AIR CANADA

# ANNUAL REPORT 2007

# TABLE OF CONTENTS

# MESSAGE FROM ROBERT MILTON

During the past year your company accomplished a tremendous amount and 2007 was a success both from an operational and financial standpoint. Air Canada continued to be a global leader and innovator in the industry and it is primed to perform to the high expectations set for it.

Air Canada carried 33 million passengers safely to their destination in 2007 and posted an impressive full year load factor of 80.6 per cent. This was the company's fourth consecutive annual record load factor, which is noteworthy given capacity increased 2.8 per cent over the previous year. Travellers are making Air Canada their airline of choice and it was selected the "Best Airline in North America" in a worldwide survey of 14 million airline passengers conducted by Skytrax.

Air Canada also demonstrated its earning power as a stand-alone, pure airline in 2007 with record operating income of $433 million. This was achieved despite the fact fuel prices during the year reached levels never before seen. Looking forward, its prudent management, disciplined approach to cost control and ongoing fleet renewal position the company well should high oil prices persist or other economic pressures arise.

This is the final annual report I will submit as Air Canada chairman, having relinquished my board role at the end of 2007. At this time, I would like to recognize the achievement of Montie Brewer and his management team in delivering on the ambitious plan presented to investors during the public offering process. Beyond this, I must also recognize the employees of Air Canada for their hard work and dedication, not only over the year past but throughout the years of my association with the company.

It has been a privilege and even more, the realization of a personal dream, to have had the opportunity to work for and lead Air Canada. I wish my successor as chairman, David Richardson, the very best. Investors should share my confidence that under his leadership, with the management depth and skilled workforce possessed by the company, Air Canada is poised to sustain its successful trajectory far into the future.

**Robert Milton**
Past Chairman of the Board
Air Canada

# MESSAGE FROM THE PRESIDENT AND CEO OF AIR CANADA

In 2007, its first full year as a stand-alone public company since restructuring, Air Canada achieved the financial goals it set out to attain. It delivered record operating income of $433 million and generated operating and passenger revenue increases of four and five per cent respectively over 2006.

Importantly, we controlled expenses and prudently invested capital to achieve efficiency gains. As a result, our unit cost fell 1.2 per cent over 2006 and productivity grew 1.6 per cent, measured by available seat miles per full time employee. Further evidence of our efficiency was a passenger load factor of 80.6 per cent for the year, our fourth consecutive annual record load factor.

We have made significant progress with the four key drivers of our business – Our Fleet, Our New Revenue Model, Our New Reservation System, now called Polaris, and Our People. For 2008, with fuel prices persisting at record levels and the economic environment less certain, we will continue to emphasize these four areas but with heightened cost control discipline.

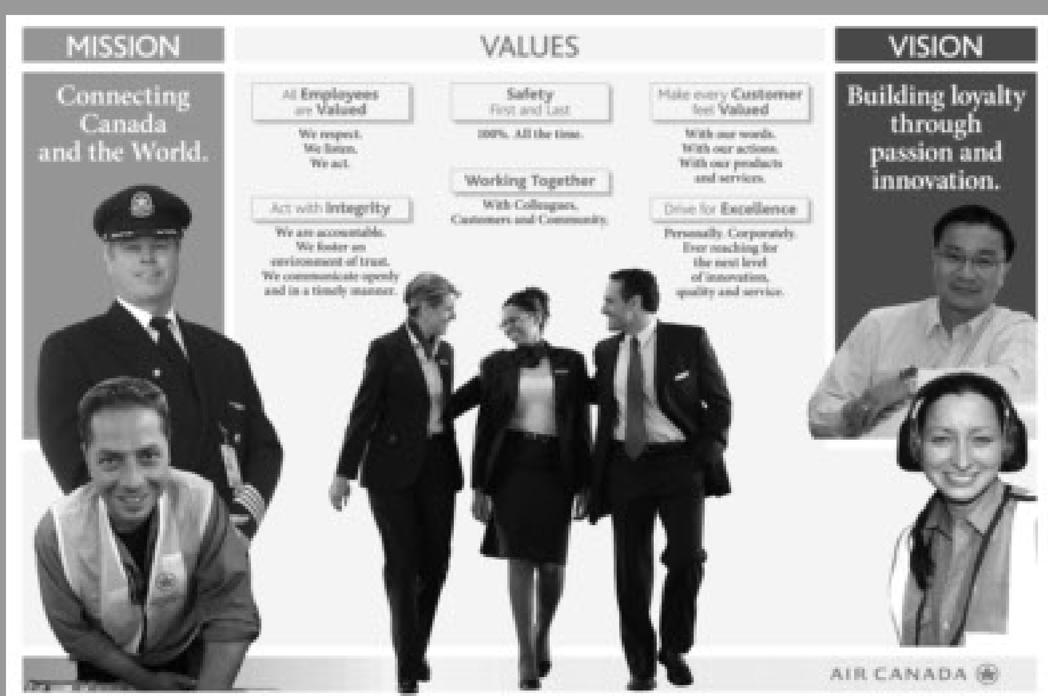
We took delivery of eight Boeing 777s into our fleet in 2007 and deliveries will continue through this year until we have 18 by early 2009. As well, the last of 60 Embraer aircraft ordered have been delivered. Each of these aircraft types has been popular with customers and resulted in significant cost reductions, including a 15 per cent savings per seat from the 777-300 over the Airbus A340-300 it replaced. The interior refurbishment of our existing fleet will be virtually complete in 2008 so customers boarding most Air Canada aircraft will enjoy personalized seatback audio visual entertainment and access to a power plug and USB port. Those in Executive First will luxuriate in industry-leading, lie flat suites on international flights.

Our award winning new revenue model will evolve further. More à la carte options are under development to broaden customer choice and convenience. We will introduce more Flight Pass and subscription products, whose sales increased 87 per cent in 2007 over 2006. Evidencing the virtues of our simplified revenue model is the fact 73 per cent of domestic Canada sales last year were made directly with Air Canada either online or through our call centres. As well, the model is extracting a revenue premium, with 45 per cent of domestic customers choosing in 2007 to purchase a higher priced ticket than the lowest cost Tango fare.

Testing and refinement of Polaris through 2008 and until full implementation will ensure Air Canada has a new reservation system to meet the challenges and seize the opportunities of the 21st Century information age. Already, we have deployed the first phase of Polaris, ACpedia. It is a search engine that facilitates faster, more consistent customer service and it has also enabled us to cull unnecessary processes and outdated rules accrued over Air Canada's seven decades in business.

Finally, Air Canada's stabilization is making it possible to equip our people with new tools. This includes not only new aircraft, but also technology to facilitate important tasks such as scheduling and maintenance. The payout to employees of $29.2 million in Sharing Our Success incentives in 2007 reinforced the link between performance and reward, aligning the interests of the company's various stakeholders. Management is committed to continue nurturing an atmosphere of understanding, respect and trust. With bargaining unit contracts expiring in mid-2009, an improved atmosphere will contribute to productive contract negotiations and mutually-beneficial collective agreements.

For a corporation to excel it is essential that everyone be mindful of why the company exists and what it wishes to be known for. To this end, we took time in early 2008 to capture and refine Air Canada's Mission, Vision and Values. These are to be instilled in every employee so that all our efforts are directed to common, positive goals.




Our chosen Mission statement is: Air Canada – Connecting Canada and the World. Its simplicity is deceptive because "connecting" implies more than just moving people from place to place; we bring them together for enriching experiences. And our view is not parochial given we aim to make connections possible worldwide, so we must be a global leader.

Complementing this is our Vision, which is: Building Loyalty through passion and innovation. We gain customer loyalty with an intense commitment to service, our determination to be the best, and by delivering a superior travel experience. To secure this loyalty, we continually simplify processes to make travel more convenient and expand our offerings through technology, products and other new features.

