appeal through its membership in Star Alliance®, its trans-Atlantic revenue-sharing joint venture with United Airlines and Deutsche Lufthansa AG, referred to as A++, and through numerous codeshare and interline agreements. Furthermore, Air Canada has access to Canada's wide portfolio of international route rights, and Canada's multi-ethnic demographic profile provides the airline with further opportunities to profitably capture demand for international travel. These attributes, combined with Air Canada's powerful brand and industry-leading products and services, allow it to leverage its network and benefit from the higher margins generally available in international markets.

Air Canada plans to selectively and profitably expand its international services by leveraging its new aircraft and improved cost structure, and by exploiting the following competitive advantages:

- A widely recognized brand and a strong position in the market for trans-Atlantic and trans-Pacific travel to-and-from Canada and to-and-from North and South America via Canada.

- An extensive and expanding global network, enhanced by the airline's membership in Star Alliance, numerous codeshare agreements and participation in the A++ joint venture.

- A flexible fleet mix, enabling the airline to redeploy or otherwise manage capacity to match changes in demand.

- Air Canada Altitude®, Air Canada's frequent flyer program, which recognizes the airline's most frequent flyers by offering them a range of exclusive travel privileges, including the benefits derived from Air Canada's partnership with the Aeroplan® program, which allows all customers to earn and redeem Aeroplan Miles.

- Competitive products and services, including lie-flat beds in the International Business Class cabin, concierge services, Maple Leaf® lounges and, at its Toronto global hub, an exclusive Air Canada Signature Suite offering eligible International Business Class customers exclusive amenities, including *à la carte* meal service in the suite's complimentary restaurant.

- Geographically well-positioned hubs (Toronto, Montreal and Vancouver) with efficient in-transit facilities, accentuating the advantages of flying Air Canada for customers travelling between the U.S. and Asia or Europe.

- Favourable slot times at busy airports, including Beijing, Shanghai, Hong Kong, Tokyo-Narita, Tokyo-Haneda, Paris-Charles de Gaulle, Frankfurt, London-Heathrow, New York-LaGuardia, and Washington-Ronald Reagan National Airport.

In 2018, Air Canada plans to launch additional international services, including non-stop Air Canada service from Montreal to Tokyo-Narita and Dublin; from Vancouver to Paris and Zurich; and from Toronto to Shannon and Buenos Aires (which had previously been operated as a one-stop service via Santiago). Air Canada also plans to launch non-stop seasonal Air Canada Rouge service from Toronto to Bucharest, Porto and Zagreb; and from Montreal to Bucharest and Lisbon. In addition, Air Canada service between Vancouver and Delhi will be converted from a seasonal service to a year-round service.

Air Canada enhances its domestic and transborder network through capacity purchase agreements with Jazz, Sky Regional, Air Georgian and other airlines (operating under the Air Canada Express banner). Air Canada Express provides a network of local traffic, as well as high volumes of feeder traffic that flow into Air Canada's long-haul network and support its strategy to grow international transit traffic to and from the U.S. A number of new routes were announced, including, beginning in 2018, non-stop Air Canada Express service from Montreal to Baltimore and Pittsburgh; from Toronto to Omaha and Providence; from Edmonton to San Francisco, Kelowna and Victoria; from Calgary to Comox; and from Vancouver to Sacramento.

Air Canada continues to increase sixth freedom traffic, particularly from the U.S., with its award-winning products and services, geographically well-positioned Canadian hubs, extensive network and other competitive advantages.

Lester B. Pearson International Airport ("Toronto Pearson") offers a strategic advantage due to its proximity to densely populated major U.S. markets and serves a large number of business and leisure travelers flying to and from Toronto. Air Canada's and its Star Alliance partners' operations are consolidated in one terminal at Toronto Pearson, which also has efficient in-transit facilities that allow passengers and their bags to move seamlessly between Canadian and U.S. Customs and Immigration. For several years, Air Canada has worked closely with the GTAA to transform Toronto Pearson into the leading North American airport and gain a greater share of the global sixth freedom market.

Air Canada is also growing its Vancouver hub into a premier gateway to Asia-Pacific markets and developing Montreal into a complementary trans-Atlantic hub. With the new flights being introduced between Vancouver and cities across North America, Air Canada is poised to offer some of the shortest elapsed travel time between continental North America and Pacific Asia, providing a better travel experience. The airline's Montreal hub not only links North America with key markets in France, but also positions Montreal as a premier gateway to the Atlantic. Given the improvements that are being made in Toronto, Vancouver and Montreal, the airline is able to build its network from the U.S. to provide increased connection flows to its international flights. In Calgary, Air Canada has relocated its international and U.S. operations to the new state-of-the-art terminal which now includes connection processes comparable to Air Canada's other hubs.

The development of commercial alliances with major international carriers is another important element of Air Canada's business strategy. These arrangements provide Air Canada with an effective means to leverage and broaden its network offerings. Air Canada achieves this through its membership in Star

Alliance and through its participation in the A++ joint venture. By coordinating pricing, scheduling and sales (under the joint venture), Air Canada is better able to serve customers by offering more travel options, while reducing travel times.

The airline's numerous codeshare and interline agreements further allow it to achieve greater critical mass and network scope. Air Canada has 34 codeshare partners, of which 24 are Star Alliance members and 10 are non-members (Aer Lingus, Central Mountain Air, Etihad, Eurowings, GOL Linhas Aéreas Inteligentes, Jet Airways, Middle East Airlines, SriLankan Airlines, Cathay Pacific and Virgin Australia). In addition to its new codeshare agreements with Cathay Pacific and Virgin Australia, in 2017, Air Canada also expanded the scope of existing codeshare agreements with Lufthansa Group, United Airlines, Croatia Airlines, Asiana Airlines, Thai Airways, Air India and Avianca Brazil.

In April 2018, subject to government and regulatory approvals, Air Canada will deepen its relationship with Star Alliance partner Air China. Air Canada will place its code on Air China's flights between Beijing and Zhengzhou, Xiamen, Shenzhen and Nanjing, as well as Air China's flight between Montreal and Havana. At the same time, Air China will place its code on Air Canada's new daily Montreal to Shanghai flight, as well as Air Canada's flights from Vancouver to Victoria, Kelowna, Saskatoon, and Regina. Beyond this, Air Canada and Air China are working to finalize a planned joint venture which is expected to be implemented in 2018. The planned joint venture would solidify Air Canada's investment in China, which currently consists of five daily flights from Canada, and could facilitate further growth potential from Air Canada's hubs.

Air Canada continues to assess new strategic partnerships in support of its business plan and international growth strategy.

Customer engagement

Providing a consistently high level of customer service and growing the airline's premium customer base are important aspects of Air Canada's business strategy. Air Canada continually strives to improve customer loyalty and generate positive referrals to attract new customers. The airline recognizes that its ongoing success is dependent on consistently delivering superior value and innovative products, providing the highest levels of customer service and anticipating the changing needs of customers.

Loyalty program

Air Canada Altitude is designed to recognize and reward its most frequent travelers with exclusive perks and privileges based on the number of miles or segments customers fly combined with their total spend. These privileges, including priority airport services, lounge access, and eUpgrade credits, are designed to enhance the Air Canada experience and encourage loyalty from frequent flyers. Altitude members also benefit from Air Canada's partnership with the Aeroplan program, which provides a wide range of ways to earn and redeem Aeroplan Miles, including flights and upgrades to over 1,200 destinations worldwide.

Consistent with its promise of continued investments in the customer experience, in May 2017, Air Canada announced its intention to launch a new loyalty program in 2020 upon the expiry of its commercial agreement with Aimia, the operator of Aeroplan, the airline's loyalty program. By operating its own loyalty program, Air Canada will be better able to strengthen its customer relationships, offer members more flexible rewards, and deliver a more consistent end-to-end customer experience. The new program will offer broad earning and redemption opportunities, more personalized service and a better digital experience for Air Canada customers. Like all of Air Canada's North American peers, Air Canada will be able to make decisions in real time that address specific needs, further improving the customer experience.

Passenger service system

Air Canada concluded an agreement with Amadeus for the full Amadeus Altéa Suite passenger service system (PSS) including reservations, inventory and departure control solutions. The new reservation system, scheduled to be implemented in 2019, will allow Air Canada to optimize its flight schedule by providing the ability to more easily manage inventory between any given origin and destination and automate rebookings during flight disruptions, such as those caused by extreme weather. It will also support Air Canada's international network through seamless booking and customer handling with Star Alliance and interline partners.

Products and services

Investing in products and services remains pivotal to Air Canada's commitment to customer engagement. To this end, the airline has partnered with leading brands and introduced premium products that enhance the customer's journey.

The Boeing 787 Dreamliner, with its newly designed cabins and next generation in-flight entertainment, has been enthusiastically received by customers. Air Canada has introduced the 787's three-cabin international product and seating configuration on all 25 of its Boeing 777 aircraft as well. Moreover, the new Boeing 737 MAX and Bombardier C-Series aircraft will be standardized with Air Canada's new interior look, consistent North America business class seating and additional preferred seats.

In 2017, Air Canada launched a Premium Economy cabin on select wide-body flights within North America, offering a service specification aligned to its International Premium Economy product.

In 2017, Air Canada also introduced a new concierge office in Montréal–Pierre Elliott Trudeau International Airport ("Montreal-Trudeau"), similar in design to those at Toronto Pearson and Vancouver International, and added concierge service in Dublin, Mumbai and Taipei to further improve the customer experience for its Altitude Super Elite 100K members and customers travelling in International Business Class. Air Canada plans to introduce new concierge services in Madrid and Melbourne in 2018. Additionally, its Premium Agent service was launched in several Canadian hubs, offering an elevated level of personalized service at key customer touch points. Air Canada also introduced enhanced self-service bag drop for passengers with checked baggage at Calgary International Airport, with planned expansion to Montreal-Trudeau, Toronto Pearson and Vancouver International.

For the comfort and convenience of premium customers, Air Canada operates 22 Maple Leaf Lounges, including three lounges in Europe (London-Heathrow, Paris-Charles de Gaulle and Frankfurt), three lounges in the United States (Los Angeles International Airport, New York LaGuardia and Newark Liberty International) and 16 lounges across Canada. In 2017, Air Canada upgraded several of its lounges (Edmonton International Airport, Vancouver International Airport and Los Angeles International Airport) and plans to refurbish several more in 2018. It also intends to open a new lounge in Saskatoon Diefenbaker Airport and re-locate its current lounges in New York-LaGuardia and St. John's International Airport.

In late 2017, Air Canada unveiled the Air Canada Signature Suite for its International Business Class customers at its Toronto Pearson global hub. The new suite is an exclusive airport retreat where eligible premium customers can dine *à la carte* at a complimentary, full-service restaurant from a menu created by acclaimed chef David Hawksworth, or enjoy hors d'œuvres, champagne, fine wines and cocktails in an intimate, Canadian-designed and decorated setting.

For customers in the U.S., Air Canada has electronic boarding passes available through mobile devices at all U.S. airports. Air Canada also offers TSA Pre-check, allowing eligible customers to experience expedited, more efficient security screening for flights out of U.S. airports where the service is available. Air Canada continues to expand electronic boarding pass functionality around the world, where local regulations allow.

Air Canada has preferred seats available offering additional pitch on its entire mainline fleet. It has made it easier for customers to conveniently purchase these seats when booking or at any time prior to boarding, including through its website, its airport kiosks or mobile devices. Most preferred seats are located near the front of the aircraft, enabling customers to disembark more quickly at their destination.

Air Canada and Air Canada Rouge offer Wi-Fi connectivity on their narrow-body aircraft fleets and are planning for Wi-Fi connectivity to be installed and operational across their wide-body fleets in 2019. Air Canada also plans to introduce complimentary Wi-Fi service as a reward option for Altitude Elite 75K and Super Elite 100K members, making Air Canada the first airline in North America to offer the choice of complimentary Wi-Fi to its most frequent flyers.

Air Canada launched an all-new website and mobile app in 2017 and further enhanced its digital experience: for example, by providing customers the ability to instantly find the airline's lowest available fares within a 270-day period on its website. To further enhance the booking process, customers can now import mobile bookings made via a mobile app to make changes to their itinerary on Air Canada's website. Air Canada continues to optimize the booking flow to make flight selection, cabin upgrades and ancillary products and services easier to select. Going forward, continuous improvement through Air Canada's new digital test-and-learn practice will further optimize its direct channels.

Air Canada is upgrading its customer relationship management system to gain valuable customer insights on travel patterns and preferences. With better insight into its customers, the airline will be in a better position to serve them. The upgraded system will allow the joining of operational, commercial and digital elements. The customer data platform will be connected to all Air Canada systems and channels to differentiate service and deploy offers in more locations than previously possible, allowing Air Canada to stimulate traffic, increase yields and improve customer loyalty. The improved system is scheduled to be implemented towards the latter half of 2018, with full benefits expected to be realized after Air Canada's new loyalty program launches in 2020.

Additionally, Air Canada was the first airline to have flight information and related content accessible through Alexa, Amazon's AI-powered voice service. It offers customers flight status information, fare quotes, mobile app tips, and general information on travel documents, ticket policies, TSA pre-check availability, as well as baggage carousel information, with more options planned to be added in the future.

Air Canada received a number of awards recognizing its industry-leading products and services in 2017, including being named Best Airline in North America in the 2017 Skytrax World Airline Awards. Skytrax also rates Air Canada as the only Four-Star network carrier in North America.

Air Canada also received the following awards:

- Best Long-Haul Airline in the Americas for 2018 by AirlineRatings.com, an airline safety and product rating agency that promotes excellence in the industry. AirlineRatings.com gave Air Canada its top seven-star rating for both safety and product.

- Winner in Airline Strategy Awards Finance Category by the air transport industry news and analysis provider Flight Airline Business.

- The 2017 Baxter Travel Media Agents' Choice Awards for Best Airline Traditional Service and Best Airline Executive Service for the 8th year in a row.

In early 2018, Air Canada was named the 2018 Eco-Airline of the Year by Air Transport World ("ATW") in its 44th Annual Airline Industry Achievement Awards. In recognizing Air Canada's environmental accomplishments, ATW cited the carrier's commitment to emissions reductions through supporting the development of alternative fuels and its numerous green programs and partnerships, including being the first airline in the world to voluntarily join the World Bank's IMF Cabin Pricing Leadership Coalition.

Culture change

A healthy and dynamic corporate culture is a competitive advantage that can significantly strengthen long-term performance. To this end, Air Canada has made positive culture change, with an emphasis on entrepreneurship, engagement, empowerment and pay-for-performance, a cornerstone of its business strategy.

As a foundational measure, Air Canada placed renewed focus on transparent employee communication. This has included reinforcing corporate priorities at every opportunity since their adoption in 2009 as well as continual explanation of the rationale behind its strategic initiatives and the importance of adapting to changing market conditions. Along with traditional channels, Air Canada continues to develop new methods for reaching out to all levels of the organization, for example with the increased use of executive-led, town hall meetings with employees across the network and through social media.

Through these means, Air Canada seeks to create a sense of purpose, shared values and common goals among employees.

Effective communication is two-way, therefore, employee opinions are solicited on matters affecting them. This reflects the view that employees are more likely to embrace culture change if they actively participate in it. Air Canada encourages feedback and ideas from employees who are often best placed to identify improvements and changes necessary for success.

Training is another important element of engagement. It ensures employees have the skills and necessary tools to perform their jobs and it also signals to the individual that Air Canada is willing to invest in the employee's well-being and future development. Air Canada's cultural evolution entails continuous improvement, and learning and empowerment, all geared towards ensuring employees feel valued and have a sense of purpose.

Employees at Air Canada feel confident about their skills to do their job. Much of this is attributed to the expanded training programs, focus groups and workshops specifically designed to facilitate better decision-making, a more effective and personalized approach to communication styles, and a greater appreciation for the value each person can bring to any given situation. Comments from participants indicate that they appreciate the learning and networking opportunities and wish to actively play a role in their own development.

Training also promotes effective collaboration to ensure delivery on the customer promise. For new managers, Air Canada has a comprehensive employee on-boarding experience, integrated management practices, as well as development programs intended to cultivate Air Canada's leadership behaviours and values. Customer-facing, management and emerging leaders are targeted for various programs – all designed around the principles of customer orientation, innovation and promoting the importance of brand loyalty.

Within the management development stream, Air Canada's programs include mentoring, custom development plans and a suite of emerging leadership opportunities for mid-level managers. These programs are designed to enhance leadership skills, provide a path to the employee career planning and to help employees grow through a concept of learning by doing. Air Canada believes in the concept of giving back and many programs allow past participants to become alumni contributors who coach other, newer members. In some cases, participants of the emerging leaders program will continue to work in tandem with other departments based on their casework within the program – allowing them to share their insight, research and innovative ideas.

Air Canada also has a number of customer service training programs, including Concierge Excellence (CGX) Recurrent Program which is a program focused on service excellence skills and personalized service; PIT Training which is a program that fosters enhanced teamwork and communication as well as improved efficiencies in Standard Operating Procedures (SOP) practice; and Project ADL - Airports Digital Learning, which provides a new learning experience by making learning available online for front-line employees in rooms conveniently located to employees' work site and designed to enhance the overall learning experience. The airline also refreshed its customer service training for all new flight attendant recruits.

A final aspect of engagement is recognition. Participation in the employee recognition program, Shine, has increased to almost 95% company-wide. The Shine program offers options for employees to publicly recognize colleagues online and/or offer award points which can be exchanged for merchandise and e-gifts. In addition to Shine, Air Canada's long-established Award of Excellence recognition program honours outstanding employees annually. Award of Excellence recipients are nominated by their peers for their work and community involvement.

To encourage the development of a corporate culture, which is focused on transformation and performance, Air Canada has a profit sharing program that rewards eligible employees for their contributions, sharing the financial success of the airline.

As at December 31, 2017, in aggregate, 23,243,099 shares or 8.5% of total issued and outstanding shares of Air Canada were held by Air Canada employees and unions, including 17,646,765 shares held under a trust arrangement in connection with pension arrangements concluded in 2009.

Results from Air Canada's engagement and employee satisfaction surveys demonstrate a steadily upward, positive trend in almost every aspect of the employee experience. Staff increasingly view that communication has improved, as have teamwork and cooperation among departments, and there is a growing sense of community. A higher proportion of employees agree strongly that Air Canada is on the right track towards stability and sustainability and the vast majority of employees agree that they understand the business imperatives.

Employees' perceptions toward senior management have also improved significantly since 2014, indicating that senior management actively listens and demonstrates care and concern for employees. This is particularly evident among pilots, flight attendants and maintenance workers. A high proportion of employees feel confident in their skills to do their job. Employees and managers see improvements in their ability to provide direction and support, which is attributed to the expanded training programs available to many front line and management employees.

In 2017, Air Canada was named one of Canada's Top 100 Employers for 2018 in an annual national employer survey by Mediacorp Canada Inc. Canada's Top 100 Employers competition recognizes employers with exceptional human resources programs and forward-thinking workplace policies. Starting with an initial list of more than 90,000 employers, Mediacorp graded those selected on eight criteria: Physical Workplace; Work Atmosphere & Social; Health, Financial & Family Benefits; Vacation & Time-Off; Employee Communications; Performance Management; Training & Skills Development; and Community Involvement.

In addition to being named one of the Top 100 Employers in Canada, Air Canada received other recognitions for employee relations and engagement in 2017, including:

- One of the 50 Most Engaged Workplaces in North America by Achievers, an employee social recognition company;
- The second most attractive company brand to work for in Canada according to the Randstad Employer Brand Research independent survey;
- One of Canada's Best Diversity Employers by Mediacorp Canada Inc.;
- One of Montreal's top employers by Mediacorp Canada Inc.;
- One of North America's Best Candidate Experience by Talent Board.

Furthermore, in recognition of the ongoing significant evolution underway at Air Canada, two officers in the organization were honored for their outstanding contributions: Michael Rousseau, Executive Vice President and Chief Financial Officer, was named Canada's CFO of the year for 2017 by Financial Executives International Canada and Lucie Guillemette, Executive Vice President and Chief Commercial Officer, was named by the Women's Executive Network as one of Canada's top 100 most powerful women.

Labour

Starting in 2014, Air Canada entered into multiple long-term labour agreements with unions representing its unionized workforce. These agreements provide additional stability and flexibility, as well as demonstrate a collaborative partnership supporting its transformation into a global champion. These agreements include the following:

- ACPA (Pilots) – In 2014, Air Canada and ACPA, representing pilots, ratified a new contract providing collective agreement terms for 10 years, ending September 29, 2024, subject to certain renegotiation provisions and benchmarks over this period. In 2017, Air Canada ratified amendments to its existing long-term labour agreement with ACPA. The amendments to the 10-year agreement provide additional commercial opportunities as well as increased operational flexibility. The next renegotiation period is scheduled to arise in June 2020.