Underpinning our Mission and Vision are core Values that inform all we do as individuals and collectively at Air Canada. These values serve as touchstones to guide our actions. Some, such as Safety, have always been and will remain at the forefront of every activity. Everything must be 100 per cent safe, all the time, without compromise

Other values, however, we have long espoused but not always fully abided by, particularly during the restructuring period when our very survival was in question. This would include those that relate to people and so Air Canada is rededicating itself to such values as Working Together and ensuring All Employees Are Valued. It is imperative that everyone contributing feels appreciated as an integral member of our team if Air Canada is to fulfill its Mission and pursue its Vision in 2008 and beyond.

In summary, 2007 was a year of achievement that further advanced our company's ongoing progress to sustained profitability. Much work remains to be done, however, and we will continue to strengthen our business by emphasizing the four key drivers of our strategy. We are doing this against a backdrop of historically high fuel prices, changeable economic conditions and other cost pressures that will impose constraints and demand added vigilance in managing our business.

I would like to conclude by thanking investors for their confidence in Air Canada and our employees for their hard work during 2007. Shareholders should be encouraged that their company has a solid plan, the resources and the committed people necessary to actualize both its Mission and Vision so it is a sustainable, profitable airline for the long term.

**Montie Brewer**
President and Chief Executive Officer

## 1. HIGHLIGHTS

The following table provides the reader with financial and operating highlights for Air Canada, excluding the consolidation of Jazz Air LP ("Jazz") operations (previously "Air Canada Services") for the periods indicated.

| ($ millions, except per share figures) | Fourth Quarter 2007 | Fourth Quarter 2006 | Fourth Quarter Change $ | Year 2007 | Year 2006 | Year Change $ |
|---|---|---|---|---|---|---|
| **Financial** | | | | | | |
| Operating revenues | 2,513 | 2,423 | 90 | 10,646 | 10,164 | 482 |
| Operating income | 72 | (5) | 77 | 433 | 114 | 319 |
| Operating income, excluding special charges (1) | 72 | (13) | 85 | 433 | 236 | 197 |
| Non-operating expenses | (52) | (52) | - | (122) | (191) | 69 |
| Income (loss) before non-controlling interest, foreign exchange and provision for income taxes | 20 | (57) | 77 | 311 | (77) | 388 |
| Income (loss) for the period | 35 | (144) | 179 | 429 | (74) | 503 |
| Operating margin % | 2.9 % | -0.2 % | 3.1 pp | 4.1 % | 1.1 % | 3.0 pp |
| Operating margin %, excluding special charges (1) | 2.9 % | -0.5 % | 3.4 pp | 4.1 % | 2.3 % | 1.8 pp |
| EBITDAR (2) | 274 | 213 | 61 | 1,263 | 948 | 315 |
| EBITDAR, excluding special charges (1) (2) | 274 | 205 | 69 | 1,263 | 1,070 | 193 |
| EBITDAR margin % | 10.9 % | 8.8 % | 2.1 pp | 11.9 % | 9.3 % | 2.6 pp |
| EBITDAR margin %, excluding special charges (1) | 10.9 % | 8.5 % | 2.4 pp | 11.9 % | 10.4 % | 1.5 pp |
| Cash, cash equivalents and short-term investments | 1,239 | 2,110 | (871) | 1,239 | 2,110 | (871) |
| Free cash flow | (892) | (365) | (527) | (2,233) | (652) | (1,581) |
| Adjusted debt/equity ratio, excluding PDP financing | 65.4 % | 65.7 % | (0.3) pp | 65.4% | 65.7 % | (0.3) pp |
| Earnings per share - basic (3) | $ 0.35 | $ (1.55) | $ 1.90 | $ 4.29 | $ (0.83) | $ 5.12 |
| Earnings per share - diluted (3) | $ 0.35 | $ (1.55) | $ 1.90 | $ 4.27 | $ (0.83) | $ 5.10 |
| **Operating Statistics** | | | **Change %** | | | **Change %** |
| Revenue passenger miles (millions) (RPM) | 11,446 | 11,160 | 2.6 | 50,629 | 48,993 | 3.3 |
| Available seat miles (millions) (ASM) | 14,715 | 14,343 | 2.6 | 62,814 | 61,083 | 2.8 |
| Passenger load factor | 77.8 % | 77.8 % | - | 80.6 % | 80.2 % | 0.4 pp |
| Passenger revenue yield per RPM (cents) (4) | 18.9 | 18.5 | 2.1 | 18.4 | 18.1 | 1.6 |
| Passenger revenue per ASM (cents) (4) | 14.7 | 14.4 | 2.1 | 14.8 | 14.5 | 2.1 |
| Operating revenue per ASM (cents) (4) | 17.0 | 16.9 | 0.4 | 17.0 | 16.6 | 1.9 |
| Operating expense per ASM ("CASM") (cents) | 16.6 | 16.9 | (2.0) | 16.3 | 16.5 | (1.2) |
| CASM, excluding fuel expense (cents) | 12.4 | 12.9 | (3.5) | 12.2 | 12.3 | (0.8) |
| CASM, excluding fuel expense and the special charge for labour restructuring (cents) (1) | 12.4 | 12.9 | (3.9) | 12.2 | 12.3 | (0.4) |
| Average number of full-time equivalent (FTE) employees (thousands) | 23.9 | 23.3 | 2.5 | 23.9 | 23.6 | 1.3 |
| Aircraft in operating fleet at period end (5) | 340 | 332 | 2.4 | 340 | 332 | 2.4 |
| Average fleet utilization (hours per day) (6) | 9.3 | 9.1 | 2.2 | 9.8 | 9.5 | 3.2 |
| Average aircraft flight length (miles) (6) | 851 | 847 | 0.5 | 874 | 873 | 0.1 |
| Fuel price per litre (cents) (7) | 67.5 | 64.1 | 5.3 | 65.6 | 66.2 | (1.0) |
| Fuel litres (millions) | 905 | 906 | (0.1) | 3,873 | 3,813 | 1.6 |

(1) A special charge for labour restructuring of $28 million was recorded in the first quarter of 2006. The fourth quarter of 2006 includes a favourable adjustment of $8 million relating to the special charge for labour restructuring recorded in the first quarter of 2006. A special charge of $102 million was recorded to operating revenues in the third quarter of 2006 in connection with Air Canada's obligation for the redemption of pre-2002 Aeroplan miles.

(2) See section 19 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income.

(3) Earnings per share – basic and diluted are the consolidated Air Canada figures as reported under GAAP.

(4) Yield and RASM percentage changes for the fourth quarter of 2007 exclude a favourable adjustment of $26 million relating to a change in accounting estimates.

(5) Operating fleet excludes chartered freighters in 2007 and 2006. Includes Jazz aircraft covered under the Jazz CPA.

(6) Excludes third party carriers operating under capacity purchase arrangements other than Jazz aircraft covered under the Jazz CPA (which are included).

(7) Includes fuel handling and fuel hedging expenses.

## 2. INTRODUCTION

In this MD&A, "we", "us", "our", "Air Canada" and "Corporation" refer to Air Canada and/or one or more of Air Canada's subsidiaries, unless indicated otherwise.

This Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A") for 2007 provides the reader with a view of Air Canada through the eyes of management and includes an overview of our business strategy, an analysis of our financial results for the fourth quarter and the full year 2007, risks and uncertainties associated with our business and a discussion on our controls and procedures. This MD&A should be read in conjunction with Air Canada's 2007 audited consolidated financial statements and notes. All financial information has been prepared in accordance with Generally Accepted Accounting Principles in Canada ("GAAP"), unless indicated otherwise. Air Canada's audited consolidated financial statements are based on accounting policies consistent with those disclosed in Note 2 to the Corporation's annual audited consolidated financial statements for 2007.