- IAMAW (Maintenance, Operations and Baggage) – In 2016, Air Canada and the IAMAW, representing technical maintenance, operational support and airport baggage handlers, concluded a new contract providing collective agreement terms for 10 years, ending March 31, 2026, subject to certain renegotiation provisions over this period. The next of which is scheduled to arise in January 2019.

- CALDA (Dispatchers) – In 2016, Air Canada and CALDA, representing flight dispatchers, concluded a new contract providing collective agreement terms for 12 years, ending February 29, 2028, subject to certain renegotiation provisions over this period. The next of which is scheduled to arise in November 2018.

- CUPE (Flight Attendants) – In 2015, Air Canada and CUPE, representing flight attendants, concluded a new contract providing collective agreement terms for 10 years, ending March 31, 2025, subject to certain renegotiation provisions over this period. The next of which is scheduled to arise in December 2018.

- Unifor (Customer Service and Sales Agents) – In 2015, Air Canada and Unifor, representing the airline's customer service and sales agents concluded a new contract providing collective agreement terms for five years, ending February 28, 2020.

5. OVERVIEW

Full year 2017 financial summary

The following is an overview of Air Canada's results of operations and financial position for full year 2017 compared to full year 2016.

- Record operating revenues of $16,252 million in 2017, an increase of $1,575 million or 11% from 2016. On capacity growth of 11.6%, record passenger revenues of $14,471 million increased $1,323 million or 10.1% from 2016.

- Operating expenses of $14,888 million in 2017, an increase of $1,556 million or 12% from 2016. CASM increased 0.1% from 2016. Adjusted CASM decreased 3.0% from 2016. Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

- Operating income of $1,364 million in 2017 compared to operating income of $1,345 million in 2016.

- Record EBITDAR of $2,921 million in 2017 compared to record EBITDAR of $2,768 million in 2016. The airline reported a 2017 EBITDAR margin of 18.0%, in line with the range of 17% to 19% projected in Air Canada's news release dated October 25, 2017. This compared to an EBITDAR margin of 18.9% in 2016. Special items are excluded from all of Air Canada's reported EBITDAR calculations. Refer to section 6 of this MD&A for information on special items. EBITDAR is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

- Record income before income taxes of $1,279 million in 2017 versus record income before income taxes of $877 million in 2016.

- Record adjusted pre-tax income of $1,158 million in 2017 versus adjusted pre-tax income of $1,148 million in 2016. Adjusted pre-tax income is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

- Net income of $2,038 million or $7.34 per diluted share in 2017 versus net income of $876 million or $3.10 per diluted share in 2016. In the third quarter of 2017, Air Canada recognized substantially all of its unrecorded deferred income tax assets. Refer to section 13 "Critical Accounting Estimates and Judgments" of this MD&A for additional information.

- Adjusted net income of $1,142 million or $4.11 per diluted share in 2017 versus adjusted net income of $1,147 million or $4.06 per diluted share in 2016. Starting as of and including the fourth quarter of 2017, adjusted net income is determined net of tax and includes the income tax effect of adjustments included in the measurement of adjusted net income. Prior to the fourth quarter of 2017, there was no deferred income tax expense recorded because of significant unrecognized deferred tax assets. A tax expense of $16 million affected fourth quarter and full year 2017 adjusted net income results. Adjusted net income is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

- Adjusted net debt of $6,116 million at December 31, 2017, a decrease of $974 million from December 31, 2016, reflecting the impact of higher cash and short-term investment balances and the benefit of a stronger Canadian dollar on U.S. dollar denominated debt balances. Adjusted net debt is an additional GAAP measure. Refer to section 9.3 "Adjusted Net Debt" of this MD&A for additional information.

- The airline's leverage ratio (adjusted net debt to trailing 12-month EBITDAR) was 2.1 at December 31, 2017 versus a ratio of 2.6 at December 31, 2016. Leverage ratio is a non-GAAP financial measure. Refer to section 9.3 "Adjusted Net Debt" of this MD&A for additional information.

- Record net cash flows from operating activities of $2,738 million in 2017, an improvement of $317 million from 2016. Record free cash flow of $1,056 million in 2017 was above the range of $600 million to $900 million projected in Air Canada's news release dated October 25, 2017, mainly as a result of higher cash flows from operations. The free cash flow generated in 2017 also reflected an improvement of $1,205 million from 2016 due to higher cash flows from operating activities and a reduced level of net capital expenditures year-over-year. Free cash flow is a non-GAAP financial measure. Refer to section 9.5 "Consolidated Cash Flow Movements" of this MD&A for additional information.

- Return on invested capital ("ROIC") for the 12 months ended December 31, 2017 of 13.9%, in line with the range of 13.5% to 14.5% projected in Air Canada's news release dated October 25, 2017. This compared to ROIC of 16.7% for the 12 months ended December 31, 2016. The decrease in ROIC was mainly due to higher retained earnings. ROIC is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Fourth quarter 2017 financial summary

The following is an overview of Air Canada's results of operations for the fourth quarter of 2017 compared to the fourth quarter of 2016.

- Record operating revenues of $3,820 million in the fourth quarter of 2017, an increase of $395 million or 12% from the fourth quarter of 2016. On capacity growth of 9.5%, record passenger revenues of $3,381 million increased $346 million or 11.4% from the fourth quarter of 2016.

- Operating expenses of $3,687 million in the fourth quarter of 2017, an increase of $280 million or 8% from the fourth quarter of 2016. CASM decreased 1.2% from the fourth quarter of 2016. Adjusted CASM decreased 1.2% from the fourth quarter of 2016, in line with the 0.5% to 1.5% decrease forecasted in Air Canada's news release dated October 25, 2017.

- Operating income of $133 million in the fourth quarter 2017 compared to fourth quarter 2016 operating income of $18 million.

- Record EBITDAR of $521 million in the fourth quarter of 2017 compared to EBITDAR of $455 million in the fourth quarter of 2016. The airline reported a record fourth quarter 2017 EBITDAR margin of 13.6% versus a fourth quarter 2016 EBITDAR margin of 13.3%. Special items are excluded from all of Air Canada's reported EBITDAR calculations. Refer to section 7 of this MD&A for information on special items.

- Income before income taxes of $20 million in the fourth quarter of 2017 versus a loss before income taxes of $178 million in the fourth quarter of 2016.

- Adjusted pre-tax income of $77 million in the fourth quarter of 2017 versus adjusted pre-tax income of $39 million in the fourth quarter of 2016. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

- Net income of $8 million or $0.02 per diluted share in the fourth quarter of 2017 versus a net loss of $179 million or $0.66 per diluted share in the fourth quarter of 2016.

- Adjusted net income of $61 million or $0.22 per diluted share in the fourth quarter of 2017 versus adjusted net income of $38 million or $0.14 per diluted share in the fourth quarter of 2016. Starting as of and including the fourth quarter of 2017, adjusted net income is determined net of tax and includes the income tax effect of adjustments included in the measurement of adjusted net income. Prior to the fourth quarter of 2017, there was no deferred income tax expense recorded because of significant unrecognized deferred tax assets. A tax expense of $16 million affected fourth quarter and full year 2017 adjusted net income results. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

- Record net cash flows from operating activities of $389 million in the fourth quarter of 2017, an improvement of $38 million from the fourth quarter of 2016. Negative free cash flow of $43 million deteriorated by $164 million from the fourth quarter of 2016 due to higher net capital expenditures year-over-year partly offset by the higher cash flows from operating activities versus the same quarter in 2016. Refer to section 9.5 "Consolidated Cash Flow Movements" of this MD&A for additional information.

6. RESULTS OF OPERATIONS – FULL YEAR 2017 VERSUS FULL YEAR 2016

The following table and discussion provides and compares results of Air Canada for 2017 and 2016:

	Full Year			
(Canadian dollars in millions, except per share figures)	**2017**	**2016**	**Change $**	**Change %**
Operating revenues				
Passenger	$ 14,471	$ 13,148	$ 1,323	10
Cargo	650	512	138	27
Other	1,131	1,017	114	11
Total revenues	**16,252**	**14,677**	**1,575**	**11**
Operating expenses				
Aircraft fuel	2,927	2,279	648	28
Regional airlines expense				
Aircraft fuel	412	327	85	26
Other	2,205	2,081	124	6
Wages, salaries and benefits	2,671	2,510	161	6
Airport and navigation fees	905	859	46	5
Aircraft maintenance	938	894	44	5
Depreciation, amortization and impairment	956	816	140	17
Sales and distribution costs	777	703	74	11
Ground package costs	538	489	49	10
Aircraft rent	503	462	41	9
Food, beverages and supplies	383	349	34	10
Communications and information technology	254	242	12	5
Special items	30	91	(61)	(67)
Other	1,389	1,230	159	13
Total operating expenses	**14,888**	**13,332**	**1,556**	**12**
Operating income	**1,364**	**1,345**	**19**	
Non-operating income (expense)				
Foreign exchange gain (loss)	120	(38)	158	
Interest income	60	48	12	
Interest expense	(311)	(374)	63	
Interest capitalized	36	58	(22)	
Net financing expense relating to employee benefits	(65)	(76)	11	
Gain on financial instruments recorded at fair value	23	4	19	
Gain on sale and leaseback of assets	52	19	33	
Gain (loss) on debt settlements and modifications	21	(89)	110	
Other	(21)	(20)	(1)	
Total non-operating expense	**(85)**	**(468)**	**383**	
Income before income taxes	**1,279**	**877**	**402**	
Recovery of (provision for) income taxes	759	(1)	760	
Net income	**$ 2,038**	**$ 876**	**$ 1,162**	
Diluted earnings per share	**$ 7.34**	**$ 3.10**	**$ 4.24**	
EBITDAR (1)	**$ 2,921**	**$ 2,768**	**$ 153**	
Adjusted pre-tax income (1)	**$ 1,158**	**$ 1,148**	**$ 10**	
Adjusted net income (1)	**$ 1,142**	**$ 1,147**	**$ (5)**	
Adjusted earnings per share – diluted (1)	**$ 4.11**	**$ 4.06**	**$ 0.05**	

(1) EBITDAR, adjusted pre-tax income, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

System passenger revenues

In 2017, system passenger revenues of $14,471 million increased $1,323 million or 10.1% from 2016 on traffic growth of 11.3% partly offset by a yield decline of 1.0%. On a stage-length adjusted basis, yield increased 1.7% when compared to 2016. Business cabin system revenues increased $334 million or 13.4% from 2016 on traffic and yield growth of 9.8% and 3.3%, respectively. In 2017, the stronger Canadian dollar versus 2016 decreased the Canadian dollar value of sales in foreign countries and had a negative impact of $69 million on system passenger revenues.

The table below provides passenger revenue by geographic region for 2017 and 2016.

Passenger Revenue (Canadian dollars in millions)	**Full Year 2017**	**Full Year 2016**	**$ Change**	**% Change**
Canada	$ 4,582	$ 4,426	$ 156	3.5
U.S. transborder	3,164	2,879	285	9.9
Atlantic	3,517	3,026	491	16.2
Pacific	2,192	1,985	207	10.4
Other	1,016	832	184	22.2
System	**$ 14,471**	**$ 13,148**	**$ 1,323**	**10.1**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics by geographic region for 2017 versus 2016.

Full Year 2017 versus Full Year 2016	**Passenger Revenue % change**	**Capacity (ASMs) % Change**	**Traffic (RPMs) % Change**	**Passenger Load Factor pp Change**	**Yield % Change**	**PRASM % Change**
Canada	3.5	2.1	2.3	0.1	1.4	1.5
U.S. transborder	9.9	10.5	11.1	0.4	(0.9)	(0.4)
Atlantic	16.2	14.3	14.0	(0.2)	2.0	1.7
Pacific	10.4	17.7	15.6	(1.5)	(4.5)	(6.2)
Other	22.2	18.2	19.6	1.0	2.0	3.3
System	**10.1**	**11.6**	**11.3**	**(0.2)**	**(1.0)**	**(1.3)**

Components of the year-over-year change in full year system passenger revenues in 2017 versus 2016 included:

- The 11.3% traffic increase which reflected traffic growth in all markets. The traffic increase included gains in the business and premium economy cabins as well as incremental connecting traffic via Canada to international destinations.

- The 1.0% yield decrease which reflected:

    - an increase in average stage length of 4.8% which had the effect of reducing system yield by 2.7 percentage points;

    - an unfavourable currency impact of $69 million, mainly attributable to the first and fourth quarters of 2017;

    - the effect of launch pricing to support the introduction of new Pacific services and the impact of increased industry capacity and competitive pricing activities on certain Pacific services, primarily in the first nine months of 2017;

    - a higher proportion of seats into long-haul leisure markets; and

  - a higher proportional growth of lower-yielding sixth freedom traffic in support of the airline's international expansion strategy.

These factors were largely offset by the following:

  - volume and yield growth in high-yielding business and premium economy passengers;
  - growth in high-yielding local traffic and improvements to the overall fare mix; and
  - an increase in preferred seat/advance seat selection and airport paid upgrade revenues.

Domestic passenger revenues

In 2017, domestic passenger revenues of $4,582 million increased $156 million or 3.5% from 2016.

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

- The 2.3% traffic increase which reflected traffic growth on all major domestic services and included gains in the business cabin. The traffic increase year-over-year was due to strong passenger demand on services within Canada as well as incremental connecting traffic to U.S. and international destinations.
- The 1.4% yield increase which reflected yield improvements on most major domestic services. A greater proportional growth of high-yielding passengers as well as strong growth in point-to-point passengers across all markets also contributed to the yield improvement year-over-year.

U.S. transborder passenger revenues

In 2017, U.S. transborder passenger revenues of $3,164 million increased $285 million or 9.9% from 2016.

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

- The 11.1% traffic increase which reflected traffic growth on all major U.S. transborder services and included gains in the business cabin. The traffic increase year-over-year was mainly driven by the launch of year-round Air Canada Express service from Toronto to San Antonio and Memphis; Vancouver to Dallas-Fort Worth and Denver; and Montreal to Dallas-Fort Worth and Washington–Dulles. Strong passenger demand between Canada and the U.S. and growth of international-to-international connecting passenger flows from the U.S. in support of Air Canada's international expansion strategy were also contributing factors.
- The 0.9% yield decline which reflected the impact of increased industry capacity on U.S. long-haul and short-haul routes and an unfavourable currency impact of $11 million. Yield growth on U.S. sun routes, such as Florida, Hawaii and Las Vegas was a partly offsetting factor.

Atlantic passenger revenues

In 2017, Atlantic passenger revenues of $3,517 million increased $491 million or 16.2% from 2016.

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

- The 14.0% traffic increase which reflected traffic growth on most major Atlantic services, led by the launch of seasonal services from Vancouver to Frankfurt and London-Gatwick; Montreal to Tel Aviv, Marseille, Algiers and Reykjavík; and Toronto to Berlin and Reykjavík. Air Canada also launched year-round service from Toronto to Mumbai. The overall traffic increase included strong gains in the business and premium economy cabins.

- The 2.0% yield increase which reflected yield improvements on most major Atlantic services, led by gains in the business and premium economy cabins. An unfavourable currency impact of $27 million was a partly offsetting factor.

Pacific passenger revenues

In 2017, Pacific passenger revenues of $2,192 million increased $207 million or 10.4% from 2016.

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

- The 15.6% traffic increase which reflected traffic growth on all major Pacific services with the exception of services to Hong Kong where traffic was impacted by increased industry capacity and aggressive pricing activities. The overall traffic increase year-over-year was mainly driven by the launch of year-round services from Toronto to Seoul; Montreal to Shanghai; and Vancouver to Taipei. The launch of seasonal service from Vancouver to Nagoya also contributed to the traffic growth year-over-year.

- The 4.5% yield decline which reflected the effect of launch pricing to support the introduction of new services and the impact of increased industry capacity and competitive pricing activities on certain Pacific services. Growth in lower-yielding international-to-international passenger flows (mainly between Asia and the U.S/Latin America) and an unfavourable currency impact of $20 million were also contributing factors.

Other passenger revenues

In 2017, Other passenger revenues (from routes to and from the Caribbean, Mexico and Central and South America) of $1,016 million increased $184 million or 22.2% from 2016.

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

- The 19.6% traffic increase which reflected traffic growth on routes to traditional sun destinations and on services to South America. The traffic growth included gains in all cabins. The traffic increase year-over-year was largely driven by the use of larger aircraft on routes to Sao Paulo and Santiago and, to a lesser extent, the launch of services from Toronto to Cartagena and from Montreal to Lima.

- The 2.0% yield increase which reflected yield improvements on all major services and included gains in all cabins.

Cargo revenues

In 2017, cargo revenues of $650 million increased $138 million or 27% from 2016 on traffic growth of 29.7% partly offset by a yield decline of 2.1%. Traffic growth was recorded in all markets. The Pacific market turned in a particularly strong performance with traffic growth significantly surpassing capacity growth in 2017 and yield improving year-over-year.

The table below provides cargo revenue by geographic region for the periods indicated.

Cargo Revenue **(Canadian dollars in millions)**	**Full Year 2017**	**Full Year 2016**	**$ Change**	**% Change**
Canada	$ 75	$ 63	$ 12	19.6
U.S. transborder	35	29	6	24.2
Atlantic	213	187	26	13.9
Pacific	271	193	78	39.8
Other	56	40	16	39.3
System	**$ 650**	**$ 512**	**$ 138**	**27.0**

Other revenues

In 2017, other revenues of $1,131 million increased $114 million or 11% from 2016, mainly due to an increase in ground package revenues at Air Canada Vacations. An increase in passenger and airline-related fees, particularly those related to seat selection, preferred seating and upgrades, was also a contributing factor.

CASM and adjusted CASM

The following table compares Air Canada's CASM and Adjusted CASM for the periods indicated.

In 2017, CASM increased 0.1% and adjusted CASM decreased 3.0% when compared to 2016.

	Full Year			
			Change	
(cents per ASM)	**2017**	**2016**	**¢**	**%**
Aircraft fuel	2.83	2.46	0.37	15.0
Regional airlines expense				
Aircraft fuel	0.40	0.35	0.05	14.3
Other	2.13	2.25	(0.12)	(5.3)
Wages and salaries	1.99	2.09	(0.10)	(4.8)
Benefits	0.59	0.62	(0.03)	(4.8)
Airport and navigation fees	0.87	0.93	(0.06)	(6.5)
Aircraft maintenance	0.91	0.96	(0.05)	(5.2)
Depreciation, amortization and impairment	0.92	0.88	0.04	4.5
Sales and distribution costs	0.75	0.76	(0.01)	(1.3)
Ground package costs	0.52	0.53	(0.01)	(1.9)
Aircraft rent	0.49	0.50	(0.01)	(2.0)
Food, beverages and supplies	0.37	0.38	(0.01)	(2.6)
Communications and information technology	0.25	0.26	(0.01)	(3.8)
Special items	0.03	0.10	(0.07)	(70.0)
Other	1.34	1.31	0.03	2.3
CASM	**14.39**	**14.38**	**0.01**	**0.1**
Remove:				
Aircraft fuel expense (1), ground package costs at Air Canada Vacations and special items	(3.78)	(3.44)	(0.34)	(9.9)
Adjusted CASM (2)	**10.61**	**10.94**	**(0.33)**	**(3.0)**

(1) Includes aircraft fuel expense related to regional airline operations.
(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating expenses

In 2017, operating expenses of $14,888 million increased $1,556 million or 12% from 2016 on capacity growth of 11.6%.

In 2017, the favourable impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), when compared to 2016, decreased operating expenses by $152 million (comprised of $83 million relating to aircraft fuel expense and an aggregate of $69 million relating to non-fuel operating expenses).

The more notable components of the year-over-year change in operating expenses are described below.

Aircraft fuel expense

In 2017, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to $3,339 million, an increase of $733 million or 28% from 2016. This increase reflected higher jet fuel prices (before the impact of foreign exchange), which accounted for an increase of $577 million and a higher volume of fuel litres consumed, which accounted for an increase of $260 million. These increases were partly offset by a favourable currency impact of $83 million and hedging gains of $21 million.

Regional airlines expense

In 2017, regional airlines expense of $2,617 million increased $209 million or 9% from 2016. This increase reflected the impact of higher base jet fuel prices year-over-year, increased flying, which was the result of fleet expansion initiatives in the Air Canada Express fleet, and an increase in engine maintenance expense due to timing of events.