In November 2006, Air Canada completed an initial public offering (the "Air Canada IPO") of an aggregate 9,523,810 variable voting shares and voting shares for gross proceeds of $200 million ($187 million net of offering costs of $13 million) and a secondary offering by ACE Aviation Holdings Inc. ("ACE") of an aggregate of 15,476,190 variable voting shares and voting shares for gross proceeds of $325 million ($304 million net of offering costs of $21 million).

Prior to May 24, 2007, Air Canada's consolidated financial statements included the financial position, results of operations and cash flows of Jazz as Air Canada was deemed to be the primary beneficiary of Jazz under Accounting Guideline 15 "Consolidation of Variable Interest Entities" ("AcG-15"). ACE's distribution of units of Jazz Air Income Fund on May 24, 2007 gave rise to a reconsideration of which entity should consolidate Jazz and, as a result, Jazz Air Income Fund was deemed to be the primary beneficiary of Jazz under AcG-15. Jazz is still considered to be a variable interest entity, however, Air Canada is no longer the primary beneficiary under AcG-15.

Effective May 24, 2007, the results and financial position of Jazz are no longer consolidated within Air Canada. Prior to May 24, 2007, Air Canada had two reportable segments: Air Canada Services (which is now referred to as Air Canada), the passenger and cargo transportation services business operated by Air Canada and related ancillary services, and Jazz, Air Canada's regional capacity provider. Segment information was used to allow for the separate presentation of Air Canada's financial results as this segment was the primary focus of the Air Canada shareholders. Refer to Note 15 "Segment Information" to Air Canada's 2007 audited consolidated financial statements for additional information. Refer to section 12 of this MD&A "Related Party Transactions" for a description of transactions between the Corporation and Jazz.

Certain comparative figures have been reclassified to conform to the financial statement presentation adopted in the current period. In particular, Air Canada has reclassified the presentation of certain aircraft sublease revenues from Jazz. The revised presentation relates to aircraft that are accounted for as owned aircraft by Air Canada but are accounted for as operating leases in Jazz. This revised presentation does not impact the consolidated results for any period presented, however it does result in an increase in Air Canada's inter-segment revenue and aircraft rent of $5 million for the three months ended December 31, 2007 and $22 million for the twelve months ended December 31, 2007 ($8 million for the three months ended December 31, 2006 and $27 million for the twelve months ended December 31, 2006).

Except where the context otherwise requires, all monetary amounts are stated in millions of Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 20 "Glossary". Except as otherwise noted, this MD&A is current as of February 6, 2008.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward Looking Statements" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a detailed description of risks relating to Air Canada, refer to section 17 of this MD&A ("Risk Factors").

For further information on Air Canada's public disclosure file, including Air Canada's Initial Annual Information Form dated March 27, 2007, consult SEDAR at ***www.sedar.com*** or Air Canada's website at ***www.aircanada.com***.

**CAUTION REGARDING FORWARD-LOOKING INFORMATION**

Air Canada's public communications may include written or oral forward looking statements within the meaning of applicable securities laws. Such statements are included in this MD&A and may be included in other filings with regulatory authorities and securities regulators. Forward-looking statements relate to analyses and other information that are 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. These forward-looking statements are identified by the use of terms and phrases such as "anticipate", "believe", "could", "estimate", "expect", "intend", "may", "plan", "predict", "project", "will", "would", and similar terms and phrases, including references to assumptions.

Forward-looking statements, by their nature, are based on assumptions, including those described below, and are subject to important risks and uncertainties. Any forecasts or forward-looking predictions or statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Results indicated in forward-looking statements may differ materially from actual results due to a number of factors, including without limitation, energy prices, general industry, market and economic conditions, currency exchange and interest rates, competition, war, terrorist attacks, epidemic diseases, insurance issues and costs, changes in demand due to the seasonal nature of the business, the ability to reduce operating costs, employee and labour relations, pension issues, supply issues, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties as well as the factors identified throughout this MD&A and, in particular, those identified in the "Risk Factors" section (Section 17) of this MD&A. The forward-looking statements contained in this MD&A represent the Corporation's expectations as of the date of this MD&A and are subject to change after such date. However, the Corporation disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

Assumptions were made by Air Canada in preparing and making forward-looking statements. In addition to other assumptions contained in this MD&A, Air Canada has assumed that growth in North America and globally will slow in 2008 but that an economic recession will not take place, despite an increasing risk of one in the United States. Air Canada has also assumed that the Canadian dollar will trade, on average, at par with the US dollar in the first quarter 2008 and throughout the full year 2008 and that the price of fuel will average 76 cents per litre in the first quarter of 2008 and 74 cents per litre for the full year 2008 (both net of current hedging positions).

## 3. OUR STRATEGY

**The Air Canada Business**

We are Canada's largest domestic and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-US transborder market and in the international market to and from Canada.

We enhance our network through a capacity purchase agreement with Jazz pursuant to which we purchase substantially all of Jazz's fleet capacity based on predetermined rates and we determine the routes and schedule operated by Jazz. Jazz operates small jet and turboprop aircraft that have lower trip costs than conventional large jet aircraft, allowing Jazz to provide service to Air Canada's customers in lower density markets and also in higher density markets at off-peak times throughout Canada and the United States.

In 2007, Air Canada, together with Jazz, operated an average of approximately 1,370 scheduled flights each day and carried over 33 million passengers. Air Canada, together with Jazz, provided direct passenger service to 158 destinations and, through commercial agreements with other unaffiliated regional airlines, to an additional 14 destinations, for a total of 172 direct destinations on five continents.

We are a founding member of the Star Alliance® network. The Star Alliance® network currently includes 19 member airlines and three regional member airlines. Through its membership in the Star Alliance® network, we are able to offer our customers access to approximately 897 destinations in 160 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges.

Through our long-term relationship with Aeroplan Limited Partnership ("Aeroplan"), Air Canada's frequent flyer program provider, we are able to build customer loyalty by offering those customers who are Aeroplan members the opportunity to earn Aeroplan miles when they fly with Air Canada. Aeroplan is also Air Canada's single largest customer. The relationship with Aeroplan provides a long-term stable and recurring source of revenue from the purchase by Aeroplan of Air Canada seats to be provided to Aeroplan members who choose to redeem their Aeroplan miles for air travel rewards.

The Corporation also generates revenues from cargo services provided by Air Canada and AC Cargo Limited Partnership ("Air Canada Cargo"), from tour operator services provided by Touram Limited Partnership ("Air Canada Vacations") and from ground handling services provided by ACGHS Limited Partnership ("Air Canada Ground Handling").

Air Canada and Air Canada Cargo provide air cargo services on domestic, US transborder and international flights. Air Canada Cargo is a major domestic and US transborder air cargo carrier and uses the entire cargo capacity on aircraft operated by Air Canada and Jazz on domestic and transborder routes. Air Canada offers cargo services on its international flights and currently uses one chartered all freighter MD-11 aircraft to supplement Canada-Europe services.

Air Canada Vacations is one of Canada's leading tour operators. Based in Montreal and Toronto, Air Canada Vacations operates its business in the outgoing leisure travel market (Caribbean, Mexico, Europe, South America and US) through developing, marketing and distributing vacation travel packages and services through a network of independent travel agencies in Canada as well as its website, aircanadavacations.com.

Air Canada Ground Handling provides passenger handling services to Air Canada, Jazz and other airlines with a primary focus on Canadian stations. Services covered include passenger check-in, gate management, baggage and cargo handling and processing, cabin cleaning, de-icing as well as aircraft ramp services.