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

	Full Year			
			Change	
(Canadian dollars in millions)	**2017**	**2016**	**$**	**%**
Capacity purchase fees	$ 1,267	$ 1,199	$ 68	6
Aircraft fuel	412	327	85	26
Airport and navigation	293	290	3	1
Sales and distribution costs	146	142	4	3
Aircraft rent	40	31	9	29
Depreciation, amortization and impairment	28	23	5	22
Other operating expenses	431	396	35	9
Total regional airlines expense	**$ 2,617**	**$ 2,408**	**$ 209**	**9**

Wages, salaries and benefits expense

In 2017, wages and salaries expense of $2,059 million increased $123 million or 6% from 2016. This increase was mainly due to a higher number of full-time equivalent ("FTE") employees to support the airline's international growth. The average number of FTE employees increased 6.7% when compared to 2016.

In 2017, employee benefits expense of $612 million increased $38 million or 7% from 2016, better than the increase of $50 million projected in Air Canada's news release dated October 25, 2017. This better than anticipated performance included the favourable impact of an annual valuation related to workers' compensation, which benefitted from a reduction in overall claims. The increase in employee benefits expense year-over-year was mainly due to the higher level of FTE employees and to the impact of lower discount rates, which increased the current service cost of defined benefit pension plans. In 2016, Air Canada recorded a gain on post-employment liabilities which reduced employee benefits expense by $10 million.

Airport and navigation fees

In 2017, airport and navigation fees of $905 million increased $46 million or 5% from 2016, largely due to growth in wide-body and international flying. The favourable impact of Air Canada's agreement with the Greater Toronto Airports Authority, which is allowing the airline to increase international connecting traffic at Toronto Pearson International Airport on a more cost effective basis, a Nav Canada rate reduction (a rate reduction of 6% in the first eight months of 2017 and a rate reduction of 3.9% in the last four months of 2017) and a $15 million one-time refund from Nav Canada were partly offsetting factors.

Aircraft maintenance expense

In 2017, aircraft maintenance expense of $938 million increased $44 million or 5% from 2016, better than the increase of $70 million projected in Air Canada's news release dated October 25, 2017. This better than anticipated performance was mainly due to the favourable impact of having extended Airbus A320 aircraft leases earlier than previously forecasted. The increase in aircraft maintenance expense year-over-year was mainly driven by the impact of having additional Boeing 787 aircraft in the fleet in 2017, which have engines under power-by-the-hour arrangements, and an increase in engine and components maintenance activity. These increases were largely offset by the impact of having a greater number of aircraft leases being extended in 2017 and to more favourable end-of-lease conditions on aircraft lease extensions. The impact of a stronger Canadian dollar on U.S. denominated maintenance expenses was also an offsetting factor.

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

	Full Year			
(Canadian dollars in millions)	**2017**	**2016**	**Change $**	**Change %**
Technical maintenance	$ 824	$ 742	$ 82	11
Maintenance provisions [1]	100	133	(33)	(25)
Other	14	19	(5)	(26)
Total aircraft maintenance expense	**$ 938**	**$ 894**	**$ 44**	**5**

(1) Maintenance provisions relate to return conditions on aircraft leases which are recorded over the term of the lease.

Depreciation, amortization and impairment expense

In 2017, depreciation, amortization and impairment expense of $956 million increased $140 million or 17% from 2016, in line with the increase of $145 million projected in Air Canada's news release dated October 25, 2017. The increase in depreciation, amortization and impairment expense year-over-year was mainly due to the addition of Boeing 787 aircraft to Air Canada's mainline fleet and an increase in expenses related to aircraft refurbishment programs.

Sales and distribution costs

In 2017, sales and distribution costs of $777 million increased $74 million or 11% from 2016, reflecting, in large part, a higher volume of ticket sales and an increase in credit card expenses (in line with sales and revenue growth). The favourable impact of new commission programs introduced in North America during 2017 and growth in direct bookings when compared to 2016 were partly offsetting factors.

Ground package costs

In 2017, the cost of ground packages at Air Canada Vacations of $538 million increased $49 million or 10% from 2016. This increase was mainly due to higher passenger volumes partly offset by a decrease in the price of ground packages and, to a lesser extent, a favourable currency impact when compared to 2016.

Aircraft rent expense

In 2017, aircraft rent expense of $503 million increased $41 million or 9% from 2016, reflecting a greater number of leased aircraft, primarily Boeing 787 aircraft. The impact of lower lease rates year-over-year and a favourable currency impact were partly offsetting factors.

Special items

In 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations. Air Canada paid the fine in the second quarter of 2017. Air Canada has appealed the decision. Refer to section 18 "Risk Factors" of this MD&A for additional information.

In 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

Other expenses

In 2017, other expenses of $1,389 million increased $159 million or 13% from 2016, reflecting, in large part, the capacity growth and the impact of Air Canada's international expansion strategy. An increase in customer inconvenience expense, reflecting the impact of operational disruptions caused by severe weather, was also a contributing factor.

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

	Full Year			
(Canadian dollars in millions)	**2017**	**2016**	**Change $**	**Change %**
Terminal handling	$ 296	$ 237	$ 59	25
Crew cycle	197	177	20	11
Building rent and maintenance	167	154	13	8
Miscellaneous fees and services	164	141	23	16
Remaining other expenses	565	521	44	8
Total other expenses	**$ 1,389**	**$ 1,230**	**$ 159**	**13**

Non-operating income (expense)

In 2017, non-operating expense of $85 million improved $383 million from 2016.

Components of the year-over-year change in full year non-operating income (expense) included:

- In 2017, gains on foreign exchange amounted to $120 million compared to losses on foreign exchange of $38 million in 2016. Foreign exchange gains on long-term debt of $402 million were largely offset by foreign exchange losses on foreign currency derivatives of $274 million. The foreign exchange gains on long-term debt in 2017 were attributable to a stronger Canadian dollar at December 31, 2017 when compared to December 31, 2016. The December 31, 2017 closing exchange rate was US$1=C$1.2571 while the December 31, 2016 closing exchange rate was US$1=C$1.3427.

- In 2017, interest expense decreased $63 million, reflecting, in large part, the impact of a $1.25 billion refinancing transaction concluded in October 2016 and, to a lesser extent, the benefit of lower debt balances.

- In 2017, Air Canada recorded a gain of $52 million on the sale and leaseback of four Boeing 787-9 aircraft. In 2016, Air Canada recorded a gain of $19 million on the sale and leaseback of two Boeing 787-9 aircraft.

- Air Canada recorded a $27 million gain on debt modifications in 2017 related to the repricing of the US$1.1 billion senior secured credit facility concluded in June 2017.

- In 2016, Air Canada recorded a loss on debt settlements of $89 million of which $82 million was related to the $1.25 billion refinancing transaction concluded in October 2016 and $7 million was related to the prepayment of debt associated with the disposal of Embraer 190 aircraft.

Income taxes

Deferred income tax assets are recognized only to the extent that it is probable that future taxable income will be available to realize them. In making this assessment, consideration is given to available positive and negative evidence and relevant assumptions, including historical financial results, and expectations relating to future taxable income, the overall business environment, and industry-wide trends.

In 2017, Air Canada determined that it was probable that substantially all of the unrecorded deferred income tax assets, which include non-capital losses, would be realized. Accordingly, a tax recovery of $759 million was recorded, representing the initial recognition of previously unrecognized tax assets of $787 million in the third quarter of 2017. Air Canada also recorded a deferred tax provision of $12 million in the fourth quarter and a current income tax expense of $16 million for the year.

7. RESULTS OF OPERATIONS – FOURTH QUARTER 2017 VERSUS FOURTH QUARTER 2016

The following table and discussion provides and compares results of Air Canada for the fourth quarter of 2017 and the fourth quarter of 2016:

	Fourth Quarter			
(Canadian dollars in millions, except per share figures)	2017	2016	Change $	Change %
Operating revenues				
Passenger	$ 3,381	$ 3,035	$ 346	11
Cargo	183	155	28	18
Other	256	235	21	9
Total revenues	**3,820**	**3,425**	**395**	**12**
Operating expenses				
Aircraft fuel	735	598	137	23
Regional airlines expense				
Aircraft fuel	112	90	22	24
Other	563	532	31	6
Wages, salaries and benefits	674	633	41	6
Airport and navigation fees	201	203	(2)	(1)
Aircraft maintenance	243	200	43	22
Depreciation, amortization and impairment	245	212	33	16
Sales and distribution costs	169	172	(3)	(2)
Ground package costs	106	101	5	5
Aircraft rent	126	120	6	5
Food, beverages and supplies	89	82	7	9
Communications and information technology	62	60	2	3
Special items	-	91	(91)	(100)
Other	362	313	49	16
Total operating expenses	**3,687**	**3,407**	**280**	**8**
Operating income	**133**	**18**	**115**	
Non-operating income (expense)				
Foreign exchange loss	(62)	(29)	(33)	
Interest income	18	13	5	
Interest expense	(79)	(83)	4	
Interest capitalized	9	8	1	
Net financing expense relating to employee benefits	(18)	(24)	6	
Gain (loss) on financial instruments recorded at fair value	(1)	9	(10)	
Gain (loss) on debt settlements and modifications	24	(82)	106	
Other	(4)	(8)	4	
Total non-operating expense	**(113)**	**(196)**	**83**	
Income (loss) before income taxes	**20**	**(178)**	**198**	
Recovery of (provision for) income taxes	(12)	(1)	(11)	
Net income (loss)	**$ 8**	**$ (179)**	**$ 187**	
Diluted earnings (loss) per share	**$ 0.02**	**$ (0.66)**	**$ 0.68**	
EBITDAR (1)	**$ 521**	**$ 455**	**$ 66**	
Adjusted pre-tax income (1)	**$ 77**	**$ 39**	**$ 38**	
Adjusted net income (1)	**$ 61**	**$ 38**	**$ 23**	
Adjusted earnings per share – diluted (1)	**$ 0.22**	**$ 0.14**	**$ 0.08**	

(1) EBITDAR, adjusted pre-tax income, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

System passenger revenues

In the fourth quarter of 2017, system passenger revenues of $3,381 million increased $346 million or 11.4% from the fourth quarter of 2016 on traffic growth of 9.9% and a yield improvement of 1.4%. On a stage-length adjusted basis, yield increased 4.0% when compared to the same quarter in 2016. Business cabin system revenues increased $96 million or 15.3% from the fourth quarter of 2016 on traffic and yield growth of 8.2% and 6.6%, respectively. In the fourth quarter of 2017, the stronger Canadian dollar versus the fourth quarter of 2016 decreased the Canadian dollar value of sales in foreign countries and had a negative impact of $41 million on system passenger revenues.

The table below provides passenger revenue by geographic region for the fourth quarter of 2017 and the fourth quarter of 2016.

Passenger Revenue (Canadian dollars in millions)	**Fourth Quarter 2017**	**Fourth Quarter 2016**	**$ Change**	**% Change**
Canada	$ 1,137	$ 1,079	$ 58	5.4
U.S. transborder	740	697	43	6.3
Atlantic	757	619	138	22.2
Pacific	502	442	60	13.5
Other	245	198	47	23.7
System	**$ 3,381**	**$ 3,035**	**$ 346**	**11.4**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics by geographic region for the fourth quarter of 2017 and the fourth quarter of 2016.

Fourth Quarter 2017 versus Fourth Quarter 2016	**Passenger Revenue % change**	**Capacity (ASMs) % Change**	**Traffic (RPMs) % Change**	**Passenger Load Factor pp Change**	**Yield % Change**	**PRASM % Change**
Canada	5.4	1.4	1.6	0.2	3.5	3.8
U.S. transborder	6.3	6.7	7.1	0.3	(0.7)	(0.3)
Atlantic	22.2	13.9	14.4	0.3	6.8	7.3
Pacific	13.5	12.2	13.7	1.0	(0.2)	1.1
Other	23.7	18.7	17.9	(0.6)	4.8	4.1
System	**11.4**	**9.5**	**9.9**	**0.3**	**1.4**	**1.8**

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

System	**Year-over-Year by Quarter (% Change)**				
	Q4'16	**Q1'17**	**Q2'17**	**Q3'17**	**Q4'17**
Passenger revenues	7.0	8.1	11.9	9.1	11.4
Capacity (ASMs)	17.1	15.4	13.5	9.1	9.5
Traffic (RPMs)	15.3	14.0	13.6	8.8	9.9
Passenger load factor (pp change)	(1.2)	(1.0)	0.1	(0.2)	0.3
Yield	(7.2)	(5.1)	(1.4)	0.4	1.4
PRASM	(8.6)	(6.3)	(1.2)	0.1	1.8

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

- The 9.9% traffic increase which reflected traffic growth in all markets and included gains in the business and premium economy cabins. Consistent with the airline's objective of increasing global international-to-international connecting traffic through its major Canadian hubs (sixth freedom traffic), the traffic growth in the fourth quarter of 2017 reflected an increase in connecting traffic via Canada to international destinations.

- The 1.4% system yield increase which reflected:

  - Yield increases in the domestic, Atlantic and Other markets, in large part due to:

    - greater proportional growth of high-yielding business and premium economy passengers;
    - yield growth in both the business and premium economy cabins;
    - growth in high-yielding local traffic and an improvement in the overall fare mix;
    - the introduction of seat selection fees on certain international markets; and
    - an increase in airport paid upgrade revenues.

  These factors were partly offset by the following:

  - an increase in average stage length of 4.6%, due to long-haul international expansion, which had the effect of reducing system yield by 2.6 percentage points;
  - an unfavourable currency impact of $41 million;
  - the impact of increased industry capacity on U.S. long-haul and short-haul routes;
  - a higher proportion of seats into long-haul leisure markets, led by an increase in lower-cost flights operated by Air Canada Rouge; and
  - a higher proportional growth of lower-yielding sixth freedom traffic in support of the airline's international expansion strategy.

Domestic passenger revenues

In the fourth quarter of 2017, domestic passenger revenues of $1,137 million increased $58 million or 5.4% from the fourth quarter of 2016.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

Canada	Year-over-Year by Quarter (% Change)				
	Q4'16	Q1'17	Q2'17	Q3'17	Q4'17
Passenger revenues	2.5	1.7	4.0	3.0	5.4
Capacity (ASMs)	5.5	3.2	2.8	1.5	1.4
Traffic (RPMs)	5.7	3.6	3.3	1.0	1.6
Passenger load factor (pp change)	0.1	0.3	0.5	(0.4)	0.2
Yield	(3.1)	(1.7)	0.8	2.2	3.5
PRASM	(2.9)	(1.3)	1.4	1.7	3.8

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

- The 3.5% yield increase which reflected yield improvements on most major domestic services. Rapidair® routes, linking Toronto and Montreal/Ottawa recorded a particularly strong yield performance versus the same quarter in 2016. The overall yield increase included gains in the business cabin and on connecting traffic.

- The 1.6% traffic increase which included gains in the business cabin. The traffic increase year-over-year was due to strong passenger demand on services within Canada as well as incremental connecting traffic to U.S. and international destinations.

U.S. transborder passenger revenues

In the fourth quarter of 2017, U.S. transborder passenger revenues of $740 million increased $43 million or 6.3% from the fourth quarter of 2016.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

U.S. Transborder	Year-over-Year by Quarter (% Change)				
	Q4'16	Q1'17	Q2'17	Q3'17	Q4'17
Passenger revenues	10.1	9.5	16.3	8.0	6.3
Capacity (ASMs)	14.1	9.6	15.2	10.9	6.7
Traffic (RPMs)	15.0	12.0	16.2	9.3	7.1
Passenger load factor (pp change)	0.6	1.8	0.7	(1.2)	0.3
Yield	(4.3)	(2.2)	0.3	(1.0)	(0.7)
PRASM	(3.6)	-	1.2	(2.4)	(0.3)

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

- The 7.1% traffic increase which reflected traffic growth on all major U.S. transborder services and included gains in the business cabin. The traffic increase year-over-year was mainly driven by the launch of year-round Air Canada Express service from Toronto to San Antonio and Memphis; Vancouver to Dallas-Fort Worth and Denver; and Montreal to Dallas-Fort Worth and Washington–Dulles. Strong passenger demand between Canada and the U.S. and growth of international-to-international connecting passenger flows from the U.S. in support of Air Canada's international expansion strategy were also contributing factors.

- The 0.7% yield decline which reflected an unfavourable currency impact of $11 million, increased industry capacity on U.S. long-haul and short-haul routes, and growth in lower-yielding international-to-international connecting traffic from and to the U.S. Yield growth on U.S. sun routes, such as Florida, Hawaii and Las Vegas was a partly offsetting factor.

Atlantic passenger revenues

In the fourth quarter of 2017, Atlantic passenger revenues of $757 million increased $138 million or 22.2% from the fourth quarter of 2016.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

Atlantic	Year-over-Year by Quarter (% Change)				
	Q4'16	Q1'17	Q2'17	Q3'17	Q4'17
Passenger revenues	8.3	8.3	14.3	17.7	22.2
Capacity (ASMs)	21.5	19.7	12.6	13.3	13.9
Traffic (RPMs)	19.3	14.4	13.7	13.7	14.4
Passenger load factor (pp change)	(1.4)	(3.5)	0.8	0.3	0.3
Yield	(9.2)	(5.3)	0.6	3.5	6.8
PRASM	(10.9)	(9.5)	1.5	3.9	7.3

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

- The 14.4% traffic increase which reflected traffic growth on all major Atlantic services with the exception of services to the United Arab Emirates where capacity was reduced year-over-year. The traffic increase year-over-year was mainly driven by the launch of seasonal services from Vancouver to Frankfurt and London-Gatwick; Montreal to Tel Aviv, Marseille, Algiers and Reykjavík; and Toronto to Berlin and Reykjavík. Air Canada also launched year-round service from Toronto to Mumbai. The overall traffic increase included strong gains in the business and premium economy cabins.

- The 6.8% yield increase which reflected yield improvements on all major Atlantic services, led by gains in the business and premium economy cabins.

Pacific passenger revenues

In the fourth quarter of 2017, Pacific passenger revenues of $502 million increased $60 million or 13.5% from the fourth quarter of 2016.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

Pacific	Year-over-Year by Quarter (% Change)				
	Q4'16	Q1'17	Q2'17	Q3'17	Q4'17
Passenger revenues	12.1	12.5	12.5	5.7	13.5
Capacity (ASMs)	31.9	30.3	23.2	10.1	12.2
Traffic (RPMs)	23.7	22.5	19.7	9.4	13.7
Passenger load factor (pp change)	(5.3)	(5.1)	(2.5)	(0.6)	1.0
Yield	(9.3)	(8.1)	(6.0)	(3.4)	(0.2)
PRASM	(15.0)	(13.6)	(8.7)	(4.0)	1.1

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

- The 13.7% traffic increase which reflected traffic growth on all major Pacific services and included gains in the business and premium economy cabins. The traffic increase year-over-year was mainly driven by the launch of year-round services from Montreal to Shanghai, Vancouver to Taipei and, to a much lesser extent, Vancouver to Melbourne. The launch of seasonal service from Vancouver to Nagoya and the use of a larger aircraft on services from Toronto to Seoul also contributed to the traffic growth year-over-year.

- The 0.2% yield decline which reflected a yield decline on services to Hong Kong offset by yield improvements on services to China, Japan, Korea and the South Pacific. The yield decline on services to Hong Kong reflected the impact of increased industry capacity and competitive pricing activities.

Other passenger revenues

In the fourth quarter of 2017, Other passenger revenues (from routes to and from the Caribbean, Mexico and Central and South America) of $245 million increased $47 million or 23.7% from the fourth quarter of 2016.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

Other	Year-over-Year by Quarter (% Change)				
	Q4'16	Q1'17	Q2'17	Q3'17	Q4'17
Passenger revenues	7.3	18.8	34.7	15.3	23.7
Capacity (ASMs)	13.2	20.1	24.1	8.4	18.7
Traffic (RPMs)	15.7	22.8	26.4	10.1	17.9
Passenger load factor (pp change)	1.8	1.9	1.5	1.4	(0.6)
Yield	(7.6)	(3.4)	6.5	4.4	4.8
PRASM	(5.5)	(1.2)	8.4	6.1	4.1

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

- The 17.9% traffic increase which reflected traffic growth on services to South America and on routes to traditional sun destinations. The traffic growth included gains in all cabins. The traffic increase year-over-year was largely driven by the use of larger aircraft on routes to Sao Paulo and Santiago and, to a lesser extent, the launch of services from Toronto to Cartagena and from Montreal to Lima.

- The 4.8% yield increase which reflected yield improvements on all major services and included gains in all cabins.

Cargo revenues

In the fourth quarter of 2017, cargo revenues of $183 million increased $28 million or 18.4% from the fourth quarter of 2016 on traffic growth of 19.0% partly offset by a yield decline of 0.5%. Traffic growth was recorded in all markets and was in part due to the introduction of new international routes. In the fourth quarter of 2017, both the Atlantic and Pacific markets reflected yield increases versus the same quarter in 2016.

The table below provides cargo revenue by geographic region for the periods indicated.

Cargo Revenue (Canadian dollars in millions)	**Fourth Quarter 2017**	**Fourth Quarter 2016**	**$ Change**	**% Change**
Canada	$ 20	$ 18	$ 2	13.3
U.S. transborder	9	9	-	9.9
Atlantic	58	52	6	12.5
Pacific	79	63	16	23.7
Other	17	13	4	28.1
System	**$ 183**	**$ 155**	**$ 28**	**18.4**

Other revenues

In the fourth quarter of 2017, other revenues of $256 million increased $21 million or 9% from the same quarter in 2016, mainly due to an increase in ground package revenues at Air Canada Vacations and an increase in passenger and airline-related fees.

CASM and adjusted CASM

In the fourth quarter of 2017, both CASM and adjusted CASM decreased 1.2% when compared to the same quarter in 2016.

The following table compares Air Canada's CASM and Adjusted CASM for the periods indicated.

	Fourth Quarter			
			Change	
(cents per ASM)	**2017**	**2016**	**¢**	**%**
Aircraft fuel	3.04	2.71	0.33	12.2
Regional airlines expense				
Aircraft fuel	0.46	0.41	0.05	12.2
Other	2.33	2.41	(0.08)	(3.3)
Wages and salaries	2.26	2.23	0.03	1.3
Benefits	0.53	0.64	(0.11)	(17.2)
Airport and navigation fees	0.83	0.92	(0.09)	(9.8)
Aircraft maintenance	1.01	0.90	0.11	12.2
Depreciation, amortization and impairment	1.01	0.96	0.05	5.2
Sales and distribution costs	0.70	0.78	(0.08)	(10.3)
Ground package costs	0.44	0.46	(0.02)	(4.3)
Aircraft rent	0.52	0.54	(0.02)	(3.7)
Food, beverages and supplies	0.37	0.37	-	-
Communications and information technology	0.26	0.27	(0.01)	(3.7)
Special items	-	0.41	(0.41)	(100.0)
Other	1.48	1.41	0.07	5.0
CASM	**15.24**	**15.42**	**(0.18)**	**(1.2)**
Remove:				
Aircraft fuel expense [1], ground package costs at Air Canada Vacations and special items	(3.94)	(3.98)	0.04	1.0
Adjusted CASM [2]	**11.30**	**11.44**	**(0.14)**	**(1.2)**

(1) *Includes aircraft fuel expense related to regional airline operations.*
(2) *Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.*

Operating expenses

In the fourth quarter of 2017, operating expenses of $3,687 million increased $280 million or 8% from the fourth quarter of 2016 on capacity growth of 9.5%.

In the fourth quarter of 2017, the favourable impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), when compared to the fourth quarter of 2016, decreased operating expenses by $67 million (comprised of $35 million relating to aircraft fuel expense and an aggregate of $32 million relating to non-fuel operating expenses).

The more notable components of the year-over-year change in operating expenses are described below.

Aircraft fuel expense

In the fourth quarter of 2017, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to $847 million, an increase of $159 million or 23% from the fourth quarter of 2016. This increase mainly reflected higher jet fuel prices (before the impact of foreign exchange), which accounted for an increase of $151 million and a higher volume of fuel litres consumed, which accounted for an increase of $55 million. These increases were partly offset by a favourable currency impact of $35 million and hedging gains of $12 million.

Regional airlines expense

In the fourth quarter of 2017, regional airlines expense of $675 million increased $53 million or 9% from the fourth quarter of 2016. This increase reflected the impact of higher base jet fuel prices year-over-year, an increase in engine maintenance expense due to timing of events, and increased flying, which was the result of fleet expansion initiatives in the Air Canada Express fleet.

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

	Fourth Quarter			
(Canadian dollars in millions)	**2017**	**2016**	**Change $**	**Change %**
Capacity purchase fees	$ 330	$ 304	$ 26	9
Aircraft fuel	112	90	22	24
Airport and navigation	71	72	(1)	(1)
Sales and distribution costs	35	36	(1)	(3)
Aircraft rent	10	8	2	25
Depreciation, amortization and impairment	7	6	1	17
Other operating expenses	110	106	4	4
Total regional airlines expense	**$ 675**	**$ 622**	**$ 53**	**9**

Wages, salaries and benefits expense

In the fourth quarter of 2017, wages and salaries expense of $546 million increased $54 million or 11% from the fourth quarter of 2016. This increase was mainly due to a higher number of FTE employees to support the airline's international growth. The average number of FTE employees increased 8.0% in the fourth quarter of 2017 when compared to the fourth quarter in 2016.

In the fourth quarter of 2017, employee benefits expense of $128 million decreased $13 million or 9% from the fourth quarter of 2016, reflecting the favourable impact of an annual valuation related to workers' compensation, which benefitted from a reduction in overall claims, and lower expenses associated with disability benefit plans. The higher level of FTE employees and lower discount rates, which increased the current service cost of defined benefit pension plans, were partly offsetting factors.

Airport and navigation fees

In the fourth quarter of 2017, airport and navigation fees of $201 million decreased $2 million or 1% from the fourth quarter in 2016, reflecting the favourable impact of Air Canada's agreement with the Greater Toronto Airports Authority, which is allowing the airline to increase international connecting traffic at Toronto Pearson International Airport on a more cost effective basis, a $15 million one-time refund from Nav Canada, and the effect of a 3.9% Nav Canada rate reduction effective September 1, 2017. The impact of increased wide-body and international flying was an offsetting factor.

Aircraft maintenance expense

Aircraft maintenance expense of $243 million in the fourth quarter of 2017 increased $43 million or 22% from the fourth quarter of 2016, reflecting, in large part, the impact of having additional Boeing 787 aircraft in the fleet in 2017, which have engines under power-by-the-hour arrangements. A favourable currency impact was a partly offsetting factor.

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

(Canadian dollars in millions)	Fourth Quarter			
	2017	2016	Change $	Change %
Technical maintenance	$ 206	$ 154	$ 52	34
Maintenance provisions (1)	31	39	(8)	(21)
Other	6	7	(1)	(14)
Total aircraft maintenance expense	**$ 243**	**$ 200**	**$ 43**	**22**

(1) Maintenance provisions relate to return conditions on aircraft leases which are recorded over the term of the lease.

Depreciation, amortization and impairment expense

In the fourth quarter of 2017, depreciation, amortization and impairment expense of $245 million increased $33 million or 16% from the fourth quarter in 2016, mainly due to the addition of Boeing 787 aircraft to Air Canada's mainline fleet.

Sales and distribution costs

In the fourth quarter of 2017, sales and distribution costs of $169 million decreased $3 million or 2% from the fourth quarter in 2016, reflecting, in large part, the favourable impact of new commission programs in North America during 2017 and growth in direct bookings when compared to the same quarter in 2016. A higher volume of ticket sales and an increase in credit card expenses (in line with sales and revenue growth) were offsetting factors.

Ground package costs

In the fourth quarter of 2016, the cost of ground packages at Air Canada Vacations of $106 million increased $5 million or 5% from the fourth quarter in 2016. This increase was mainly due to higher passenger volumes partly offset by a decrease in the prices of ground packages and a favourable currency impact when compared to the fourth quarter of 2016.

Aircraft rent expense

In the fourth quarter of 2017, aircraft rent expense of $126 million increased $6 million or 5% from the fourth quarter in 2016, reflecting a greater number of leased aircraft, primarily Boeing 787 aircraft. A favourable currency impact and lower lease rates year-over-year were partly offsetting factors.

Special items

In the fourth quarter of 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

Other expenses

In the fourth quarter of 2017, other expenses of $362 million increased $49 million or 16% from the fourth quarter in 2016, reflecting, in large part, the capacity growth and the impact of Air Canada's international expansion strategy. An increase in customer inconvenience expense, reflecting the impact of operational disruptions caused by severe weather, was also a contributing factor.

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

	Fourth Quarter			
(Canadian dollars in millions)	2017	2016	Change $	Change %
Terminal handling	$ 69	$ 55	$ 14	25
Crew cycle	51	44	7	16
Building rent and maintenance	41	40	1	3
Miscellaneous fees and services	45	43	2	5
Remaining other expenses	156	131	25	19
Total other expenses	**$ 362**	**$ 313**	**$ 49**	**16**

Non-operating income (expense)

In the fourth quarter of 2017, non-operating expense of $113 million improved $83 million from the fourth quarter of 2016.

Components of the year-over-year change in fourth quarter non-operating income (expense) included:

- In the fourth quarter of 2017, losses on foreign exchange amounted to $62 million compared to losses on foreign exchange of $29 million in the fourth quarter of 2016. Foreign exchange losses of $49 million were recorded on long-term debt and foreign exchange losses of $8 million were recorded on maintenance provisions.

- Air Canada recorded a $27 million gain on debt modifications in the fourth quarter of 2017 related to the repricing of the US$1.1 billion senior secured credit facility concluded in June 2017.

- In the fourth quarter of 2016, Air Canada recorded a loss on debt settlements of $82 million related to the $1.25 billion refinancing transaction concluded in October 2016.

8. FLEET

Mainline and Air Canada Rouge

The following table provides Air Canada's and Air Canada Rouge's operating fleet as at December 31, 2017. Refer to the Air Canada Express section below for information on the fleet of aircraft operated by regional airlines operating flights on behalf of Air Canada under capacity purchase agreements with Air Canada.

Mainline	**Total Seats**	**Number of Operating Aircraft**	**Average Age**	**Owned**	**Finance Lease**	**Operating Lease**
Wide-body Aircraft						
Boeing 787-8	251	8	3.2	8	-	-
Boeing 787-9	298	22	1.4	16	-	6
Boeing 777-300ER	450/400	19	7.5	10	1	8
Boeing 777-200LR	300	6	10.1	4	-	2
Boeing 767-300ER	211	10	28.8	6	1	3
Airbus A330-300	292	8	17.2	8	-	-
Narrow-body Aircraft						
Boeing 737 MAX 8	169	2	0.1	2	-	-
Airbus A321	185/190	15	14.7	5	-	10
Airbus A320	146	42	24.2	1	-	41
Airbus A319	120	18	19.7	5	-	13
Embraer 190	97	25	10.5	25	-	-
Total Mainline		**175**	**14.5**	**90**	**2**	**83**
Air Canada Rouge						
Wide-body Aircraft						
Boeing 767-300ER (1)	282	24	20.3	2	2	20
Narrow-body Aircraft						
Airbus A321	200	5	2.0	-	-	5
Airbus A319 (1)	136	20	19.5	17	-	3
Total Air Canada Rouge		**49**	**18.1**	**19**	**2**	**28**
Total Mainline and Air Canada Rouge		**224**	**15.3**	**109**	**4**	**111**

(1) The Boeing 767 aircraft and the Airbus A319 aircraft reflected as owned in the table above are owned by Air Canada and leased to Air Canada Rouge.

The following table provides the number of aircraft in Air Canada's operating fleet as at December 31, 2017 as well as Air Canada's planned operating fleet, including aircraft operating and expected to be operated by Air Canada Rouge, as at December 31, 2018 and December 31, 2019.

	Actual	Planned			
Mainline	**December 31, 2017**	**2018 fleet changes**	**December 31, 2018**	**2019 fleet changes**	**December 31, 2019**
Wide-body aircraft					
Boeing 787-8	**8**	-	**8**	-	**8**
Boeing 787-9	**22**	5	**27**	2	**29**
Boeing 777-300ER	**19**	-	**19**	-	**19**
Boeing 777-200LR	**6**	-	**6**	-	**6**
Boeing 767-300ER	**10**	(4)	**6**	(5)	**1**
Airbus A330-300	**8**	-	**8**	4	**12**
Narrow-body aircraft					
Boeing 737 MAX 8	**2**	16	**18**	18	**36**
Airbus A321	**15**	-	**15**	-	**15**
Airbus A320	**42**	-	**42**	(11)	**31**
Airbus A319	**18**	(2)	**16**	(2)	**14**
Embraer 190	**25**	(6)	**19**	(5)	**14**
Bombardier C-Series CS300	**-**	-	**-**	1	**1**
Total Mainline	**175**	**9**	**184**	**2**	**186**
Air Canada Rouge					
Wide-body aircraft					
Boeing 767-300ER	**24**	1	**25**	-	**25**
Narrow-body aircraft					
Airbus A321	**5**	1	**6**	-	**6**
Airbus A319	**20**	2	**22**	-	**22**
Total Air Canada Rouge	**49**	**4**	**53**	**-**	**53**
Total wide-body aircraft	**97**	**2**	**99**	**1**	**100**
Total narrow-body aircraft	**127**	**11**	**138**	**1**	**139**
Total Mainline and Air Canada Rouge	**224**	**13**	**237**	**2**	**239**

In addition to the above-referenced 36 Boeing 737 MAX aircraft that Air Canada plans to have in its operating fleet by the end of 2019, Air Canada expects to introduce an additional 25 Boeing 737 MAX aircraft between 2020 and 2021 (for a total of 61 aircraft). These aircraft are replacing existing Airbus narrow-body aircraft in Air Canada's mainline fleet.

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 C-Series CS300 aircraft. Deliveries are scheduled to begin in late 2019 and extend to 2022. The first 25 aircraft on delivery are expected to replace existing Embraer 190 aircraft in the mainline fleet, with incremental aircraft supporting Air Canada's hub and network growth.

Air Canada Express

The following table provides, as at December 31, 2017, 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 December 31, 2017			
	Jazz	**Sky Regional**	**Other**	**Total**
Embraer 175	-	25	-	25
Bombardier CRJ-100/200	10	-	14	24
Bombardier CRJ-705/900	21	-	-	21
Bombardier Dash 8-100	16	-	-	16
Bombardier Dash 8-300	26	-	-	26
Bombardier Dash 8-Q400	44	-	-	44
Total Air Canada Express	**117**	**25**	**14**	**156**

The following table provides the number of aircraft planned, as at December 31, 2018, 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, 2018			
	Jazz	**Sky Regional**	**Other**	**Total**
Embraer 175	-	25	-	25
Bombardier CRJ-100/200	10	-	14	24
Bombardier CRJ-705/900	21	-	-	21
Bombardier Dash 8-100	15	-	-	15
Bombardier Dash 8-300	26	-	-	26
Bombardier Dash 8-Q400	44	-	-	44
Total Air Canada Express	**116**	**25**	**14**	**155**

Other aircraft with CPA carriers

Air Georgian and EVAS also operate a total of 15, 18-passenger Beech 1900 aircraft on behalf of Air Canada pursuant to their capacity purchase agreements with Air Canada.

9. FINANCIAL AND CAPITAL MANAGEMENT

9.1. Liquidity

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

Liquidity needs are primarily related to meeting obligations associated with financial liabilities, capital commitments, ongoing operations, contractual and other obligations (including pension funding obligations and covenants in credit card agreements), which are further discussed in sections 9.6, 9.7 and 9.8 of this MD&A. Air Canada monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available for use as well as those assets being used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. At December 31, 2017, unrestricted liquidity amounted to $4,181 million (comprised of cash and short-term investments of $3,804 million and undrawn lines of credit of $377 million). In addition, Air Canada monitors its financial leverage as measured by the adjusted net debt to EBITDAR ratio, as further described in section 9.3 of this MD&A.

9.2. Financial position

The following table provides a condensed consolidated statement of financial position of Air Canada as at December 31, 2017 and as at December 31, 2016.

(Canadian dollars in millions)	**December 31, 2017**	**December 31, 2016**	**$ Change**
Assets			
Cash, cash equivalents and short-term investments	$ 3,804	$ 2,979	$ 825
Other current assets	1,493	1,368	125
Current assets	5,297	4,347	950
Deposits and other assets	465	468	(3)
Property and equipment	9,252	8,520	732
Pension assets	1,583	1,153	430
Deferred income tax	472	-	472
Intangible assets	318	315	3
Goodwill	311	311	-
Total assets	**$ 17,698**	**$ 15,114**	**$ 2,584**
Liabilities			
Current liabilities	$ 5,060	$ 4,424	$ 636
Long-term debt and finance leases	5,448	5,911	(463)
Pension and other benefit liabilities	2,592	2,436	156
Maintenance provisions	1,003	922	81
Other long-term liabilities	216	202	14
Total liabilities	**14,319**	**13,895**	**424**
Total shareholders' equity	**3,379**	**1,219**	**2,160**
Total liabilities and shareholders' equity	**$ 17,698**	**$ 15,114**	**$ 2,584**

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

At December 31, 2017, property and equipment amounted to $9,252 million, an increase of $732 million from December 31, 2016. The increase in property and equipment was mainly due to additions of $2,379 million, including nine Boeing 787-9 aircraft (four of which were financed under sale and operating leaseback transactions), two Boeing 737 MAX aircraft, progress payments on future aircraft deliveries and capitalized maintenance costs. These were largely offset by the sale of four Boeing 787 aircraft under sale and operating leaseback transactions and the impact of depreciation expense of $934 million.

As described in section 6 "Results of Operations – Full Year 2017 versus Full Year 2016" of this MD&A, in 2017, Air Canada began recognizing the value of substantially all of its unrecorded deferred income tax assets. As at December 31, 2017 the deferred income tax asset amounted to $472 million.

The net long-term pension and other benefit liabilities of $1,009 million (comprised of pension and other benefit liabilities of $2,592 million net of pension assets of $1,583 million) decreased $274 million from December 31, 2016. This decrease was mainly due to strong investment returns on pension plan assets, partially offset by the impact of a 30 basis point decrease in the discount rate used to value the liabilities, resulting in a net gain on remeasurements on employee benefit liabilities of $511 million (before the impact of income taxes - $189 million, net of tax) recorded on Air Canada's consolidated statement of comprehensive income.

9.3. Adjusted net debt

The following table reflects Air Canada's adjusted net debt balances as at December 31, 2017 and as at December 31, 2016.

(Canadian dollars in millions, except where indicated)	December 31, 2017	December 31, 2016	$ Change
Total long-term debt and finance leases	$ 5,448	$ 5,911	$ (463)
Current portion of long-term debt and finance leases	671	707	(36)
Total long-term debt and finance leases, including current portion	6,119	6,618	(499)
Less cash, cash equivalents and short-term investments	(3,804)	(2,979)	(825)
Net debt	**$ 2,315**	**$ 3,639**	**$ (1,324)**
Capitalized operating leases (1)	3,801	3,451	350
Adjusted net debt	**$ 6,116**	**$ 7,090**	**$ (974)**
EBITDAR (trailing 12 months)	**$ 2,921**	**$ 2,768**	**$ 153**
Adjusted net debt to EBITDAR ratio (2)	**2.1**	**2.6**	**(0.5)**

(1) *Adjusted net debt is an additional GAAP financial measure and 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 $543 million for the 12 months ended December 31, 2017 and $493 million for the 12 months ended December 31, 2016.*

(2) *Adjusted net debt to trailing 12-month EBITDAR ratio (also referred to as "leverage ratio" in this MD&A) is a non-GAAP financial measure and is used by Air Canada as a means to measure financial leverage. Leverage ratio is calculated by dividing adjusted net debt by trailing 12-month EBITDAR. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.*

At December 31, 2017, total long-term debt and finance leases (including current portion) of $6,119 million decreased $499 million from December 31, 2016. In 2017, new borrowings of $733 million were more than offset by debt repayments of $808 million and the favourable impact of a stronger Canadian dollar of $402 million, as at December 31, 2017 compared to December 31, 2016, on Air Canada's foreign currency denominated debt (mainly U.S. dollars). As noted in section 9.4 "Working Capital" of this MD&A, debt repayments included the exercise of end of lease purchase options which increased Air Canada's owned and encumbered aircraft and reduced outstanding debt. In addition, Air Canada purchased one Boeing 787 and two Boeing 737 aircraft with cash.

Adjusted net debt amounted to $6,116 million at December 31, 2017, a decrease of $974 million from December 31, 2016, reflecting the impact of higher cash and short-term investment balances of $825 million and lower long-term debt and finance lease balances of $499 million. The impact of a higher capitalized operating lease balance of $350 million was a partly offsetting factor.

At December 31, 2017, the adjusted net debt to EBITDAR ratio was 2.1 versus 2.6 as at December 31, 2016.

At December 31, 2017, Air Canada's weighted average cost of capital ("WACC"), on a pre-tax basis, was approximately 7.6% (compared to approximately 7.9% at December 31, 2016). WACC is based on an estimate by management and consists of an estimated cost of equity of 20.0% and an average cost of debt and finance leases of 4.5% (compared to an estimated cost of equity of 21.1% and an average cost of debt and finance leases of 4.6% at December 31, 2016).

9.4. Working capital

The following table provides information on Air Canada's working capital balances as at December 31, 2017 and as at December 31, 2016.