**Our Business Strategy**
We have made significant progress in our goal of improving the way we do business. By focusing on our innovative customer driven model, our fleet renewal program and employee productivity, we have been successfully driving our strategy to build a new Air Canada. Our record load factors, RASM growth and reduced CASM are all indicators that our new business model is working.

We have won numerous awards for our customer service and our innovative products in 2007.

- We were ranked "Best Airline in North America" for the second time in three years in a passenger survey of 14 million air travelers conducted by Skytrax.
- We were named the favourite scheduled airline of Canada's travel agents in the Eighth Annual Agents' Choice Awards for the Canadian Travel Industry based on a survey of travel agents conducted by Baxter Travel Media.
- We were voted ''Best Airline in North America" and "Best Airline in Canada" by the readers of US frequent flyer magazine, Global Traveler, and "Best Airline in Canada" by the readers of Business Traveler magazine.
- We received Air Transport World magazine's 2007 Airline Industry Achievement Award for Market Leadership.
- We were recognized by the Canadian Information Productivity Awards (CIPA), for our Corporate Flight Pass, web check-in and kiosk products.

To help us grow our business profitably, our priorities in 2008 include:

- **Leveraging our innovative customer driven revenue model**
  Our transparent and simplified branded fare structure provides customers with the ability to pay for higher branded fares and enjoy the attributes which come with these fares or purchase lower branded fares and then purchase selected attributes which typically are attached only to higher branded fares. This has allowed us to match the lowest fare in the markets in which we operate and maintain revenue premiums from customers who are willingly purchasing higher fares with additional attributes. In 2007, 45% of our domestic consumers chose a branded fare higher than Tango, our lowest fare.

  We plan to continue to provide customers with competitive fares and, starting in the second quarter of 2008, our branded fare model is scheduled to roll out new value added services and "à la carte" options as well as to expand to new markets on the international front.

- **Further developing our innovative revenue strategy**
  In the drive to provide our customers with new and unique products, in 2007, we continued to further expand the offering of "Flight Passes" and "subscriptions" payment options for fixed credit flight passes and unlimited travel, respectively. The launch of the Hong Kong/China Pass and the expanded Sun Passes significantly enlarged the geographical reach of the Flight Pass product. New Flight Pass concepts and increased penetration in the small and medium enterprise and corporate market has allowed us to generate additional revenues from higher customer satisfaction, brand preference and share of travel spend.

  Flight Passes provide customers with the ability to lock-in their cost of travel through advance purchase of multiple segments within a defined geographic area.

  Starting with a new Flight Pass shopping environment on ***www.aircanada.com*** in January 2008, we are scheduled to roll out several new Flight Pass products in order to provide customers with more travel options, geographical reach and purchase flexibility.

- **Continuing to focus on costs and improving our cost structure**
  Our business strategy is focused on continually evaluating and improving our cost structure to remain highly competitive.

For the fourth quarter of 2007 and for the full year 2007, we reduced our CASM by 2.0% and 1.2%, respectively, over the corresponding periods in 2006. Excluding fuel expense and special charges, CASM was down 3.9% from the fourth quarter of 2006 and 0.4% from the full year 2006. This was achieved in spite of increasing pressure from higher fuel prices, particularly in the second half of the year. We have continued to seek means to reduce our fuel burden by negotiating competitive fuel rates from our suppliers and implementing fuel saving initiatives throughout our operations. In addition, in order to manage our exposure to jet fuel prices and minimize volatility in operating cash flows, we have focused on a structured fuel hedging program which is described in section 10 of this MD&A.

In 2008, in order to further reduce our operating costs to remain at a competitive level, our plan includes the following initiatives:

- The continued renegotiation of various supplier agreements;
- The review of the base commission structure offered on various routes;
- The continued implementation of our fuel efficiency program which includes weight reduction initiatives and optimum flight speed and altitude guidelines to maximize fuel savings without affecting on-time performance or passenger connections.

Our fleet renewal program is providing cost efficiencies through fuel and maintenance savings driven by more efficient aircraft being brought into the fleet. For example, the Boeing 777-300 aircraft is generating a 15% cost saving per seat as compared to the Airbus 340-300 aircraft. At the same time as the new aircraft are being added to our fleet, we are removing older less efficient aircraft. Refer to section 6 of this MD&A for additional information on our fleet.

- **Maintaining a high degree of web penetration and increasing direct distribution**
  Our transparent pricing strategy and our user friendly web platform have contributed to a high level of web penetration which in turn has allowed us to reduce our distribution costs.

  Air Canada maintains two websites, one for consumers and the other for travel agencies. Both websites offer the same unique products. Customers continue to benefit from the ability to check into Air Canada flights departing from any Canadian city and from select US and select international cities to Canada up to 24 hours prior to departure by using the web check-in facility provided on the Air Canada website. This has allowed us to generate cost savings while increasing customer satisfaction.

  Air Canada's application programming interface, referred to as ac2u, allows third party booking platforms to access Air Canada's full range of products and attributes, including Flight Pass and "à la carte" pricing, in a simple, industry standard format, while maintaining the branded integrity of the product. This effectively extends the reach of Air Canada's new revenue model further than what could be obtained by ***www.aircanada.com*** alone. The implementation of the multi-year agreement announced on August 17, 2007 between Galileo International LLC ("Galileo") and Air Canada to provide Galileo-connected Canadian travel agents access to Air Canada's full range of products and attributes via ac2u will continue the growth of Air Canada's direct distribution to both consumers and travel agents.

- **Further enhancing our product offering through a redesigned network and a renewed fleet**
  Within North America, we adopted a demand-based network strategy. This has resulted in offering improved frequencies on key routes, maintaining competitive frequencies on other routes and introducing new non-stop routes thus serving customers to destinations where such demand was expected. We are implementing our network redesign in the North American market through the use of large regional jet aircraft which have lower trip costs than conventional narrow-body aircraft.

In order to support the expansion of our international operations and deliver a superior aircraft product in the international market to and from Canada, we are progressively introducing Boeing 777 aircraft into our fleet. In 2007, we introduced eight Boeing 777 aircraft into our fleet. In 2008, we plan to take delivery of an additional nine Boeing 777 aircraft, one of which was delivered in January 2008. The new Boeing 777 aircraft is allowing us to modernize and re-size our fleet and reduce operating costs through fuel and maintenance savings in addition to gaining greater manpower efficiency and economies of scale. This new aircraft is also providing us with the ability to serve new markets that could not be previously served in an efficient manner.

To remain competitive, in addition to acquiring new aircraft, we offer our customers a world class product. The new Embraer and Boeing 777 aircraft are being delivered with the new seats and entertainment systems. We continue to refurbish aircraft that fly international routes so that all seats in the Executive First cabin will convert into lie-flat beds. Our Boeing 767-300 aircraft are scheduled to have refurbished interiors by June 2008. Our other aircraft are planned to have refurbished interiors by the end of 2008, with the exception of the Airbus A330 aircraft which are expected to be completed by early 2009. Refurbished aircraft will have new seats and personal in-flight entertainment systems and in-seat power outlets at every seat in Economy Class, Executive Class and Executive First. In the domestic market, Air Canada will have a world class product to build on the significant travel awards already received. In the first quarter of 2008, we also expect to have completed our fleet transition to the planned 60 Embraer aircraft which have been deployed to open new markets and to add frequencies in previously single daily markets. We are planning to add seven new routes in North America in the summer of 2008.

We believe that Canada's multi-ethnic demography provides us with growing demand for international travel. Coupled with the large number of available route authorities, we believe Air Canada is well poised for growth in the Canada-international market.

In 2007, in comparison with 2006, we added 3% more flights on international routes, mainly composed of new non-stop and expanded services on the Atlantic market from western Canada, Maritimes to London and seasonal Montreal – Rome, and by a 10% increase in flights to sun markets such as the Dominican Republic and Mexico. Our strategy for the Pacific market is to operate our new and larger Boeing 777 aircraft on the key routes from Toronto to such destinations as Japan, Hong Kong and China. By the end of 2008, we are scheduled to have received 17 of our planned 18 Boeing 777 aircraft, with which we expect to continue to expand our international presence. Air Canada's plans for the China and broader Asia market are to deploy Boeing 777 aircraft on all Toronto services and gradually increase frequencies. Current plans include an increase to five flights per week in the winter 2008-2009 season on Toronto-Beijing and four flights per week on Toronto-Shanghai. Current route authorities between Canada and China would allow Air Canada to add additional non-stop routes and, with the planned delivery of Boeing 787 aircraft in 2010, the Corporation will look at opportunities to add new markets in the broader Asia-Pacific region. With our partner Lufthansa, we are planning to increase by 19% our capacity to the important German market in the summer peak. We are adding new destinations such as Ottawa-Frankfurt and Toronto-Madrid to enhance our year-round presence in business markets in Europe.

We use three main hubs (Toronto, Montreal and Vancouver) across Canada for our domestic, transborder and international routes to serve customers traveling to or from the U.S to Asia and Europe. In addition, our Toronto operation has been consolidated into one terminal which has provided us with the ability to more seamlessly transfer passengers to and from the US to Europe and Asia, thus increasing customer satisfaction while generating cost savings.

- **Leveraging technology for enhanced customer service and cost containment**

**New reservation system**

A new web-enabled reservation system is being developed to replace Air Canada's legacy systems for passenger reservation and airport customer service. The new system, named POLARIS, is designed to be innovative, flexible and cost effective and to allow Air Canada to facilitate and streamline the reservation and travel processes for both its customers and employees. It is also designed to provide Air Canada with the capability to bring new, innovative products to market faster, and to enhance customer experience. The POLARIS program is being implemented in phases.

One new feature being designed into the system is a customer profile database which will act as a central repository of customer information. This will provide new opportunities in improving customer service delivery. Another new feature under development is a customer account database where flight credits can be stored and compensation delivered. This will produce a solution for unused credits and enhance customer loyalty.

These and other features are designed to enhance the reservation system experience for both customers and employees. Customers' experience will include simplified steps, self-service options, expanded choice and personalization, clear value and transparency, and consistency across touch points, airports and countries. Employees' experience will include simplified steps, an intuitive easy-to-learn and operate interface and consistency across touch points. These features will reduce the time and effort required to complete transactions and increase the ability to engage in more direct customer contact and service.

The first phase of implementation which involves the roll out of a web-based document management system for all policies and procedures is currently underway and the initial pilot for this first phase launched at one of our call centres was successful. The roll out of this tool is expected to take place during the first and second quarters of 2008. The next two phases involve rolling out the reservation system and an airport control system and the Corporation is currently evaluating the timeline for their completion.

**Self-Service Check-in**

In 2007, we continued to take steps to provide passengers self-service products such as mobile check-in, web check-in and self tagging via airport kiosks. This has allowed us to simplify the business processes and enhance the travel experience for our customers while generating cost savings. Mobile check-in and web check-in are available at all Canadian airports, as well as in 26 international stations and 32 US stations. Self-tagging of baggage at airport kiosks is also available in three Canadian airports. In the latter part of 2007, we became one of the first airlines in the world to introduce paperless mobile boarding passes and we continue to focus on the elimination of paper tickets.

In 2008, we plan to expand the self-tagging service at all major Canadian airports and also in selected international stations. Enhancements to our self-service applications are planned to be introduced, such as fee collection for excess baggage and new languages at airport kiosks. Other Canadian stations will see the introduction of airport kiosks and new baggage drop off positions. We plan to continue the expansion of our mobile and web check-in product and, in the first part of the year, we plan to introduce a mobile boarding pass pilot in the US. Finally, with the expected enhancements to our flight notification product, we will be able to provide customers with more information with respect to changes to their travel plans.

**NetLine**

The legacy technology of Air Canada's current flight operations systems is being replaced by the NetLine system, an integrated software suite. The new system is designed to enable us to enhance operational efficiencies by providing better real time operational information. Furthermore, NetLine will allow for an easier and more cost effective adaptation to changes in our operational needs by leveraging new generation technology.

**OASIS**

Online Aircraft Support Integrated Solution, or OASIS, is a corporate initiative to upgrade the current legacy maintenance and engineering system - referred to as ARTOS. The maintenance and engineering system provides the organization with fleet status and maintenance planning; the technical records of the fleet; configuration control and airworthiness compliance; materials management and planning.

With the increasing complexity of today's operation, the decision was made to replace the existing applications with a cost competitive and integrated platform. The platform is designed to provide the functionality required by Air Canada's maintenance division as well as a product foundation which can be leveraged to implement future enhancements and is also designed to provide Air Canada with improved aircraft availability, resource and asset efficiencies and management information while reducing information technology expenses.

In 2008, we begin the design phase of the project with anticipated rollout of the new system beginning in early 2009 and subsequent releases through the remainder of 2009.

- **Maintaining positive employee and labour relations**

We have collective bargaining agreements with our pilots, flight attendants, maintenance personnel, certain clerical and finance personnel, customer service agents, ramp and cargo employees, dispatchers and crew schedulers which were concluded in 2003 and 2004 and which expire in 2009. No strikes or lock-outs may lawfully occur during the term of the collective agreements. On April 10, 2007, we announced that the wage review process agreed to with all labour groups in 2003 had concluded. The average of the wage adjustment agreements and awards represents an increase of approximately 5% over the three-year period mid-2006 – mid-2009.

In 2005, we introduced incentive programs and a profit sharing plan in order to engage employees in their valuable role to ensure Air Canada's success. The "Sharing Our Success" Plan emphasizes the relationship between performance and personal rewards by providing employees with financial rewards on a monthly basis when operational performance levels are achieved. The plans also permit employees to share in the fiscal year-end pre-tax profits when corporate, financial and operational performance levels are achieved. In each case, employees receive the greater of the amounts payable under the "Sharing Our Success" Plan and the annual profit sharing plan. In 2007, a total of $29.2 million was paid in advance under the "Sharing Our Success" Plan.

As part of our ongoing objective to improve overall employee relations throughout the organization, we completed a two-day training program for substantially all management employees, including executive and senior management. Called "Relationship Matters", this program focused on skills training around the principles of leadership, effective communication and taking ownership and accountability for one's own area of responsibility. A survey of participants has shown that a majority of participating managers felt that the training has enhanced their leadership and communication skills and behaviours and has improved the communication at all levels within the organization. We are planning to offer this program in the first quarter of 2008 to our frontline unionized employees in lead functions.

In the latter part of 2007, we commenced a second training program that focuses on the institutional relationships between Air Canada and its unions. Called "Labour Relationships Matter", this program provides participants with knowledge, skills and tools to build and maintain authentic and constructive relationships with union representatives and unionized employees in accordance with Air Canada's labour relations philosophy. Executive management has completed the training and, over the course of the first two quarters of 2008, all management employees including senior management will participate in the program.

In addition, we conducted an extensive survey of our employee population, with focus groups and telephone interviews conducted by The Strategic Counsel. The survey was designed to identify the most significant and prevalent employee concerns to enable us to proactively address these issues wherever possible in order to benefit our employees, employee relations and our operations.

As part of our continued focus on employee communication, Air Canada has initiated a new employee communication medium. Supplementing the "Employee Annual Report" launched in 2006, the "Employee Mid-Year Report" provides all employees with a timely update on the progress on all aspects of Air Canada's business strategy.