(Canadian dollars in millions)	December 31, 2017	December 31, 2016	$ Change
Cash, cash equivalents and short-term investments	$ 3,804	$ 2,979	$ 825
Accounts receivable	814	707	107
Other current assets	679	661	18
Total current assets	**$ 5,297**	**$ 4,347**	**$ 950**
Accounts payable and accrued liabilities	1,961	1,644	317
Advance ticket sales	2,428	2,073	355
Current portion of long-term debt and finance leases	671	707	(36)
Total current liabilities	**$ 5,060**	**$ 4,424**	**$ 636**
Net working capital	**$ 237**	**$ (77)**	**$ 314**

The net working capital of $237 million at December 31, 2017 represented an improvement of $314 million from December 31, 2016. The net cash flows from operating activities of $2,738 million more than offset the impact of capital expenditures of $2,422 million (which resulted in a net cash outflow of $949 million after deducting the financing drawn or sale-leaseback proceeds received relating to the delivery of eight Boeing 787 aircraft). In 2017, Air Canada purchased one Boeing 787 and two Boeing 737 MAX aircraft using cash and exercised purchase and early termination options on four financed Airbus A330 aircraft and five financed Airbus A321 aircraft, increasing the number of owned and unencumbered aircraft. The growth in advance ticket sales of $355 million was largely driven by Air Canada's capacity growth.

9.5. Consolidated cash flow movements

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

(Canadian dollars in millions)	Fourth Quarter 2017	Fourth Quarter 2016	Fourth Quarter $ Change	Full Year 2017	Full Year 2016	Full Year $ Change
Net cash flows from operating activities	**$ 389**	**$ 351**	**$ 38**	**$ 2,738**	**$ 2,421**	**$ 317**
Proceeds from borrowings	-	1,230	(1,230)	733	2,538	(1,805)
Reduction of long-term debt and finance lease obligations	(240)	(1,807)	1,567	(814)	(2,275)	1,461
Shares purchased for cancellation	(35)	(5)	(30)	(71)	(94)	23
Distributions related to aircraft special purpose leasing entities	-	-	-	-	(32)	32
Issue of shares	2	1	1	9	2	7
Financing fees	(11)	-	(11)	(26)	(2)	(24)
Net cash flows from (used in) financing activities	**$ (284)**	**$ (581)**	**$ 297**	**$ (169)**	**$ 137**	**$ (306)**
Short-term investments	(167)	238	(405)	(998)	(99)	(899)
Additions to property, equipment and intangible assets	(432)	(230)	(202)	(2,422)	(2,921)	499
Proceeds from sale of assets	2	3	(1)	5	352	(347)
Proceeds from sale-leaseback of assets	-	-	-	740	351	389
Other	(24)	(16)	(8)	(16)	(9)	(7)
Net cash flows used in investing activities	**$ (621)**	**$ (5)**	**$ (616)**	**$ (2,691)**	**$ (2,326)**	**$ (365)**
Effect of exchange rate changes on cash and cash equivalents	**$ 12**	**$ 5**	**$ 7**	**$ (23)**	**$ (17)**	**$ (6)**
Increase (decrease) in cash and cash equivalents	**$ (504)**	**$ (230)**	**$ (274)**	**$ (145)**	**$ 215**	**$ (360)**

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

(Canadian dollars in millions)	Fourth Quarter 2017	Fourth Quarter 2016	Fourth Quarter $ Change	Full Year 2017	Full Year 2016	Full Year $ Change
Net cash flows from operating activities	**$ 389**	**$ 351**	**$ 38**	**$ 2,738**	**$ 2,421**	**$ 317**
Additions to property, equipment and intangible assets, net of proceeds from sale-leaseback transactions	(432)	(230)	(202)	(1,682)	(2,570)	888
Free cash flow (1)	**$ (43)**	**$ 121**	**$ (164)**	**$ 1,056**	**$ (149)**	**$ 1,205**

(1) Free cash flow is a non-GAAP financial measure used by Air Canada as an indicator of the financial strength and performance of its business, indicating how much cash it is able to generate from operations and after capital expenditures. Free cash flow is calculated as net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale and leaseback transactions. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Free cash flow

In the fourth quarter of 2017, net cash flows from operating activities of $389 million increased $38 million when compared to the same quarter in 2016. This increase was mainly due to the impact of stronger cash operating results and higher net cash inflows from working capital. In the fourth quarter of 2017, negative free cash flow of $43 million deteriorated by $164 million from the fourth quarter of 2016 due to a higher level of net capital expenditures year-over-year partly offset by higher cash flows from operating activities versus the same quarter in 2016.

In 2017, net cash flows from operating activities of $2,738 million increased $317 million when compared to 2016. This increase in net cash flows from operating activities was mainly due to the impact of stronger cash operating results, the impact of higher cash inflows from working capital and the impact of lower pension funding payments. The higher cash inflows from working capital was mainly due to the impact of the growth in advance ticket sales which is consistent with the capacity growth. In 2017, free cash flow of $1,056 million improved $1,205 million from 2016 due to a lower level of net capital expenditures year-over-year and the impact of higher cash flows from operating activities versus 2016.

Net cash flows from financing activities

In the fourth quarter of 2017, reduction of long-term debt and finance lease obligations amounted to $240 million.

In 2017, proceeds from borrowings amounted to $733 million and reduction of long-term debt and finance lease obligations amounted to $814 million.

Refer to sections 9.4 "Working Capital", 9.2 "Financial Position" and 9.3 "Adjusted Net Debt" of this MD&A for additional information.

9.6. Capital expenditures and related financing arrangements

Boeing 787 aircraft

As of the date of this MD&A, Air Canada has outstanding purchase commitments with The Boeing Company ("Boeing") for five Boeing 787 aircraft (three of which remain to be delivered in 2018 and two of which remain to be delivered in 2019). Air Canada also has purchase options for 13 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing and delivery positions), and purchase rights for 10 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on Boeing's then current pricing and available delivery positions).

In December 2017, Air Canada completed a private offering of enhanced equipment trust certificates ("EETCs") covering nine Boeing 737 MAX 8 aircraft and four Boeing 787-9 aircraft. Two of the four Boeing 787-9 aircraft covered under the EETC transaction were delivered in early 2018 and the remaining two are scheduled for delivery in the first half of 2018. Refer to section 9.8 "Contractual Obligations" of this MD&A for additional information.

Subject to certain conditions, Air Canada has financing commitments covering up to three of the remaining five Boeing 787 firm aircraft orders, which are scheduled for delivery by 2019. The financing terms are for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments.

Boeing 737 aircraft

Air Canada has an agreement with Boeing for the purchase of Boeing 737 MAX aircraft which provides for:

- Firm orders for 61 737 MAX aircraft, initially consisting of 737 MAX 8 and 737 MAX 9 aircraft with substitution rights between them as well as for the 737 MAX 7 aircraft.
- Purchase options for 18 Boeing 737 MAX aircraft.

- Certain rights to purchase an additional 30 Boeing 737 MAX aircraft.

As of the date of this MD&A, the remaining firm order for the 737 MAX aircraft consists of 46 737 MAX 8 aircraft and 11 737 MAX 9 aircraft.

In December 2017, Air Canada completed a private offering of EETCs covering nine Boeing 737 MAX 8 aircraft and four Boeing 787-9 aircraft scheduled for delivery in 2018. Two of the nine Boeing 737 MAX 8 aircraft covered under the EETC transaction completed in December 2017 were delivered in early 2018 and the remaining seven are scheduled for delivery in the first half of 2018. Refer to section 9.8 "Contractual Obligations" of this MD&A for additional information.

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

Bombardier C-Series CS300 aircraft

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 C-Series 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 C-Series CS300 aircraft deliveries and other capital purchase commitments as at December 31, 2017 approximates $6,089 million.

(Canadian dollars in millions)	2018	2019	2020	2021	2022	Thereafter	Total
Projected committed expenditures	$ 1,821	$ 1,353	$ 1,334	$ 1,016	$ 565	$ -	$ 6,089
Projected planned but uncommitted expenditures	303	572	373	343	298	Not available	Not available
Projected planned but uncommitted capitalized maintenance (1)	129	167	163	49	98	Not available	Not available
Total projected expenditures (2)	**$ 2,253**	**$ 2,092**	**$ 1,870**	**$ 1,408**	**$ 961**	**Not available**	**Not available**

(1) *Future capitalized maintenance amounts for 2021 and 2022 and beyond are not yet determinable, however estimates of $49 million and $98 million, respectively, have been made for 2021 and 2022.*

(2) *U.S. dollar amounts are converted using the December 31, 2017 closing exchange rate of US$1=C$1.2571. The estimated aggregate cost of aircraft is based on delivery prices that include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day U.S. LIBOR rate at December 29, 2017.*

9.7. Pension funding obligations

Air Canada maintains several defined benefit pension plans, including domestic registered pension plans, supplemental pension plans and international pension plans. Air Canada also has several defined contribution pension plans as well as plans providing other retirement and post-employment benefits to its employees.

As at January 1, 2017, the aggregate solvency surplus in the domestic registered pension plans was $1.9 billion. Based on preliminary estimates, including actuarial assumptions, as at January 1, 2018, the aggregate solvency surplus in Air Canada's domestic registered pension plans is projected to be $2.5 billion. The final valuations to be made as at January 1, 2018 will be completed in the first half of 2018. Based on preliminary estimates, Air Canada does not expect to make any past service payments in 2018.

As permitted by applicable legislation and subject to applicable plan rules, amounts in excess of 105% on a solvency basis may be used to reduce current service contributions under the defined benefit component or to fund the employer contribution to a defined contribution component within the same pension plan.

On a cash basis, total employer pension funding contributions (including the international and supplemental plans) amounted to $90 million in 2017, as described in the table below.

(Canadian dollars in millions)	2017
Current service domestic registered plans	$ -
Other pension arrangements (1)	90
Total employer pension funding contributions	**$ 90**

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

On a cash basis, total pension funding contributions (including the international and supplemental plans) are forecasted to be $90 million in 2018, as described in the table below.

(Canadian dollars in millions)	2018
Current service domestic registered plans	$ 1
Other pension arrangements (1)	89
Total projected employer pension funding contributions	**$ 90**

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

As at December 31, 2017, taking into account the effect of financial instrument risk management tools, approximately 75% of Air Canada's pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk. Air Canada may continue to increase the percentage of pension liabilities being matched with fixed income products, subject to favourable market conditions.

Refer to the "Pension Plans" discussion in section 18 "Risk Factors" of this MD&A for additional information and a discussion of important risks relating to Air Canada pension funding obligations.

9.8. Contractual obligations

Private offering of enhanced equipment trust certificates

In December 2017, in connection with the financing of four new Boeing 787-9 aircraft and nine new Boeing 737 MAX 8 aircraft, Air Canada completed the closing of a private offering of three tranches of EETCs with a combined aggregate face amount of approximately US$719 million.

The private offering was comprised of Class AA certificates, Class A certificates and Class B certificates.

- The Class AA certificates, with a US$400 million face amount, have an interest rate of 3.300% per annum and a final expected distribution date of January 15, 2030.
- The Class A certificates, with a US$172 million face amount, have an interest rate of 3.550% per annum and a final expected distribution date of January 15, 2030.
- The Class B certificates, with US$147 million face amount, have an interest rate of 3.700% per annum and a final expected distribution date of January 15, 2026.

The three tranches of certificates have a combined weighted average interest rate of 3.422% per annum.

The table below provides Air Canada's contractual obligations as at December 31, 2017, 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. The table below also includes the impact of the financing associated with four new Boeing 787-9 aircraft and nine new Boeing 737 MAX-8 aircraft as described above, the proceeds of which are held in escrow and drawn upon the delivery of these aircraft.

(Canadian dollars in millions)	**2018**	**2019**	**2020**	**2021**	**2022**	**Thereafter**	**Total**
Principal							
Long-term debt obligations	$ 624	$ 487	$ 523	$ 853	$ 243	$ 3,269	$ 5,999
Finance lease obligations	47	44	47	16	14	55	223
Total principal obligations	**$ 671**	**$ 531**	**$ 570**	**$ 869**	**$ 257**	**$ 3,324**	**$ 6,222**
Interest							
Long-term debt obligations	$ 230	$ 210	$ 191	$ 148	$ 127	$ 277	$ 1,183
Finance lease obligations	18	14	9	6	5	14	66
Total interest obligations	**$ 248**	**$ 224**	**$ 200**	**$ 154**	**$ 132**	**$ 291**	**$ 1,249**
Total long-term debt and finance lease obligations	**$ 919**	**$ 755**	**$ 770**	**$ 1,023**	**$ 389**	**$ 3,615**	**$ 7,471**
Operating lease obligations	**$ 606**	**$ 520**	**$ 397**	**$ 288**	**$ 210**	**$ 882**	**$ 2,903**
Committed capital expenditures	**$ 1,821**	**$ 1,353**	**$ 1,334**	**$ 1,016**	**$ 565**	**$ -**	**$ 6,089**
Total contractual obligations (1)	**$ 3,346**	**$ 2,628**	**$ 2,501**	**$ 2,327**	**$ 1,164**	**$ 4,497**	**16,463**
EETC financing (principal and interest)	**$ 12**	**$ 86**	**$ 84**	**$ 82**	**$ 80**	**$ 808**	**$ 1,152**
Total obligations, including the impact of the EETC financing	**$ 3,358**	**$ 2,714**	**$ 2,585**	**$ 2,409**	**$ 1,244**	**$ 5,305**	**$ 17,615**

(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.

Covenants in credit card agreements

Air Canada's principal credit card processing agreements for credit card processing services contain triggering events upon which Air Canada is required to provide the applicable credit card processor with cash deposits. The obligations to provide cash deposits and the required amount of deposits are each based upon a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio for Air Canada and the unrestricted cash and short-term investments of Air Canada. In 2017, Air Canada made no cash deposits under these agreements (nil in 2016).

9.9. Share information

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

	December 31, 2017	December 31, 2016
Issued and outstanding shares		
Variable voting shares	115,986,084	86,657,994
Voting shares	157,090,562	186,554,808
Total issued and outstanding shares	**273,076,646**	**273,212,802**
Class A variable voting and Class B voting shares potentially issuable		
Stock options	6,121,252	8,985,958
Total shares potentially issuable	**6,121,252**	**8,985,958**
Total outstanding and potentially issuable shares	**279,197,898**	**282,198,760**

Issuer bid

In May 2017, Air Canada received approval from the Toronto Stock Exchange ("TSX") for the renewal of its normal course issuer bid for its Class A variable voting shares and Class B voting shares (collectively the "Shares"), authorizing, between May 31, 2017 and May 30, 2018, the purchase of up to 22,364,183 Shares, representing 10% of the public float as at May 17, 2017. The renewal followed the conclusion of the 2016 normal course issuer bid which expired on May 29, 2017.

In 2017, Air Canada purchased, for cancellation, 4,042,818 Shares at an average cost of $17.49 per Share for aggregate consideration of $71 million. The excess of the cost over the average book value of $59 million was charged to retained earnings. At December 31, 2017, a total of 20,718,565 Shares remain available for repurchase under the existing issuer bid.

10. 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)	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2017 Q3	2017 Q4
Passenger	$ 2,864	$ 3,143	$ 4,106	$ 3,035	$ 3,095	$ 3,517	$ 4,478	$ 3,381
Cargo	116	111	130	155	134	154	179	183
Other	363	204	215	235	413	239	223	256
Operating revenues	**3,343**	**3,458**	**4,451**	**3,425**	**3,642**	**3,910**	**4,880**	**3,820**
Aircraft fuel	446	527	708	598	659	701	832	735
Regional airlines expense								
Aircraft fuel	64	77	96	90	95	96	109	112
Other	505	501	543	532	537	552	553	563
Wages, salaries & benefits	608	611	658	633	644	663	690	674
Airport and navigation fees	198	211	247	203	210	230	264	201
Aircraft maintenance	221	243	230	200	228	226	241	243
Depreciation, amortization and impairment	182	202	220	212	228	242	241	245
Sales and distribution costs	182	170	179	172	205	199	204	169
Ground package costs	231	85	72	101	256	103	73	106
Aircraft rent	112	112	118	120	122	130	125	126
Food, beverages and supplies	77	86	104	82	85	97	112	89
Communications and information technology	67	59	56	60	71	58	63	62
Special items	-	-	-	91	30	-	-	-
Other	296	297	324	313	326	332	369	362
Operating expenses	**3,189**	**3,181**	**3,555**	**3,407**	**3,696**	**3,629**	**3,876**	**3,687**
Operating income (loss)	**154**	**277**	**896**	**18**	**(54)**	**281**	**1,004**	**133**
Foreign exchange gain (loss)	50	(17)	(42)	(29)	70	68	44	(62)
Interest income	10	13	12	13	12	14	16	18
Interest expense	(96)	(98)	(97)	(83)	(79)	(80)	(73)	(79)
Interest capitalized	23	15	12	8	9	9	9	9
Net financing expense relating to employee benefits	(18)	(17)	(17)	(24)	(16)	(16)	(15)	(18)
Gain (loss) on financial instruments recorded at fair value	(10)	(1)	6	9	-	7	17	(1)
Gain on sale and leaseback of assets	-	19	-	-	26	26	-	-
Gain (loss) on debt settlements and modifications	(6)	(1)	-	(82)	-	-	(3)	24
Other	(6)	(4)	(2)	(8)	(5)	(6)	(6)	(4)
Total non-operating income (expense)	**(53)**	**(91)**	**(128)**	**(196)**	**17**	**22**	**(11)**	**(113)**
Income (loss) before income taxes	$ 101	$ 186	$ 768	$ (178)	$ (37)	$ 303	$ 993	$ 20
Recovery of (provision for) income taxes	-	-	-	(1)	-	(3)	774	(12)
Net income (loss)	**$ 101**	**$ 186**	**$ 768**	**$ (179)**	**$ (37)**	**$ 300**	**$ 1,767**	**$ 8**
Diluted earnings (loss) per share	**$ 0.35**	**$ 0.66**	**$ 2.74**	**$ (0.66)**	**$ (0.14)**	**$ 1.08**	**$ 6.37**	**$ 0.02**
EBITDAR (1)	**$ 460**	**$ 605**	**$ 1,248**	**$ 455**	**$ 342**	**$ 670**	**$ 1,388**	**$ 521**
Adjusted pre-tax income (loss) (1)	**$ 85**	**$ 203**	**$ 821**	**$ 39**	**$ (87)**	**$ 218**	**$ 950**	**$ 77**
Adjusted net income (loss) (1) (2)	**$ 85**	**$ 203**	**$ 821**	**$ 38**	**$ (87)**	**$ 218**	**$ 950**	**$ 61**
Adjusted earnings (loss) per share – diluted (1)	**$ 0.30**	**$ 0.72**	**$ 2.93**	**$ 0.14**	**$ (0.32)**	**$ 0.78**	**$ 3.43**	**$ 0.22**

(1) EBITDAR, adjusted pre-tax income (loss), adjusted net income (loss) and adjusted earnings (loss) per share – diluted are non-GAAP financial measures. Reconciliations of these measures to comparable GAAP measures can be found in "Non-GAAP Financial Measures" of this MD&A and in Air Canada's MD&A reports, available at aircanada.com.

(2) In the first nine months of 2017, Air Canada recorded a tax recovery of $790 million, which was revised to $771 million with $19 million reclassified directly to retained earnings in the fourth quarter of 2017. This tax recovery is excluded from adjusted net income as it reflects a one-time recognition of previously unrecognized income tax assets.

The following table provides a breakdown of the most significant items included in regional airlines expense for the last eight quarters.

(Canadian dollars in millions, except where indicated)	**2016**				**2017**			
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Capacity purchase fees	$ 293	$ 289	$ 313	$ 304	$ 308	$ 314	$ 315	330
Aircraft fuel	64	77	96	90	95	96	109	112
Airport and navigation	68	71	79	72	69	73	80	71
Sales and distribution costs	35	35	36	36	37	40	34	35
Aircraft rent	7	8	8	8	10	10	10	10
Depreciation, amortization and impairment	5	6	6	6	6	7	8	7
Other operating expenses	97	92	101	106	107	108	106	110
Total regional airlines expense	**$ 569**	**$ 578**	**$ 639**	**$ 622**	**$ 632**	**$ 648**	**$ 662**	**675**

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

System	**2016**				**2017**			
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Passenger PRASM (cents)	14.1	13.8	14.2	13.5	13.2	13.6	14.2	13.7
CASM (cents)	16.1	14.2	12.5	15.4	16.1	14.3	12.5	15.2
Adjusted CASM (cents) (1)	12.3	11.2	9.4	11.4	11.6	10.8	9.2	11.3
Fuel cost per litre (cents) (2)	48.1	52.2	55.2	59.4	63.2	61.3	59.4	67.5

(1) Adjusted CASM is a non-GAAP financial measure. A reconciliation of this measure to a comparable GAAP measure can be found in "Non-GAAP Financial Measures" of this MD&A and in Air Canada's MD&A reports, available at aircanada.com.

(2) Includes aircraft fuel expense related to regional airline operations. Includes fuel handling expenses.