## 4. RESULTS OF OPERATIONS – FOURTH QUARTER 2007 VERSUS FOURTH QUARTER 2006

Air Canada recorded operating income of $72 million and net income of $35 million in the fourth quarter of 2007. In the same period of 2006, Air Canada, including the consolidation of Jazz's operations, reported consolidated operating income of $29 million and a net loss of $144 million.

Prior to May 24, 2007, Air Canada had two reportable segments: Air Canada Services and Jazz. Effective May 24, 2007, Air Canada no longer consolidates the operations of Jazz. As a result of this change, Air Canada's consolidated results for the fourth quarter of 2007 are not directly comparable to its consolidated results for the fourth quarter of 2006. **For comparative purposes, the following table and discussion provides the reader with the results of Air Canada for the fourth quarter of 2007, which no longer includes the consolidation of Jazz, and the results of Air Canada, excluding the consolidation of Jazz (previously the "Air Canada Services" segment) for the fourth quarter of 2006.**

| Unaudited ($ millions) | Fourth Quarter | | Change | |
|---|---|---|---|---|
| | 2007 | 2006 | $ | % |
| **Operating revenues** | | | | |
| Passenger | $ 2,196 | $ 2,071 | $ 125 | 6 |
| Cargo | 142 | 166 | (24) | (14) |
| Other | 175 | 186 | (11) | (6) |
| | **2,513** | **2,423** | **90** | **4** |
| **Operating expenses** | | | | |
| Wages, salaries and benefits | 468 | 443 | 25 | 6 |
| Aircraft fuel | 615 | 583 | 32 | 5 |
| Aircraft rent | 62 | 83 | (21) | (25) |
| Airport and navigation fees | 238 | 232 | 6 | 3 |
| Aircraft maintenance, materials and supplies | 173 | 205 | (32) | (16) |
| Communications and information technology | 67 | 68 | (1) | (1) |
| Food, beverages and supplies | 67 | 76 | (9) | (12) |
| Depreciation, amortization and obsolescence | 140 | 135 | 5 | 4 |
| Commissions | 37 | 49 | (12) | (24) |
| Capacity purchase with Jazz | 227 | 224 | 3 | 1 |
| Special charge for labour restructuring | - | (8) | 8 | (100) |
| Other | 347 | 338 | 9 | 3 |
| | **2,441** | **2,428** | **13** | **1** |
| **Operating income (loss)** | **72** | **(5)** | **77** | |
| **Non-operating income (expense)** | | | | |
| Interest income | 22 | 24 | (2) | |
| Interest expense | (89) | (88) | (1) | |
| Interest capitalized | 20 | 22 | (2) | |
| Gain (loss) on disposal of assets | - | (10) | 10 | |
| Gain (loss) on financial instruments recorded at fair value | (1) | 1 | (2) | |
| Other | (4) | (1) | (3) | |
| | (52) | (52) | - | |
| **Income (loss) before the following items** | **20** | **(57)** | **77** | |
| Non-controlling interest | (3) | (3) | - | |
| Foreign exchange gain (loss) | 20 | (107) | 127 | |
| Recovery of (provision for) income taxes | (2) | 23 | (25) | |
| **Income (loss) for the period** | **$ 35** | **$ (144)** | **$ 179** | |
| **EBITDAR(1)** | **$ 274** | **$ 213** | **$ 61** | |
| **EBITDAR(1), excluding special charge** | **$ 274** | **$ 205** | **$ 69** | |
| **Earnings per share - Basic and diluted(2)** | **$ 0.35** | **$ (1.55)** | **$ 1.90** | |

(1) See section 19 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income.

(2) Earnings per share – basic and diluted are the consolidated Air Canada figures as reported under GAAP.

Air Canada reported operating income of $72 million in the fourth quarter of 2007 compared to an operating loss of $5 million in the fourth quarter of 2006, an improvement of $77 million. The fourth quarter of 2007 included a favourable revenue adjustment of $26 million relating to a change in accounting estimates.

EBITDAR of $274 million in the fourth quarter of 2007 reflected an increase of $61 million over the fourth quarter of 2006.

In the first quarter of 2006, Air Canada recorded a special charge for labour restructuring of $28 million related to a non-unionized workforce reduction program. In the fourth quarter of 2006, the estimated cost of this program was revised which allowed Air Canada to record a favourable adjustment of $8 million to the special charge for labour restructuring.

Excluding the favourable adjustment to the special charge for labour restructuring of $8 million in the fourth quarter of 2006, operating income and EBITDAR improved $85 million and $69 million, respectively.

**System passenger revenues increased 6.0% over the fourth quarter of 2006**

Passenger revenues increased $125 million or 6.0% to $2,196 million in the fourth quarter of 2007, due to both traffic and yield growth. A favourable revenue adjustment of $26 million relating to a change in accounting estimates was recorded in the fourth quarter of 2007. As this change in estimates pertains to revenues recorded in prior quarters of 2007, passenger revenue, yield and RASM percentage changes provided in the table below also exclude this favourable adjustment. The following factors contributed to the year-over-year change in fourth quarter system passenger revenues:

- Traffic growth of 2.6% on a capacity increase of 2.6%, resulting in a passenger load factor unchanged from the fourth quarter of 2006.
- A system yield improvement of 2.1% (excluding the favourable adjustment of $26 million) reflecting higher fares in the Canada and US transborder markets.
- A RASM increase of 2.1% (excluding the favourable adjustment of $26 million) due to the growth in yield on an unchanged passenger load factor. RASM is calculated by the multiplication of yield times passenger load factor.
- The inclusion of certain ancillary passenger fees effective January 1, 2007 which amounted to $19 million in the fourth quarter of 2007. These ancillary passenger fees were included in other revenues in 2006.
- The stronger Canadian dollar which had a negative impact on foreign currency denominated revenues. The impact accounted for a decrease of $37 million to fourth quarter 2007 passenger revenues.

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

| Fourth Quarter 2007 Versus Fourth Quarter 2006 | Passenger Revenue % Change | Capacity (ASMs) % Change | Traffic (RPMs) % Change | Passenger Load Factor pp Change | Yield % Change | RASM % Change |
|---|---|---|---|---|---|---|
| Canada | 8.0 | 3.0 | 2.5 | (0.4) | 5.3 | 4.8 |
| US transborder | 5.4 | 0.1 | 1.0 | 0.7 | 4.3 | 5.3 |
| Atlantic | 0.3 | 4.4 | 4.1 | (0.2) | (3.7) | (4.0) |
| Pacific | (4.2) | 0.3 | (2.0) | (1.9) | (2.3) | (4.5) |
| Other | 25.3 | 6.2 | 11.2 | 3.5 | 12.8 | 18.0 |
| Other(1) | 7.9 | 6.2 | 11.2 | 3.5 | (2.9) | 1.6 |
| **System** | **6.0** | **2.6** | **2.6** | - | **3.3** | **3.3** |
| **System(1)** | **4.8** | **2.6** | **2.6** | - | **2.1** | **2.1** |

(1) System and Other passenger revenue, yield and RASM percentage changes exclude a favourable adjustment of $26 million relating to a change in accounting estimates.

**Domestic passenger revenues increased 8.0% from the fourth quarter of 2006**

Domestic passenger revenues of $972 million in the fourth quarter of 2007 increased $72 million or 8.0% from the fourth quarter of 2006, due to both yield and traffic growth. The following factors contributed to the year-over-year change in fourth quarter domestic passenger revenues:

- Traffic growth of 2.5% on a capacity increase of 3.0% resulting in a decrease in passenger load factor of 0.4 percentage points (pp) over the fourth quarter of 2006. Capacity increases were largely reflected on the transcontinental services and also on the Atlantic Canada services and within western Canada.
- A yield increase of 5.3% largely as a result of a robust market which permitted fare increases.
- RASM growth of 4.8% due to the higher yield.
- The inclusion of certain ancillary passenger fees effective January 1, 2007 which contributed 1.6 percentage points to the yield growth.

**US transborder passenger revenues increased 5.4% from the fourth quarter of 2006**

US transborder passenger revenues were $456 million in the fourth quarter of 2007, an increase of $24 million or 5.4% from the fourth quarter of 2006, mainly due to a robust market which permitted fare increases. The following factors contributed to the year-over-year change in fourth quarter US transborder passenger revenues:

- Traffic growth of 1.0% on a capacity increase of 0.1%, resulting in a passenger load factor improvement of 0.7 percentage points.
- A yield improvement of 4.3% mainly due to a robust market which permitted fare increases and the inclusion of certain ancillary passenger fees effective January 1, 2007.
- RASM growth of 5.3% due to both the yield improvement and the higher passenger load factor.

**Atlantic passenger revenues increased 0.3% from the fourth quarter of 2006**

Atlantic passenger revenues of $374 million in the fourth quarter of 2007 increased $1 million or 0.3% from the fourth quarter of 2006. The following factors contributed to the year-over-year change in fourth quarter Atlantic passenger revenues:

- Traffic growth of 4.1% on a capacity increase of 4.4% resulting in a decrease in passenger load factor of 0.2 percentage points. Traffic growth was reflected in the United Kingdom market as a result of the newly launched Edmonton – London service, increased capacity on the Vancouver – London route and the addition of the larger Boeing 777 aircraft on the Toronto – London route. Traffic growth was also reflected in the France and German markets as a result of capacity growth driven by the addition of the Boeing 777 aircraft in these markets.
- A yield decline of 3.7% due to an aggressive competitive environment mainly in the United Kingdom, French and German markets. These markets accounted for 90% of Atlantic revenues.
- A RASM decrease of 4.0% primarily as a result of the decline in yield.

**Pacific passenger revenues decreased 4.2% from the fourth quarter of 2006**

Pacific passenger revenues of $209 million in the fourth quarter of 2007 decreased $9 million or 4.2% from the fourth quarter of 2006, due to both a traffic decrease and a decline in yield. The following factors contributed to the year-over-year change in fourth quarter Pacific passenger revenues:

- A traffic decrease of 2.0% on a capacity increase of 0.3% resulting in a decline in passenger load factor of 1.9 percentage points. A 45.1% increase in Canada – China capacity was largely offset by the impact of a capacity decrease in the Japan market and the suspension of service to India.
- A yield decrease of 2.3% due to growth in longer-haul flying. The average stage length increased 15.4% from the same period in 2006. Long-haul flights generally have a lower yield per revenue passenger mile than short-haul flights. When measured on a per mile basis, the average fare paid on long-haul flights is relatively lower than short-haul flights.
- A decrease in RASM of 4.5% due to both the yield decrease and the decline in passenger load factor.

**Other passenger revenues increased 25.3% from the fourth quarter of 2006**

Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) of $185 million in the fourth quarter of 2007 increased $37 million or 25.3% from the fourth quarter of 2006. The fourth quarter of 2007 included a favourable revenue adjustment of $26 million pertaining to a change in accounting estimates. Excluding this favourable adjustment in the fourth quarter of 2007, other passenger revenues increased 7.9%. The following factors contributed to the year-over-year change in fourth quarter other passenger revenues:

- Traffic growth of 11.2% on a capacity increase of 6.2% resulting in a passenger load factor improvement of 3.5 percentage points. Traffic growth in these markets mainly reflected higher capacity to traditional leisure destinations and the addition of a new non-stop service from Vancouver to Sydney, Australia.
- A yield decline of 2.9% (excluding the favourable adjustment of $26 million) reflecting the large capacity increase driven by Air Canada Vacations as well as the capacity growth on the South America routes. Pricing actions were taken to stimulate traffic on this additional capacity which adversely impacted the yield performance.
- RASM growth of 1.6% (excluding the favourable adjustment of $26 million) due to the improvement in passenger load factor.

**Cargo revenues declined 14% from the fourth quarter of 2006**

In the fourth quarter of 2007, total cargo revenue decreased $24 million or 14% from the fourth quarter of 2006. Freighter revenues declined $20 million or 52% due to termination of Asian freighter operations. Non-freighter revenues declined $4 million or 3%. System cargo yield per revenue ton mile improved 4%. The following factors contributed to the year-over-year change in fourth quarter cargo revenues:

- A system cargo traffic decrease of 18% on a 6% reduction to available cargo capacity. Reduced freighter operations accounted for three quarters of the traffic reduction. In late 2006, the Corporation decided to terminate MD-11 freighter operations to Asia due to inadequate financial returns. One MD-11 freighter was removed in November 2006 and a second freighter was removed at the end of June 2007, bringing an end to Asia freighter operations. Air Canada continues to operate one chartered MD-11 freighter to Europe.
- A decrease in North American non-freighter revenues of $3 million or 7% due in part to reduced cargo capacity.
- A stronger Canadian dollar had a negative impact on freighter and non-freighter foreign currency denominated revenues.

**Other revenues were down 6% from the fourth quarter of 2006**

Other revenues of $175 million in the fourth quarter of 2007 decreased $11 million or 6% from the fourth quarter of 2006. The following factors contributed to the year-over-year change in fourth quarter other revenues:

- Reduced ancillary passenger fee revenue of $17 million. Certain ancillary passenger fees, which were included in other revenues in 2006, were included in passenger revenues in 2007.
- Aircraft sublease revenues from third parties of $11 million in 2007 versus nil in 2006 partially offset the above-noted decrease.

**Operating expenses increased 1% from the fourth quarter of 2006**

Operating expenses were $2,441 million in the fourth quarter of 2007, an increase of $13 million or 1% over the fourth quarter of 2006. CASM decreased 2% in the fourth quarter of 2007. Excluding fuel expense and the favourable adjustment to the special charge for labour restructuring of $8 million in 2006, CASM was down 3.9%. In our Third Quarter 2007 MD&A dated November 8, 2007, we provided guidance that CASM, excluding fuel expense, for the fourth quarter of 2007 was expected to decrease at a slightly lower rate year-over-year than experienced in the third quarter of 2007. The decline in fourth quarter CASM, excluding fuel expense, exceeded the guidance provided at that time as a result of greater than expected unit cost reductions across a wide range of categories.

The following table compares Air Canada's operating expenses per ASM for the fourth quarter of 2007 to Air Canada's operating expenses per ASM for the corresponding period in 2006. The stronger Canadian dollar versus the US dollar was a factor in the overall unit cost decrease over the fourth quarter of 2006, particularly in aircraft fuel.

| | Fourth Quarter | | Change | |
|---|---|---|---|---|
| **(cents per ASM)** | **2007** | **2006** | **cents** | **%** |
| Wages and salaries | 2.56 | 2.60 | (0.04) | (1.5) |
| Benefits | 0.62 | 0.49 | 0.13 | 26.5 |
| Ownership (DAR) [1] | 1.38 | 1.52 | (0.14) | (9.2) |
| Airport and navigation fees | 1.61 | 1.62 | (0.01) | (0.6) |
| Aircraft maintenance, materials and supplies | 1.20 | 1.43 | (0.23) | (16.1) |
| Communications and information technology | 0.46 | 0.47 | (0.01) | (2.1) |
| Food, beverages and supplies | 0.45 | 0.53 | (0.08) | (15.1) |
| Commissions | 0.25 | 0.34 | (0.09) | (26.5) |
| Capacity purchase with Jazz | 1.54 | 1.56 | (0.02) | (1.3) |
| Other | 2.34 | 2.35 | (0.01) | (0.4) |
| **Operating expense, excluding fuel expense and the special charge for labour restructuring [2]** | **12.41** | **12.91** | **(0.50)** | **(3.9)** |
| Aircraft fuel | 4.18 | 4.06 | 0.12 | 3.0 |
| Special charge for labour restructuring | - | (0.05) | 0.05 | - |
| **Total operating expense** | **16.59** | **16.92** | **(0.33)** | **(2.0)** |

(1) DAR refers to the combination of Aircraft rent and Depreciation, amortization and obsolescence.