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

	2016				2017			
System	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
RPMs (millions)	16,092	18,418	24,328	17,643	18,341	20,928	26,472	19,396
ASMs (millions)	19,833	22,344	28,458	22,091	22,894	25,357	31,050	24,191
Passenger load factor (%)	81.1%	82.4%	85.5%	79.9%	80.1%	82.5%	85.3%	80.2%
Domestic								
RPMs (millions)	3,960	4,717	6,068	4,534	4,101	4,875	6,130	4,607
ASMs (millions)	4,952	5,678	7,066	5,510	5,108	5,837	7,173	5,584
Passenger load factor (%)	80.0%	83.1%	85.9%	82.3%	80.3%	83.5%	85.4%	82.5%
U.S. Transborder								
RPMs (millions)	3,376	3,107	3,613	3,182	3,782	3,609	3,951	3,408
ASMs (millions)	4,278	3,799	4,223	3,985	4,687	4,376	4,683	4,252
Passenger load factor (%)	78.9%	81.8%	85.6%	79.9%	80.7%	82.5%	84.4%	80.1%
Atlantic								
RPMs (millions)	3,401	5,394	8,270	4,437	3,891	6,131	9,406	5,076
ASMs (millions)	4,383	6,805	9,785	5,778	5,248	7,661	11,087	6,582
Passenger load factor (%)	77.6%	79.3%	84.5%	76.8%	74.1%	80.0%	84.8%	77.1%
Pacific								
RPMs (millions)	3,218	3,902	5,002	3,959	3,943	4,671	5,471	4,501
ASMs (millions)	3,732	4,496	5,821	4,977	4,862	5,540	6,412	5,586
Passenger load factor (%)	86.2%	86.8%	85.9%	79.6%	81.1%	84.5%	85.3%	80.6%
Other								
RPMs (millions)	2,137	1,298	1,375	1,531	2,624	1,642	1,514	1,804
ASMs (millions)	2,488	1,566	1,563	1,841	2,989	1,943	1,695	2,187
Passenger load factor (%)	85.8%	82.9%	87.9%	83.1%	87.8%	84.5%	89.3%	82.5%

11. SELECTED ANNUAL INFORMATION

The following table provides selected annual information for Air Canada for the years 2015 through 2017.

	Full Year		
(Canadian dollars in millions, except per share figures)	**2017**	**2016**	**2015**
Operating revenues	$ 16,252	$ 14,677	$ 13,868
Operating expenses (1)	14,888	13,332	12,372
Operating income	**1,364**	**1,345**	**1,496**
Income before income taxes	1,279	877	308
Recovery of (provision for) income taxes (2)	759	(1)	-
Net income	**2,038**	**876**	**308**
EBITDAR (3)	**$ 2,921**	**$ 2,768**	**$ 2,542**
Adjusted pre-tax income (3)	**$ 1,158**	**$ 1,148**	**$ 1,222**
Adjusted net income (3)	**$ 1,142**	**$ 1,147**	**$ 1,222**
Basic earnings per share	**$ 7.48**	**$ 3.16**	**$ 1.06**
Diluted earnings per share	**$ 7.34**	**$ 3.10**	**$ 1.03**
Adjusted earnings per share – diluted (3)	**$ 4.11**	**$ 4.06**	**$ 4.18**
Cash, cash equivalents and short-term investments	**$ 3,804**	**$ 2,979**	**$ 2,672**
Total assets (4)	**$ 17,698**	**$ 15,114**	**$ 13,127**
Total long-term liabilities (5)	**$ 9,930**	**$ 10,178**	**$ 9,782**
Total liabilities	**$ 14,319**	**$ 13,895**	**$ 13,087**

(1) *In 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations. In 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan. In 2015, Air Canada recorded special items which increased operating expenses by $8 million. These special items included one-time payments totaling $26 million related to Air Canada's contract on collective agreement terms with CUPE; one-time payments totaling $36 million related to Air Canada's contract on collective agreement terms with the IAMAW; a $30 million recovery related to cargo investigations which was previously paid; and favourable tax-related provision adjustments of $23 million.*

(2) *In 2017, Air Canada recorded a net income tax recovery of $759 million, representing a one-time recognition of previously unrecognized income tax assets of $787 million in the third quarter of 2017, a tax provision of $12 million recorded based on fourth quarter of 2017 results and a current income tax expense of $16 million.*

(3) *EBITDAR, adjusted pre-tax income, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.*

(4) *In 2017, Air Canada recorded a deferred income tax asset of $472 million. Refer to section 13 "Critical Accounting Estimates and Judgments" of this MD&A for additional information.*

(5) *Total long-term liabilities include long-term debt (including current portion) and finance leases, pension and other benefit liabilities, maintenance provisions and other long-term liabilities.*

12. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

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

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

	Fourth Quarter		Full Year	
(Canadian dollars in millions)	**2017**	**2016**	**2017**	**2016**
Share forward contracts	$ -	$ 9	$ 26	$ 9
Fuel derivatives	(1)	-	(3)	-
Prepayment options on senior secured notes	-	-	-	(5)
Financial instruments recorded at fair value	**$ (1)**	**$ 9**	**$ 23**	**$ 4**

Risk management

Under its risk management policy, Air Canada manages its fuel price risk, foreign exchange risk and interest rate risk through the use of various financial derivative instruments. Air Canada uses these instruments solely for risk management purposes and not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be an economic hedge and offset by changes in cash flows of the relevant risk being hedged.

The fair values of derivative instruments represent the amount of the consideration that could be exchanged in an arm's length transaction between willing parties who are under no compulsion to act. The fair value of these derivatives is determined using prices in active markets, where available. When no such market is available, valuation techniques such as discounted cash flow analysis are applied. The valuation techniques incorporate all factors that would be considered in setting a price, including Air Canada's and the counterparty's respective credit risk.

Fuel price risk management

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

In 2017:

- Hedging gains on the settlement of fuel derivatives amounted to $26 million with associated premium costs of $28 million, for a net hedging loss of $2 million which was reclassified from other comprehensive income to aircraft fuel expense (net fuel hedging loss of $23 million was reclassified from other comprehensive income to aircraft fuel expense in 2016).

- Air Canada purchased crude-oil call options covering a portion of its 2017 fuel exposure. The cash premium related to these contracts was $18 million ($34 million in 2016 for 2016 and 2017 exposures).

- Fuel derivative contracts cash settled with a fair value of $26 million in favour of Air Canada ($23 million in favour of Air Canada in 2016).

As at December 31, 2017, there are no outstanding fuel derivatives. The fair value of the fuel derivatives portfolio was $14 million in favour of Air Canada as at December 31, 2016 and recorded within Prepaid expenses and other current assets on Air Canada's consolidated statement of financial condition.

Foreign exchange risk management

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

Air Canada generates certain sales in U.S. dollars and in other foreign currencies which are converted to U.S. dollars under Air Canada's risk management program. In 2017, these net operating cash inflows totaled approximately US$3.6 billion. Also in 2017, U.S. denominated operating costs amounted to approximately US$5.4 billion. Non-operating cash outflows in U.S. dollars, primarily related to interest payments on U.S. dollar denominated debt and net financing outflows amounted to approximately US$1.6 billion. For 2017, this resulted in a U.S. dollar net cash flow exposure of approximately US$3.4 billion. Air Canada has a target coverage of 70% on a rolling 18-month basis to manage the net U.S. dollar cash flow exposure described above utilizing the following risk management strategies:

Air Canada holds U.S. cash reserves as an economic hedge against changes in the value of the U.S. dollar. As at December 31, 2017, U.S. dollar cash and short-term investment balances amounted to $686 million (US$542 million) ($560 million (US$416 million) as at December 31, 2016). A portion of the cash and investment reserves are an economic hedge against long-term U.S. dollar debt while the remainder of the cash is operational cash and investment reserves which are applied against the rolling 18-month net U.S. dollar cash flow exposure. In 2017, a loss of $58 million (loss of $25 million in 2016) was recorded in foreign exchange gain (loss) on Air Canada's consolidated statement of operations reflecting the change in Canadian equivalent market value of the U.S. dollar cash and short-term investment balances held.

The level of foreign exchange derivatives entered into and their related maturity dates are dependent upon a number of factors, including the amount of foreign revenue conversion available, U.S. dollar net cash outflows, as well as the amount attributed to aircraft and debt payments. Based on the notional amount of currency derivatives outstanding at December 31, 2017, as further described below, approximately 74% of net U.S. cash outflows are hedged for 2018 and 38% for 2019, resulting in derivative coverage of 64% over the next 18 months. Operational U.S. dollar cash and investment reserves combined with derivative coverage results in a coverage of 69%.

As at December 31, 2017, Air Canada had outstanding foreign currency options and swap agreements, settling in 2018 and 2019, to purchase at maturity $3,400 million (US$2,704 million) of U.S. dollars at a weighted average rate of $1.2703 per US$1.00 (2016 – $2,612 million (US$1,946 million) with settlements in 2017 and 2018 at a weighted average rate of $1.2898 per $1.00 U.S. dollar). Air Canada also has protection in place to sell a portion of its excess Euros, Sterling, Yen, Yuan and AUD (EUR €101 million, GBP £105 million, JPY ¥8,623 million, CNY ¥41 million, and AUD $32 million) which settle in 2017 at weighted average rates of €1.1664, £1.3259, ¥0.0090, ¥0.1468 and $0.7576 per $1.00 U.S. dollar, respectively (2016 – EUR €82 million, GBP £69 million, JPY ¥2,334 million, CNY ¥53 million, and AUD $33 million with settlement in 2017 at weighted average rates of €1.1059, £1.2589, ¥0.0096, ¥0.1522 and $0.7500 respectively per $1.00 U.S. dollar).

The hedging structures put in place have various option pricing features, such as knock-out terms and profit cap limitations, and, based on the assumed volatility used in the fair value calculation, the net fair value of these foreign currency contracts as at December 31, 2017 was $215 million in favour of the counterparties (2016 – $5 million in favour of Air Canada). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During 2017, a loss of $274 million was recorded in Foreign exchange gain (loss) related to these derivatives (2016 – $136 million loss). In 2017, foreign exchange derivative contracts cash settled with a net fair value of $55 million in favour of the counterparties ($51 million in 2016 in favour of Air Canada). The total combined loss, related to U.S. cash, investments and foreign exchange derivatives recorded by Air Canada in 2017 was $332 million ($160 million loss in 2016).

Interest rate risk management

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

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

The ratio of fixed to floating rate obligations outstanding is designed to maintain flexibility in Air Canada's capital structure and is based upon a long-term objective of 60% fixed and 40% floating but allows the flexibility to adjust to prevailing market conditions. The ratio at December 31, 2017, was 73% fixed and 27% floating (76% and 24%, respectively, as at December 31, 2016).

13. CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS

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

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

Employee future benefits

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

Assumptions

Management is required to make significant estimates about actuarial and financial assumptions to determine the cost and related liabilities of Air Canada's employee future benefits.

Financial Assumptions

Discount Rate

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

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

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

	Pension Benefits		Other Employee Future Benefits	
	2017	2016	2017	2016
Discount rate used to determine:				
Net interest on the net benefit obligation for the year ended December 31	3.9%	4.1%	3.9%	4.1%
Service cost for the year end December 31	4.1%	4.3%	4.1%	4.3%
Accrued benefit obligation as at December 31	3.6%	3.9%	3.6%	3.9%
Rate of future increases in compensation used to determine:				
Accrued benefit cost for the year ended December 31	2.5%	2.5%	not applicable	not applicable
Accrued benefit obligation as at December 31	2.5%	2.5%	not applicable	not applicable

Sensitivity analysis

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

Sensitivity analysis on 2017 pension expense and net financing expense relating to pension benefit liabilities, based on different actuarial assumptions with respect to discount rate is set out below. The effects on each pension plan of a change in an assumption are weighted proportionately to the total plan obligation to determine the total impact for each assumption presented.

	0.25 Percentage Point	
(Canadian dollars in millions)	Decrease	Increase
Discount rate on obligation assumption		
Pension expense	$ 19	$ (18)
Net financing expense relating to pension benefit liabilities	23	(17)
Total	**$ 42**	**$ (35)**
Increase (decrease) in pension obligation	**$ 723**	**$ (699)**

The increase (decrease) in the pension obligation for a 0.25 percentage point change in the discount rate relates to the gross amount of the pension liabilities and is before the impact of any change in plan assets. As at December 31, 2017, approximately 75% of Air Canada's pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk.

An increase of one-year life expectancy would increase the pension benefit obligation by $492 million.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 5.8% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2017 (2016 – 5.8%). The rate is assumed to decrease gradually to 5% by 2020 (2016 – assumed to decrease gradually to 5% by 2020). A one percentage point increase in assumed health care trend rates would have increased the total of current service and interest costs by $5 million and the obligation by $64 million. A one percentage point decrease in assumed health care trend rates would have decreased the total of current service and interest costs by $4 million and the obligation by $65 million.

A 0.25 percentage point decrease in discount rate for other employee future benefits would have increased the total of current and interest costs by less than $1 million and the obligation by $55 million. A 0.25 percentage point increase in discount rate would have decreased the total of current and interest costs by less than $1 million and the obligation by $44 million.

Depreciation and amortization period for long-lived assets

Air Canada makes estimates about the expected useful lives of long-lived assets and the expected residual value of the assets based on the estimated current and future fair values of the assets, Air Canada's fleet plans and the cash flows they generate. Changes to these estimates, which can be significant, could be caused by a variety of factors, including changes to maintenance programs, changes in jet fuel prices and other operating costs, changes in utilization of the aircraft, and changing market prices for new and used aircraft of the same or similar types. Estimates and assumptions are evaluated at least annually. Generally, these adjustments are accounted for on a prospective basis, through depreciation and amortization expense. For the purposes of sensitivity analysis on these estimates, a 50% reduction to residual values on aircraft with remaining useful lives greater than five years results in an increase of $13 million to annual depreciation expense. For aircraft with shorter remaining useful lives, the residual values are not expected to change significantly.

Impairment considerations of long-lived assets

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

Maintenance provisions

The recording of maintenance provisions related to return conditions on aircraft leases requires management to make estimates of the future costs associated with the maintenance events required under the lease return condition and estimates of the expected future maintenance condition of the aircraft at the time of lease expiry. These estimates take into account current costs of these maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in maintenance expense in the period. The effect of any changes in estimates, including changes in discount rates, inflation assumptions, cost estimates or lease expiries, is also recognized in maintenance expense in the period. Assuming the aggregate cost for return conditions increases by 5%, holding all other factors constant, there would be a cumulative balance sheet adjustment to increase the provision by $52 million at December 31, 2017 and an increase to maintenance expense in 2018 of approximately $7 million. Expected future cash flows to settle the obligation are discounted. If the discount rates were to increase by 1%, holding all other factors constant, there would be a cumulative balance sheet adjustment to decrease the provision by $16 million at December 31, 2017. An equivalent but opposite movement in the discount rate would result in a similar impact in the opposite direction.

Income taxes

Deferred income tax assets are recognized only to the extent that it is probable that future taxable income will be available to realize them. In making this assessment, consideration is given to available positive and negative evidence and relevant assumptions, including historical financial results, and expectations relating to future taxable income, the overall business environment, and industry-wide trends.

In 2017, Air Canada determined that it was probable that substantially all of the unrecorded deferred income tax assets, which include non-capital losses, would be realized. Accordingly, a tax recovery of $759 million was recorded, representing the initial recognition of previously unrecognized tax assets of $787 million in the third quarter of 2017. Air Canada also recorded a deferred tax provision of $12 million in the fourth quarter and a current income tax expense of $16 million for the year.

Income tax recorded in Air Canada's consolidated statement of operations is presented below.

	Fourth Quarter		Full Year	
(Canadian dollars in millions)	**2017**	**2016**	**2017**	**2016**
Current income tax expense	$ -	$ 1	$ 16	$ 1
Deferred income tax expense (recovery)	12	-	(775)	-
Income tax expense (recovery)	**$ 12**	**$ 1**	**$ (759)**	**$ 1**

14. ACCOUNTING POLICIES

Accounting standard issued but not yet adopted

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

IFRS 15 – Revenue from contracts with customers

IFRS 15 replaces IAS 18 Revenue and related interpretations. The core principle of the new standard is to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new standard is intended to enhance disclosures about revenue, provide more comprehensive guidance for transactions that were not previously addressed and improve guidance for multiple-element arrangements. IFRS 15 is effective for annual periods beginning on January 1, 2018, with early adoption permitted.

Air Canada is applying the standard effective January 1, 2018. The standard will be applied retrospectively with adjustment to the opening consolidated statement of financial position as at January 1, 2017. Under IFRS 15, incremental costs of obtaining passenger revenues, such as credit card fees and global distribution system charges, will be capitalized at time of sale and expensed at the time of passenger revenue recognition. Currently, these costs are expensed as incurred at the time the flight ticket is sold. With this change in accounting policy for contract costs, the timing of expense recognition will be impacted.

The anticipated impact on Air Canada's consolidated statement of financial position as at January 1, 2017 is an increase to prepaid expenses and other current assets of $58 million and an equivalent increase to opening retained earnings. In addition, deferred commission costs in the amount of $40 million as at December 31, 2016, currently recorded net against the advance ticket sales liability, will be reclassified to prepaid expenses and other current assets. The amount of deferred contract cost asset will fluctuate on a quarterly basis in line with changes in the advance ticket sales liability. The anticipated impact on the consolidated statement of financial position as at December 31, 2017 is an increase to prepaid expenses and other current assets of $64 million and an equivalent increase to opening retained earnings.

In addition, certain passenger and cargo related fees and surcharges will be reclassified from other to passenger revenue and to cargo revenue on Air Canada's consolidated statement of operations. Based on Air Canada's full year 2017 results, the amount expected to be reclassified on the adoption of IFRS 15 is $122 million to passenger revenue and $58 million to cargo revenue. This reclassification will not have an impact on total operating revenues.

No other material impacts on Air Canada's financial statements were identified from the adoption of IFRS 15.

IFRS 16 – Leases

IFRS 16 replaces IAS 17 Leases and related interpretations. The core principle is that a lessee recognize assets and liabilities for all leases with a lease term of more than 12 months. A lessee is required to recognize a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments. Assets and liabilities arising from a lease are initially measured on a present value basis. The measurement includes non-cancellable lease payments (including inflation-linked payments), and also includes payments to be made in optional periods if the lessee is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease. The new standard is intended to provide an improved representation of leasing transactions, in particular those that do not currently require the lessees to recognize an asset and liability arising from an operating lease. IFRS 16 is effective for annual periods beginning on January 1, 2019, with early adoption permitted for entities that would also apply IFRS 15 Revenue from Contracts with Customers. The Corporation has the option of adopting a full retrospective approach or a modified retrospective approach on transition to IFRS 16.

Air Canada is evaluating the impact the adoption of this standard will have on its consolidated financial statements but expects this standard will have a significant impact on its consolidated balance sheet, along with a change to the recognition, measurement and presentation of lease expenses in the consolidated statement of operations. Air Canada has identified that, under IFRS 16, it has a lease in respect of aircraft used by CPA carriers providing services under the respective capacity purchase agreements, and Air Canada expects to record such aircraft as right of use assets and lease liabilities of Air Canada in accordance with the requirements of the new standard.

Air Canada will apply the standard effective January 1, 2019 and has not yet determined which method of transition to apply.

15. OFF-BALANCE SHEET ARRANGEMENTS

Guarantees

<u>Guarantees in Fuel Facilities Arrangements</u>

Air Canada participates in fuel facility arrangements operated through eight Fuel Facility Corporations, and three aircraft de-icing service facilities, along with other airlines that contract for fuel and de-icing services at various major airports in Canada. These entities operate on a cost recovery basis. The aggregate debt of these entities that has not been consolidated by Air Canada under IFRS 10 Consolidated Financial Statements is approximately $529 million as at December 31, 2017 (December 31, 2016 - $487 million), which is Air Canada's maximum exposure to loss before taking into consideration the value of the assets that secure the obligations and any cost sharing that would occur amongst the other contracting airlines. Air Canada views this loss potential as remote. Each contracting airline participating in these entities shares pro rata, based on system usage, in the guarantee of this debt. The maturities of these debt arrangements vary but generally extend beyond five years.

Indemnification Agreements

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

Air Canada expects that it would be covered by insurance for most tort liabilities and certain related contractual indemnities.

16. RELATED PARTY TRANSACTIONS

At December 31, 2017, Air Canada had no transactions with related parties as defined in the CPA Handbook, except those pertaining to transactions with key management personnel in the ordinary course of their employment or directorship agreements.

17. SENSITIVITY OF RESULTS

Air Canada's financial results are subject to many different internal and external factors which can have a significant impact on operating results. The following table describes, on an indicative basis, the financial impact that changes in fuel prices and the value of the Canadian dollar would generally have had on Air Canada's past operating results. An equivalent but opposite movement of the sensitivity factor in the table below would have generally resulted in a similar but opposite impact. These guidelines were derived from 2017 levels of activity and make use of management estimates. The impacts are not additive, do not reflect the interdependent relationship of the elements and may not be indicative of future trends or results which may vary significantly due to a wide range of factors many of which are beyond the control of Air Canada.

Key Variable (Canadian dollars in millions)	2017 Measure	Sensitivity Factor	Favourable/ (Unfavourable) Estimated Operating Income Impact	
Fuel				
Fuel – Jet fuel price (US$/barrel) (1)	71.4	US$1/barrel increase	$	(43)
Fuel – Jet fuel price (CAD cents/litre) (1)	62.6	1% increase	$	(31)

Key Variable (Canadian dollars in millions)	2017 Measure	Sensitivity Factor	Favourable/ (Unfavourable) Estimated Pre-Tax Income Impact	
Currency Exchange				
C$ to US$	C$1 = US$1.25	1 cent increase (i.e. $1.25 to $1.24 per US$)		
		Operating income (2)	$	18
		Net interest expense	$	2
		Revaluation of long-term debt, U.S. dollar cash and short-term investments and other long-term monetary items, net	$	45
		Remeasurement of outstanding currency derivatives	$	(27)
		Pre-tax Income Impact	$	38

(1) Excludes the impact of fuel surcharges and fuel hedging. Refer to section 12 "Financial Instruments and Risk Management" of this MD&A for information on Air Canada's fuel derivative instruments.

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

18. RISK FACTORS

The risks described below should be read carefully when evaluating Air Canada's business and the forward-looking statements contained in this report and other statements Air Canada may make from time to time. Any of these risks could materially and adversely affect Air Canada's business, operating results, financial condition and the outcome of matters as to which forward-looking statements are made. In addition, these risks may not be the only risks faced by Air Canada. Other risks of which Air Canada is not aware or which Air Canada currently deems not to be material may surface and have a material and adverse impact on Air Canada, its business, results from operations, financial condition and the outcome of matters as to which forward-looking statements are made.

Risks relating to Air Canada

Operating results - Air Canada may sustain significant losses and not be able to successfully achieve and/or sustain positive net profitability or realize the objectives of any or all of its initiatives

A variety of factors, including economic conditions and other factors described in this "Risk Factors" section, may result in Air Canada incurring significant losses (as has incurred in the past). Despite ongoing strategic and business initiatives, Air Canada may not be able to successfully achieve and/or sustain positive net profitability or realize the objectives of any or all of its initiatives, including those which seek to increase revenues, decrease costs, improve margins, profitably deploy additional capacity, generate sufficient returns on its capital expenditures (including those related to the additional capacity) or offset or mitigate risks facing Air Canada, including those described in this "Risk Factors" section.

Economic and geopolitical conditions - Changes in economic and geopolitical conditions could have a material adverse effect on Air Canada, its business, results from operations and financial condition

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

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

Fuel costs - Significant fluctuations or increases in fuel prices could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Fuel costs constitute one of Air Canada's largest operating cost items. Fuel prices have and may continue to fluctuate widely depending on many factors, including international market conditions, geopolitical events, jet fuel refining costs and the Canada/U.S. dollar exchange rate. Air Canada cannot accurately predict fuel prices. Due to the competitive nature of the airline industry, Air Canada may not be able to pass on increases in fuel prices to its customers by increasing its fares. In addition, Air Canada may be unable to appropriately or sufficiently, or may not, hedge the risks associated with fluctuations in fuel prices. Furthermore, the impact of lower jet fuel prices could be offset by increased price competition, and a resulting decrease in revenues, for all air carriers. Significant fluctuations (including increases) in fuel prices could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Foreign exchange - A significant deterioration of the Canadian dollar relative to the U.S. dollar could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada's financial results are sensitive to the fluctuating value of the Canadian dollar. In particular, Air Canada has a significant annual net outflow of U.S. dollars and is affected by fluctuations in the U.S./Canadian dollar exchange rate. Air Canada incurs significant expenses in U.S. dollars for items such as fuel, aircraft maintenance, airport charges, ground package costs, sales and distribution costs, interest and debt servicing payments, while a substantial portion of its revenues are generated in Canadian dollars. Due to the competitive nature of the airline industry and customer sensitivity to travel costs, Air Canada may not be able to pass on increases in foreign exchange costs to its customers by increasing its fares. In addition, Air Canada may be unable to appropriately or sufficiently hedge the risks associated with fluctuations in exchange rates. A significant deterioration of the Canadian dollar relative to the U.S. dollar or other foreign currencies would increase the costs of Air Canada relative to its U.S. or other foreign competitors. Any of these factors could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Competition - Air Canada operates in a highly competitive environment and faces increasing competition in North America and internationally

Air Canada operates within a highly competitive industry and continuously encounters substantial price competition. Carriers, including low-cost and ultra-low-cost carriers, have entered, announced their intention to enter or continue to enter or expand into the domestic (including regional), the U.S. transborder and international markets, as well as leisure-oriented markets in which Air Canada operates or plans to operate.

Carriers against which Air Canada competes, including U.S. carriers, may also undergo (and some have undergone) substantial reorganizations (including by way of merger with or acquisition by another carrier), creating reduced levels of indebtedness, lower operating costs and other competitive advantages, and may therefore be able to more effectively compete against Air Canada. Consolidation within the airline industry and carriers increasingly entering into integrated commercial cooperation arrangements, such as joint ventures, which may be able to compete more effectively, could result in increased competition.

The proximity of several American airports in cities close to the Canadian border (such as Plattsburgh, Buffalo and Bellingham) has also presented an additional challenge for Air Canada. Higher taxes, charges and fees for passengers departing from Canada has redirected appreciable passenger traffic away from Canadian airports to airports in the United States. Lower cost carriers based in the United States have and may continue to increase their capacity at these airports and attract Canadian-originating, price-sensitive customers.

Given Canada's diverse and multicultural population, Canadian gateways such as Toronto, Montreal, and Vancouver are deemed attractive by international carriers. In 2017, foreign carriers such as Aer Lingus, Aero México, Air China, Azores Airlines, Beijing Capital Airlines, British Airways, Brussels Airlines, Cathay

Pacific Airways, China Eastern Airlines, China Southern Airlines, Condor Flugdienst, Edelweiss Air, Ethiopian Airlines, EVA Air, Hainan Airlines, Hong Kong Airlines, Icelandair, Korean, Interjet, LEVEL, LOT, Lufthansa, Philippines Airlines, Primera Air, Saudi Arabian Airlines, Sichuan Airlines, TAP Air Portugal, Tunisair, Ukraine International Airlines, WOW Air and Xiamen Airlines have entered or announced their intention to enter or expand their international operations into Canada.

The prevalence of Internet travel websites and other travel product distribution channels has also resulted in a substantial increase in discounted and promotional fares initiated by Air Canada's competitors. Competitors also continue to pursue commissions/incentive actions and, in many cases, increase these payments.

Air Canada's ability to reduce its fares in order to effectively compete is dependent on Air Canada's ability to achieve acceptable operating margins and may be limited by applicable laws or government policies to encourage competition. A decision by Air Canada to match competitors' fares or react to other competitive actions could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Increased competition, from existing, emerging or new competitors, including competitors entering into new or expanded joint ventures and other arrangements, or utilizing disruptive business models or technologies, and other competitive actions, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Dependence on technology - Air Canada relies heavily on technology to operate its business and any technology systems failure or data breach could have a material adverse effect on Air Canada, its business, results from operations and financial condition

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

As part of regular business operations, Air Canada collects, processes and stores sensitive data, including personal information of our passengers and employees and information of our business partners. The secure operation of the networks and systems on which this type of information is stored, processed and maintained is critical to our business.

Technology systems may be vulnerable to a variety of sources of failure, interruption or misuse, including by reason of human error, third party suppliers' acts or omissions, natural disasters, terrorist attacks, telecommunications failures, power failures, computer viruses, unauthorized or fraudulent users (including cyber-attacks or cyber intrusions, malware, ransomware, computer viruses and the like), and other operational and security issues.

It is generally viewed that cyber-attacks have and will continue to increase in both prevalence and sophistication. Air Canada invests in initiatives, including security initiatives and disaster recovery plans; however, these initiatives may not be successful or adequately address a highly dynamic and continually evolving threat landscape. Any technology systems failure, interruption or misuse, security breach or failure to comply with applicable data confidentiality, privacy, security or other related obligations, whether at Air Canada or a third party on whom Air Canada relies, could adversely affect Air Canada's reputation and expose Air Canada to litigation, claims for contract breach, fines, sanctions or otherwise materially and adversely affect Air Canada's operations, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Leverage - Air Canada has, and is expected to continue to incur, a significant amount of indebtedness, and there can be no assurance that it will be able to satisfy its debts, lease and other obligations

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

The ability of Air Canada to make scheduled payments under its indebtedness will depend on, among other things, its future operating performance and its ability to refinance its indebtedness, if necessary. In addition, as Air Canada incurs indebtedness which bears interest at floating interest rates, to the extent these interest rates increase, its interest expense will increase. Moreover, Air Canada incurs a significant proportion of its indebtedness in foreign currencies, primarily in U.S. dollars, and as a result, future debt servicing repayments are subject to foreign exchange risk and the Canadian equivalent amount of indebtedness may increase. There can be no assurance that Air Canada will at all times be able to generate sufficient cash from its operations to satisfy its debts, lease and other obligations. Each of these factors is, to a large extent, subject to economic, financial, competitive, regulatory, operational and other factors, many of which are beyond Air Canada's control.

Strategic, business, technology and other important initiatives - A delay or failure to identify and devise, invest in and implement certain important initiatives could have a material impact on Air Canada, its business, results from operations and financial condition

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

Airport user fees and air navigation fees – Increases in airport user fees and air navigation fees could have a material adverse effect on Air Canada, its business, results from operation and financial condition

Airport and air navigation authorities have or could significantly increase their fees. The Canadian government has also announced its intention to study airport privatization. Airport privatization may increase overall aviation costs and Air Canada may not be in a position to prevent or develop alternatives to overcome cost increases. Though certain authorities have implemented some fee reductions, if authorities in Canada or elsewhere were to significantly increase their fees, Air Canada, its business, results from operations and financial condition could be materially adversely affected.

High fixed costs and low margins – The airline industry is characterized by low profit margins and high fixed costs

The airline industry has historically been characterized by low profit margins and high fixed costs. The costs of operating a flight do not vary significantly with the number of passengers carried and, therefore, a relatively small change in the number of passengers, fare pricing or traffic mix could have a significant impact on Air Canada's operating and financial results. This condition may be exacerbated by aggressive pricing by competitors, which could have the effect of driving down fares in certain markets. Accordingly, a shortfall from expected revenue levels or profit margins could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Air Canada has sought an improved ability to weather downturns in its business; however, such efforts may not be successful. As a result of high fixed costs, should Air Canada be required to reduce its overall capacity or the number of flights operated, it may not be able to successfully reduce certain fixed costs within a timeframe required to overcome any downturns, and Air Canada may also be required to incur significant termination or other restructuring costs, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key supplies and suppliers - Air Canada's failure or inability to obtain certain goods and services from key suppliers on favourable terms could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and services of desirable quality, in a timely manner, including those available at airports or from airport authorities, or otherwise required for Air Canada's business or operations, such as fuel, aircraft and related parts, aircraft maintenance services, and information technology systems and services. In certain cases, Air Canada may only be able to access goods and services from a limited number of suppliers (or from sole source suppliers) and the transition to new or alternative suppliers, which may be necessitated by reason of such suppliers increasing their rates or by their failure to perform, may not be possible or may take a significant amount of time or require significant resources. A failure, refusal or inability of a supplier may arise as a result of a wide range of causes, many of which are beyond Air Canada's control. Any failure or inability of Air Canada to successfully source goods and services, or to source goods and services of desirable quality on terms and pricing and within the timeframes acceptable to Air Canada, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Aeroplan - Failure by Aeroplan to fulfill its obligations to Air Canada or other interruptions of Aeroplan services could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada and Aeroplan are parties to a Commercial Participation and Services Agreement ("CPSA"). Through the CPSA, Air Canada offers its customers who are Aeroplan members the opportunity to earn Aeroplan Miles, which management believes is a significant factor in many customers' decision to travel with Air Canada and contributes to building customer loyalty. Aeroplan's failure to adequately operate the Aeroplan program, or to fulfill its obligations under the CPSA, or interruptions or disruptions of Aeroplan services, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Air Canada has decided not to renew the CPSA and it is scheduled to expire in June 2020. Air Canada is seeking to implement a new loyalty program which involves significant investments as well as certain risks and uncertainties, including risks relating to attracting members, implementing the required information technology and loyalty management systems, successfully concluding strategic commercial arrangements, and transitioning Air Canada from the Aeroplan program to its new loyalty program. Though Air Canada believes it would be able to mitigate and overcome risks and successfully create and launch its new loyalty program, the transition from Aeroplan's program and the launch and operation of Air Canada's new loyalty program entail risks which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Need for additional capital and liquidity - Air Canada may not be able to obtain sufficient funds in a timely way and on acceptable terms to provide adequate liquidity and to finance necessary operating and capital expenditures

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

A major decline in the market price of Air Canada's securities may negatively impact Air Canada's ability to raise capital, issue debt, retain employees, make strategic acquisitions or enter into joint arrangements. Differences between Air Canada's actual or anticipated financial results and the published expectations of financial analysts, as well as events affecting our business or operating environment, may contribute to volatility in Air Canada's securities. A major decline in the capital markets in general, or an adjustment in the market price or trading volumes of Air Canada's securities, may negatively affect our ability to raise capital, issue debt, retain senior executives and other key employees, make strategic acquisitions or enter into business arrangements.

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

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

Regional carriers - The failure by regional carriers to fulfill their obligations to Air Canada could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada seeks to enhance its network through capacity purchase agreements with regional airlines such as Jazz, Sky Regional and other airlines operating flights on behalf of Air Canada. For example, under the Jazz CPA, Jazz provides Air Canada's customers service in lower-density markets and higher-density markets at off-peak times throughout Canada and to and from certain destinations in the United States and also provides valuable traffic feed to Air Canada's mainline and Air Canada Rouge routes. Pursuant to the terms of the Jazz CPA, Air Canada pays Jazz a number of fees, some of which are fixed and others which are determined based upon certain costs incurred by Jazz. Air Canada also reimburses Jazz for certain pass-through costs incurred by Jazz (or arranges to provide the related supplies to Jazz), such as fuel, navigation, landing and terminal fees. In addition, the Jazz CPA requires that Jazz maintain a minimum fleet size and contains a minimum average daily utilization guarantee which requires Air

Canada to utilize Jazz for that amount of flying. Significant increases in Jazz's costs, the failure by Jazz to adequately fulfill its obligations under the Jazz CPA, factors which may reduce the utilization of the Jazz fleet, including economic or market downturns, and unexpected interruptions or cessation of Jazz's services could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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

Labour costs and labour relations - Air Canada may not be able to maintain labour costs at appropriate levels or secure labour agreements which permit it to successfully pursue its strategic initiatives. There can be no assurance that collective bargaining agreements will be further renewed without labour conflicts and/or disruptions

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

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

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

Air Canada's brand – The failure to preserve or grow the value of Air Canada's brand could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada believes that its success is dependent on the value of its brand and on Air Canada's ability to preserve, grow and leverage that value. The Air Canada brand is recognized throughout the world, and Air Canada has received high ratings in external brand value studies, based in part on consumer perceptions on a variety of subjective qualities. Air Canada believes it has and continues to build an excellent reputation globally for the safety and quality of its services, and for the delivery of a consistently positive passenger experience. Any failure to preserve or grow Air Canada's brand value, including by reason of the conduct of Air Canada or any of its business partners or other external parties, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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

Air Canada maintains several defined benefit pension plans, including domestic registered pension plans, supplemental pension plans and international pension plans. Canadian federal pension legislation requires that the funded status of registered pension plans be determined periodically, on both a going concern basis (essentially assuming indefinite plan continuation) and a solvency basis (essentially assuming immediate plan termination).

Air Canada's pension funding obligations (including projected funding obligations) may vary significantly based on a wide variety of factors, including pension plan solvency valuations, regulatory developments, plan demographics, changes to plan provisions, assumptions and methods used and changes in economic conditions (mainly the return on fund assets and changes in interest rates) and other factors, as well as the application of normal past service contribution rules which would generally require one fifth of any solvency deficit in a domestic registered plan, determined on the basis of an average over the previous three years, to be funded each year. Actual contributions that are determined on the basis of future valuation reports filed annually may vary significantly from projections. In addition, current service contributions in respect of a domestic registered plan are required unless they are funded (if permitted subject to applicable plan rules and legislation) through a sufficient surplus in such plan. Deteriorating economic conditions or a prolonged period of low or decreasing interest rates may result in significant increases in Air Canada's funding obligations, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Underfunded pension plans or a failure or inability by Air Canada to make required cash contributions to its registered pension plans could have a material adverse effect on Air Canada, its business, results from operations and financial condition. See section 9.7 "Pension Funding Obligations" of this MD&A for additional information.

Limitations due to restrictive covenants - Covenants contained in agreements to which Air Canada is a party may affect and, in some cases, significantly limit or prohibit the manner in which Air Canada operates its business

Some of the financing and other major agreements to which Air Canada is a party contain, and in the future may contain, restrictive, financial (including in relation to asset valuations, liquidity, fixed charge coverage ratio) and other covenants which affect and, in some cases, significantly limit or prohibit, among other things, the manner in which Air Canada may structure or operate its business, including by reducing Air Canada's liquidity, limiting Air Canada's ability to incur indebtedness, create liens, sell assets, pay dividends, make capital expenditures, and engage in acquisitions, mergers or restructurings or a change of control. Although Air Canada has, in the last few years, been able to negotiate more favourable and less restrictive covenants, there can be no assurance that it will be able to continue to do so. Future financing and other significant agreements may be subject to similar or stricter covenants which limit Air Canada's operating and financial flexibility, which could materially and adversely affect Air Canada's ability to operate its business and its profitability.

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

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

Star Alliance - Departure of a key member from Star Alliance or the failure by a key member to meet its obligations could have a material adverse effect on Air Canada, its business, results from operations and financial condition

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

Interruptions or disruptions in service - Interruptions or disruptions in service could have a material adverse effect on Air Canada, its business, results from operations and financial condition

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

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

Current legal proceedings - Air Canada is involved in or may be subject to legal proceedings which could materially adversely impact Air Canada

Investigations by competition authorities relating to Air Canada Cargo

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

In 2010, the European Commission rendered a decision finding that 12 air cargo carriers (including groups of related carriers) had infringed European Union competition law in the setting of certain cargo charges and rates for various periods between 1999 and 2006. Air Canada was among the carriers subject to the decision and a fine of 21 million Euros (approximately $29 million) was imposed on Air Canada in 2010. Air Canada appealed the decision and the European General Court granted Air Canada's appeal in 2015 and annulled the decision of the European Union with regard to Air Canada and certain other airlines, following which the European Commission refunded Air Canada the fine of 21 million Euros ($30 million), which amount was recorded as a receivable as at December 31, 2015 and received in February 2016.

In March 2017, the Commission issued a new decision, based on the same allegations and imposed the same fine (21 million Euros; approximately $30 million) on Air Canada as it had in 2010. Air Canada recorded the charge as a special item in the first quarter of 2017 and paid the fine, as required, in the second quarter of 2017, pending an outcome of an appeal it made in 2017 to the European General Court. While Air Canada cannot predict with certainty the outcome of its appeal or any related proceedings, Air Canada believes it has reasonable grounds to challenge the European Commission's ruling.

As at December 31, 2017, Air Canada has a provision of $17 million ($17 million as at December 31, 2016) relating to outstanding claims in these matters, which is recorded in Accounts payable and accrued liabilities. This provision is an estimate based upon the status of investigations and proceedings at this time and Air Canada's assessment as to the potential outcome for certain of them. The provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Air Canada has determined it is not possible at this time to predict with any degree of certainty the outcome of all remaining proceedings and investigations. Based on the outcome of any developments regarding proceedings and investigations, Air Canada may adjust the provision in its results for subsequent periods as required.

Mandatory retirement

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

Future legal proceedings

In the course of conducting their business, airlines are subject to various claims and litigation (including class action claims), including with respect to its contractual arrangements and current or new laws and regulations. Any future claims or litigation could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key personnel - Air Canada is dependent on key employees and could be materially adversely affected by a shortfall or substantial turnover

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

Risks relating to the airline industry

Terrorist attacks and security measures - Terrorist attacks and related consequences could have a material adverse effect on Air Canada, its business, results from operations and financial condition

The potential for terrorist attacks and terrorist activity causes concern and uncertainty in the minds of the traveling public. The occurrence of a terrorist attack, an attempted attack or the perceived threat of one (whether or not involving Air Canada or another carrier, or involving Air Canada's destinations, or other destinations or regions), and restrictive security measures, such as those relating to the content of carry-on baggage, passenger identification document requirements, and passenger screening procedures, could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on Air Canada's flights. It could also lead to a substantial increase in insurance, security and other costs, including higher operating costs to avoid flying over airspace near conflict zones. Any resulting reduction in passenger revenues and/or increases in costs, including insurance, security or other costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Casualty losses - Air Canada's business makes it subject to large liability claims for serious personal injury or death arising out of accidents or disasters

Due to the nature of its core business, Air Canada may be subject to liability claims arising out of accidents or disasters involving aircraft on which Air Canada's customers are traveling or involving aircraft of other carriers maintained or otherwise serviced by Air Canada or through third parties providing services to Air Canada, including claims for serious personal injury or death. Any such accident or disaster may significantly harm Air Canada's reputation for safety, which would have a material adverse effect on Air Canada, its business, results from operations and financial condition. There can be no assurance that Air Canada's insurance coverage will be sufficient to cover one or more large claims and any shortfall may be material.

Accidents and disasters may occur despite all appropriate measures being taken, and as a result of a variety of factors beyond Air Canada's control including acts of terrorism and sabotage, severe weather, lighting strikes and other natural phenomenon, bird strikes as well as the increasing prevalence of unmanned aerial vehicles.

Regulatory matters - Air Canada is subject to extensive and evolving domestic and foreign regulation

The airline industry is subject to extensive legal, regulatory and administrative controls and oversight, including in relation to taxes, airport fees and operations, route rights, security, passenger and consumer rights, flight crew and other labour rules, advertising, privacy, data security, licensing, competition, pensions, environment (including noise levels and carbon emissions), foreign exchange controls and, in some measure, pricing.

Compliance with current or future Canadian and international laws, regulations and administrative requirements, including potentially inconsistent or conflicting laws or regulations, or laws or regulations which disproportionally apply to Canadian airlines or Air Canada specifically (such as the *Air Canada Public Participation Act)*, may impose significant costs, impediments and/or competitive disadvantages, and there cannot be any assurance that current or future laws, regulations and administrative requirements will not adversely affect Air Canada, its business, results from operations and financial condition.

The ability of Air Canada to operate flights or otherwise offer air services on international routes between airports in Canada and other countries may be subject to change. Applicable arrangements between Canada and foreign governments, which govern many areas including traffic rights, may be amended from time to time, rules and policies with respect to airport operations may be revised, and the availability of appropriate slots or facilities may change. Air Canada currently operates a number of flights on international routes under government arrangements, regulations or policies that designate the number of carriers permitted to operate on such routes, the capacity of the carriers providing services on such routes, the airports at which carriers may operate international flights, or the number of carriers allowed access to particular airports. Any further limitations, additions or modifications to such arrangements, regulations or policies could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Additionally, if Canada were to adopt a more liberalized approach in relation to air services arrangements with foreign countries, such an approach could have a material adverse impact on Air Canada, its business, results from operations and financial condition and could result in the impairment of material amounts of related tangible and intangible assets.

Air Canada's current and future plans to enter into or expand revenue-sharing joint ventures and other alliance arrangements on various international routes are and may be subject to receipt of approvals from applicable Canadian and international authorities, to their not challenging them, and to satisfying the necessary applicable regulatory requirements. There can be no assurance that such conditions will be met or will continue in effect or that existing, or changes in, regulatory requirements or standards can be satisfied.

Many aspects of Air Canada's operations may also be subject to the proliferation of increasingly stringent laws and regulations relating to environmental reforms, such as in the area of climate change, and including the following:

The International Civil Aviation Organization ("ICAO") global market-based measure ("GMBM"), adopted in 2016, includes emissions from international flights. The GMBM is set to be implemented in phases, with the first two phases (occurring from 2021 to 2023, and 2024 to 2026, respectively) to be voluntary and with the third phase (from 2027 to 2035) to be mandatory. Canada voluntarily adopted the first phase. On the basis of the GMBM, the European Parliament and Council has continued exempting flights between Europe and third countries from the European Union ("EU") emissions trading system ("ETS").

In 2016, the Canadian Federal Government proposed a pan-Canadian benchmark for carbon pricing to be implemented in all Canadian jurisdictions by 2018, with pricing to be based on greenhouse gas emissions from all fossil fuels sources including jet fuel and other fuels used by Air Canada in ground operations and stationary combustion equipment. Canadian provinces may either apply an explicit price-based system, such as a carbon tax or levy, or a cap and trade system. Certain provinces, such as Alberta, British Columbia, Ontario and Québec have implemented a carbon pricing system. As of 2017, Air Canada and regional carriers operating flights on behalf of Air Canada are subject to a carbon tax for flights operating in British Columbia and in Alberta.

Air Canada cannot predict whether, or the manner in which, these or other initiatives will ultimately be implemented or their impact on Air Canada; however, future developments in Canada and abroad could adversely impact Air Canada, including by increasing its costs. While Air Canada is continually focused on efficiency improvements, including carbon footprint reduction initiatives, the impact to Air Canada of climate change and other environmental initiatives may, in part, depend upon the extent to which the increased costs relating such initiatives, if any, could be recovered, including in the form of higher passenger fares and cargo rates.

Air Canada is also subject to domestic and foreign laws regarding privacy and security of passenger, employee and other data, including advance passenger information and access to airline reservation systems, which are not consistent in all countries which may assert jurisdiction over Air Canada, including in countries where Air Canada operates or conducts business. These laws and regulations are proliferating, are becoming increasingly stringent and may conflict with one another. The need to comply with these laws and regulatory regimes results in additional operating costs and complexities, and further regulation in this area or non-compliance, including in relation to data privacy and security requirements, could have a material adverse effect on Air Canada, its business (including by impacting Air Canada's goodwill and reputation), results from operations and financial condition.

Foreign jurisdictions (including the United States, European Union countries and other jurisdictions where Air Canada operates or conducts business) have enacted and implemented, and they and domestic regulators may in the future enact and implement, consumer protection and passenger rights measures which are being increasingly adopted, such as those in the proposed *Transportation Modernization Act* tabled by the Canadian Federal Government in 2017. Such measures may impose significant, unique, inconsistent or even conflicting obligations on Air Canada, which may result in increased liability and costs to Air Canada and which could adversely impact Air Canada, its business, results from operations and financial condition.

Epidemic diseases - Epidemic diseases could impact passenger demand for air travel

Outbreaks or the threat of outbreaks of viruses or other contagions or epidemic diseases, including influenza, SARS, Ebola, Zika, as well as any travel or other advisories relating to same, whether domestic or international or whether relating to Canadian cities or regions or other cities, regions or countries, could have a material adverse effect on demand for air travel and could result in a major negative impact on traffic on Air Canada's network. Any resulting reduction in traffic in the markets served by Air Canada could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Availability of insurance coverage and increased insurance costs - Increases in insurance costs or reduction in insurance coverage could have a material adverse effect on Air Canada, its business, results from operations and financial condition

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

19. CONTROLS AND PROCEDURES

Disclosure controls and procedures and internal controls over financial reporting

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

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

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

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

Management's report on disclosure controls and procedures

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined under National Instrument 52-109) and concluded, as at December 31, 2017, that such disclosure controls and procedures were effective.

Management's report on internal controls over financial reporting

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's internal controls over financial reporting (as defined under National Instrument 52-109). In making this evaluation, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commissions ("COSO") in Internal Control - Integrated Framework (2013). Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2017, the Corporation's internal controls over financial reporting were effective. This evaluation took into consideration the Corporation's Corporate Disclosure Policy and the functioning of its Disclosure Policy Committee.

Changes in internal controls over financial reporting

There have been no changes to the Corporation's internal controls over financial reporting during the quarter ended December 31, 2017 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

20. NON-GAAP FINANCIAL MEASURES

Below is a description of certain non-GAAP financial measures used by Air Canada in an effort to provide readers with additional information on its financial and operating performance. Such measures are not recognized measures for financial statement presentation under GAAP, do not have standardized meanings, may not be comparable to similar measures presented by other entities and should not be considered a substitute for or superior to GAAP results.

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is commonly used in the airline industry and is used by Air Canada as a means to view operating results before interest, taxes, depreciation, amortization, 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. Air Canada excludes special items from EBITDAR as such items would distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

EBITDAR is reconciled to operating income as follows:

	Fourth Quarter			Full Year		
(Canadian dollars in millions, except where indicated)	**2017**	**2016**	**$ Change**	**2017**	**2016**	**$ Change**
Operating income – GAAP	**$ 133**	**$ 18**	**$ 115**	**$ 1,364**	**$ 1,345**	**$ 19**
Add back (as reflected on Air Canada's consolidated statement of operations):						
Depreciation, amortization and impairment	245	212	33	956	816	140
Aircraft rent	126	120	6	503	462	41
Add back (included in Regional airlines expense):						
Depreciation, amortization and impairment	7	6	1	28	23	5
Aircraft rent	10	8	2	40	31	9
EBITDAR (including special items)	**$ 521**	**$ 364**	**$ 157**	**$ 2,891**	**$ 2,677**	**$ 214**
Remove effect of special items (1)	-	91	(91)	30	91	(61)
EBITDAR (excluding special items)	**$ 521**	**$ 455**	**$ 66**	**$ 2,921**	**$ 2,768**	**$ 153**

(1) In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.

In the fourth quarter of 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

Adjusted CASM

Air Canada uses adjusted CASM as a means 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.

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.

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:

	Fourth Quarter			Full Year		
(Canadian dollars in millions, except where indicated)	**2017**	**2016**	**$ Change**	**2017**	**2016**	**$ Change**
Operating expense – GAAP	**$ 3,687**	**$ 3,407**	**$ 280**	**$ 14,888**	**$ 13,332**	**$ 1,556**
Adjusted for:						
Aircraft fuel expense (as reflected on Air Canada's consolidated statement of operations)	(735)	(598)	(137)	(2,927)	(2,279)	(648)
Aircraft fuel expense (included in Regional airlines expense)	(112)	(90)	(22)	(412)	(327)	(85)
Ground package costs	(106)	(101)	(5)	(538)	(489)	(49)
Special items (1)	-	(91)	91	(30)	(91)	61
Operating expense, adjusted for the above-noted items	**$ 2,734**	**$ 2,527**	**$ 207**	**10,981**	**$ 10,146**	**$ 835**
ASMs (millions)	**24,191**	**22,091**	**9.5%**	**103,492**	**92,726**	**11.6%**
Adjusted CASM (cents)	**¢ 11.30**	**¢ 11.44**	**(1.2%)**	**¢ 10.61**	**¢ 10.94**	**(3.0%)**

(1) In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.

In the fourth quarter of 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

Adjusted pre-tax income (loss)

Adjusted pre-tax income (loss) is used by Air Canada to assess the overall pre-tax financial performance of its business without the effects of 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, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications and special items. Air Canada uses adjusted pre-tax income (loss) to determine return on invested capital.

	Fourth Quarter			Full Year		
(Canadian dollars in millions, except where indicated)	**2017**	**2016**	**$ Change**	**2017**	**2016**	**$ Change**
Income (loss) before income taxes	**$ 20**	**$ (178)**	**$ 198**	**$ 1,279**	**$ 877**	**$ 402**
Adjusted for:						
Special items (1)	-	91	(91)	30	91	(61)
Foreign exchange (gain) loss	62	29	33	(120)	38	(158)
Net financing expense relating to employee benefits	18	24	(6)	65	76	(11)
Loss (gain) on financial instruments recorded at fair value	1	(9)	10	(23)	(4)	(19)
Gain on sale and leaseback of assets	-	-	-	(52)	(19)	(33)
Loss (gain) on debt settlements and modifications	(24)	82	(106)	(21)	89	(110)
Adjusted pre-tax income	**$ 77**	**$ 39**	**$ 38**	**$ 1,158**	**$ 1,148**	**$ 10**

(1) *In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.*

In the fourth quarter of 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

Adjusted net income and adjusted earnings per share – diluted

Air Canada uses adjusted net income and adjusted earnings per share – diluted as a means to assess the overall financial performance of its business without the after-tax effects of 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, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications, and special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful. Starting as of and including the fourth quarter of 2017, adjusted net income is determined net of tax and includes the income tax effect of adjustments included in the measurement of adjusted net income. Prior to the fourth quarter of 2017, there was no deferred income tax expense recorded because of significant unrecognized deferred tax assets. A tax expense of $16 million affected fourth quarter and full year 2017 adjusted net income results.

(Canadian dollars in millions, except where indicated)	Fourth Quarter 2017	Fourth Quarter 2016	Fourth Quarter $ Change	Full Year 2017	Full Year 2016	Full Year $ Change
Net income	**$ 8**	**$ (179)**	**$ 187**	**$ 2,038**	**$ 876**	**$ 1,162**
Adjusted for:						
Special items (1)	-	91	(91)	30	91	(61)
Recovery of income taxes (2)	-	-	-	(771)	-	(771)
Foreign exchange (gain) loss	57	29	28	(125)	38	(163)
Net financing expense relating to employee benefits	13	24	(11)	60	76	(16)
Loss (gain) on financial instruments recorded at fair value	1	(9)	10	(23)	(4)	(19)
Gain on sale and leaseback of assets	-	-	-	(52)	(19)	(33)
Loss (gain) on debt settlements and modifications	(18)	82	(100)	(15)	89	(104)
Adjusted net income	**$ 61**	**$ 38**	**$ 23**	**$ 1,142**	**$ 1,147**	**$ (5)**
Weighted average number of outstanding shares used in computing diluted income per share (in millions)	278	279	(1)	278	282	(4)
Adjusted earnings per share – diluted	**$ 0.22**	**$ 0.14**	**$ 0.08**	**$ 4.11**	**$ 4.06**	**$ 0.05**

(1) *In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.*

In the fourth quarter of 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

(2) *In the first nine months of 2017, Air Canada recorded a tax recovery of $790 million, which was revised to $771 million with $19 million reclassified directly to retained earnings in the fourth quarter of 2017. This tax recovery is excluded from adjusted net income as it reflects a one-time recognition of previously unrecognized income tax assets.*

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)	Fourth Quarter 2017	Fourth Quarter 2016	Full Year 2017	Full Year 2016
Weighted average number of shares outstanding – basic	**274**	**273**	**273**	**277**
Effect of dilution	4	6	5	5
Weighted average number of shares outstanding – diluted	**278**	**279**	**278**	**282**

Return on invested capital

Air Canada uses return on invested capital ("ROIC") as a means to assess the efficiency with which it allocates its capital to generate returns. Return is based on adjusted pre-tax income (or loss, as applicable), excluding interest expense and implicit interest on operating leases. Invested capital includes (i) average year-over-year long-term debt, average year-over-year finance lease obligations, average year-over-year shareholders' equity and (ii) the value of capitalized operating leases (calculated by multiplying annualized aircraft rent by 7). Air Canada previously calculated invested capital based on an asset less operating liabilities approach. Following a significant increase in Air Canada's invested capital and book value of its equity, Air Canada decided to change the methodology to a book value-based method of calculating ROIC, as described above. Refer to the definition of adjusted pre-tax income for a discussion of why Air Canada uses this measure to assess the overall pre-tax financial performance of its business.

	12 Months Ended		
(Canadian dollars in millions, except where indicated)	December 31, 2017	December 31, 2016	$ Change
Income before income taxes	**$ 1,279**	**$ 877**	**$ 402**
Remove:			
Special items [1]	30	91	(61)
Foreign exchange (gain) loss	(120)	38	(158)
Net financing expense relating to employee benefits	65	76	(11)
Gain on financial instruments recorded at fair value	(23)	(4)	(19)
Gain on sale and leaseback of assets	(52)	(19)	(33)
(Gain) loss on debt settlements and modifications [2]	(21)	89	(110)
Adjusted pre-tax income	**$ 1,158**	**$ 1,148**	**$ 10**
Adjusted for:			
Interest expense	311	374	(63)
Implicit interest on operating leases [3]	266	242	24
Adjusted pre-tax income before interest	**$ 1,735**	**$ 1,764**	**$ (29)**
Invested capital:			
Average long-term debt and finance lease obligations	6,369	6,506	(137)
Average shareholders' equity	2,299	616	1,683
Capitalized operating leases [4]	3,801	3,451	350
Invested capital	**$ 12,469**	**$ 10,573**	**$ 1,896**
Return on invested capital (%)	**13.9%**	**16.7%**	**(2.8) pp**

(1) *Special items for the 12 months ended December 31, 2017 included a provision of $30 million related to cargo investigations.*

Special items for the 12 months ended December 31, 2016 included a past service cost expense of $91 million related to the cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

(2) *Gain on debt settlements and modifications for the 12 months ended December 31, 2017 of $21 million included a gain of $27 million related to the repricing of its US$1.1 billion senior secured credit facility, a loss of $3 million related to the early exercise of a purchase option for an Airbus 330 aircraft and a loss of $2 million related to the prepayment of fixed rate debt on four Embraer 190 aircraft.*

Loss on debt settlements and modifications for the 12 months ended December 31, 2016 of $89 million included $82 million related to a $1.25 billion refinancing transaction and $7 million related to the early exercise of a purchase option for an Airbus A330 aircraft.

(3) *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.*

(4) *Capitalized operating leases are calculated by multiplying the trailing 12 months of aircraft rent by 7. Aircraft rent totaled $543 million for the 12 months ended December 31, 2017 and $493 million for the 12 months ended December 31, 2016 (includes aircraft rent related to regional operations).*

Adjusted net debt to trailing 12-month EBITDAR (leverage ratio)

Adjusted net debt to trailing 12-month EBITDAR ratio (also referred to as "leverage ratio" in this MD&A) is commonly used in the airline industry and is used by Air Canada as a means to measure financial leverage. Leverage ratio is calculated by dividing adjusted net debt by trailing 12-month EBITDAR. Refer to section 9.3 "Adjusted Net Debt" of this MD&A for a reconciliation of this non-GAAP financial measure to the nearest measure under GAAP. As mentioned above, Air Canada excludes special items from EBITDAR results (which are used to determine leverage ratio) as such items would distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

Free cash flow

Free cash flow is commonly used in the airline industry and is used by Air Canada as an indicator of the financial strength and performance of its business, indicating the amount of cash Air Canada is able to generate from operations and after capital expenditures. Free cash flow is calculated as net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale and leaseback transactions. Refer to section 9.5 "Consolidated Cash Flow Movements" of this MD&A for a reconciliation of this non-GAAP financial measure to the nearest measure under GAAP.

21. 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 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Adjusted net income (loss) – Refers to the consolidated net income (loss) of Air Canada adjusted to remove the after-tax effects of 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, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications, and special items. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Adjusted pre-tax income (loss) – Refers to the consolidated income (loss) of Air Canada before income taxes and adjusted to remove the effects of 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, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications, and special items. Refer to section 20 "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, India, the Middle East and North Africa.

ATW – Refers to Air Transport World.

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.

CALDA – Refers to the Canadian Airline Dispatchers Association.

CASM – Refers to operating expense per ASM.

CUPE – Refers to the Canadian Union of Public Employees.

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

EBITDAR – Refers to earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent. EBITDAR is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information. Air Canada excludes special items from EBITDAR.

EVAS – Refers to Exploits Valley Air Services Limited.

Free cash flow – Refers to net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale and leaseback transactions. Free cash flow is a non-GAAP financial measure. Refer to sections 9.5 and 20 of this MD&A for additional information.

IAMAW – Refers to the International Association of Machinists and Aerospace Workers.

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.

Leverage ratio – Refers to adjusted net debt to trailing 12-month EBITDAR ratio (calculated by dividing adjusted net debt by trailing 12-month EBITDAR). Leverage ratio is a non-GAAP financial measure. Refer to sections 9.3 and 20 of this MD&A for additional information.

Loss (gain) on debt settlements and modifications – Refer to gains or losses related to debt settlements and modifications 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.

Other passenger and cargo revenues – Refer to revenues from flights with origins and destinations principally in Central and South America, the Caribbean and Mexico.

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

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

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

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

Return on invested capital or ROIC – Refers to return on invested capital and is a measure used to assess the efficiency with which a company allocates its capital to generate returns. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Revenue passenger carried – Refers to the International Air Transport Association's (IATA) 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 takeoff 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 significance to the financial statements, to enable a fuller understanding of the Corporation's financial performance.

Toronto Pearson – refers to Lester B. Pearson International Airport.

Unifor – Refers to the trade union in Canada, launched in 2013, as a merger of the Canadian Auto Workers and Communications, Energy and Paperworkers unions.

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).