(2) Refer to section 19 "Non-GAAP Financial Measures" in this MD&A for additional information.

**Wages, salaries and benefits amounted to $468 million in the fourth quarter of 2007, an increase of $25 million or 6% from the fourth quarter of 2006.**

Wages and salaries expense totaled $377 million in the fourth quarter of 2007, an increase of $4 million or 1% from the fourth quarter of 2006. Factors contributing to the year-over-year fourth quarter change in wages and salaries expense included:

- The addition of 583 full-time equivalent ("FTE") employees or 2.5%, mainly reflecting increases in ground handling personnel, pilots and flight attendants. The increase was required to support the growth in ASM capacity.
- Higher average wage rates established during the wage review process with the Corporation's unionized employees, partly offset by new personnel joining the Corporation at the lower end of the wage scale.
- Reduced overtime expenses of $2 million in 2007.

Employee benefits expense amounted to $91 million in the fourth quarter of 2007, an increase of $21 million or 30% from the fourth quarter of 2006. Factors contributing to the year-over-year fourth quarter change in benefits expense included:

- A revised contractual agreement with respect to the allocation of benefits expense to ACTS LP which resulted in an increase of $9 million over 2006.
- A decrease of $8 million in the fourth quarter of 2006 related to an updated valuation of workers' compensation liabilities.
- An increase of $4 million mainly related to health benefits for active employees.

**Fuel expense increased 5% from the fourth quarter of 2006**
Fuel expense amounted to $615 million in the fourth quarter of 2007, an increase of $32 million or 5% from the fourth quarter of 2006. Factors contributing to the year-over-year fourth quarter change in fuel expense included:

- A higher base fuel price which accounted for an increase of $180 million.
- The favourable impact of a stronger Canadian dollar versus the US dollar which accounted for a decrease of $84 million.
- Fuel hedging gains of $31 million in the fourth quarter of 2007 versus hedging losses of $33 million in the fourth quarter of 2006, a favourable variance of $64 million.
- The fuel volume consumed remained unchanged in the fourth quarter of 2007 from the same period in 2006. The impact of the increase in ASM capacity was offset by the replacement of the Airbus A340 aircraft with more fuel efficient Boeing 777 aircraft and a reduction in flying from MD-11 freighter aircraft.

**Ownership costs decreased 7% from the fourth quarter of 2006**
Ownership costs, comprised of aircraft rent, depreciation, amortization and obsolescence expenses, of $202 million in the fourth quarter of 2007 decreased $16 million from the fourth quarter of 2006. Factors contributing to the year-over-year fourth quarter change in ownership costs included:

- A favourable adjustment of $9 million in 2007 versus an unfavourable adjustment of $7 million in 2006, both related to provisions on rotable spare parts, for a favourable variance of $16 million.
- The impact of reduced MD-11 freighter flying versus 2006 which accounted for a decrease of $8 million to aircraft rent.
- The impact of a stronger Canadian dollar versus the US dollar which accounted for a decrease of $8 million.
- The impact of aircraft lease returns and terminations which accounted for a decrease of $5 million.
- Other factors accounting for a net decrease of $7 million.

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

- The addition of aircraft to Air Canada's operating fleet which accounted for an increase of $18 million.
- Depreciation expenses of $10 million in 2007 related to Air Canada's aircraft interior refurbishment program. No depreciation was recorded for this program in 2006.

**Airport and navigation fees increased 3% from the fourth quarter of 2006**
Airport and navigation fees of $238 million increased $6 million or 3% over the fourth quarter of 2006. Factors contributing to the year-over-year fourth quarter change in these fees included:

- A 3% increase in aircraft frequencies.
- Higher rates for landing and general terminal fees.
- A rate reduction of 4% for navigation fees in Canada, which became effective in August 2007, partially offset the above-noted increases.

On October 16, 2007, the Greater Toronto Airports Authority ("GTAA") announced a reduction in fees charged to airlines for all services. Landing fees at Pearson Airport were reduced by 3.1% and terminal charges were reduced by 4.7% effective January 1, 2008.

**Aircraft maintenance materials and supplies decreased 16% from the fourth quarter of 2006**
Aircraft maintenance, materials and supplies of $173 million in the fourth quarter of 2007 decreased $32 million or 16% from the fourth quarter of 2006. Factors contributing to the year-over-year fourth quarter change in aircraft maintenance, materials and supplies expense included:

- The impact of a stronger Canadian dollar versus the US dollar which accounted for a decrease of $11 million in 2007.
- A $25 million reduction in airframe and engine maintenance expenses for the Boeing 767 aircraft due to the timing of maintenance events versus the same period in 2006.
- Reduced airframe and engine maintenance expenses of $10 million due to the lease and sublease of four Airbus A340 aircraft to third parties.
- A $9 million one-time charge in 2006 relating to a new component maintenance agreement with ACTS.

The above decreases were partly offset by the following:

- An increase in expense of $5 million related to the preparation of aircraft for sublease.
- An increase of $11 million relating to the narrow-body fleet, including the Embraer aircraft, and the Airbus A330 aircraft due to timing of maintenance activities versus the fourth quarter of 2006.
- Higher deicing expenses of $10 million over 2006 due to more severe weather conditions in 2007 versus the same period in 2006.

**Food, beverages and supplies decreased 12% from the fourth quarter of 2006**
Food, beverages and supplies of $67 million in the fourth quarter of 2007 decreased $9 million or 12% from the fourth quarter of 2006 despite a passenger traffic growth of 2.6%. Factors contributing to the year-over-year fourth quarter decrease in food, beverages and supplies expense included cost savings initiatives implemented by Air Canada in 2007.

**Commission expense decreased 24% from the fourth quarter of 2006**
Despite a combined passenger and cargo revenue growth of 5% over the fourth quarter of 2006, commission expense of $37 million in the fourth quarter of 2007 decreased $12 million or 24% from the fourth quarter of 2006. Factors contributing to the year-over-year fourth quarter change in commission expense included:

- The favourable impact of a new commission structure at Air Canada Vacations in 2007.
- Commercial initiatives implemented by Air Canada to lower commission costs.
- An increase in web penetration which lowers distribution costs.

Web penetration in Canada reached 64% in the fourth quarter of 2007, a 7 percentage point increase from the fourth quarter of 2006. Web penetration for combined domestic Canada and US transborder passenger sales was 55%, a 9 percentage point increase over the previous year's quarter. System-wide web penetration of 34% represented an increase of 6 percentage points from the fourth quarter of 2006. These figures do not include sales from Air Canada call centres that employ the Air Canada host platform. Including sales from call centres, Air Canada's direct penetration for Canada was 72% for the fourth quarter of 2007 versus 69% for the fourth quarter of 2006.

**Capacity purchase fees paid to Jazz increased 1% from the fourth quarter of 2006**

Capacity purchase fees paid to Jazz, pursuant to the capacity purchase agreement between Jazz and Air Canada ("Jazz CPA"), amounted to $227 million in the fourth quarter of 2007 compared to capacity fees paid to Jazz of $224 million in the fourth quarter of 2006, an increase of $3 million. ASM capacity flown by Jazz grew 2.9% over the fourth quarter of 2006 and represented 9.5% of total capacity. Refer to section 12 "Related Party Transactions" for a description of the Jazz CPA.

**Other operating expenses increased 3% from the fourth quarter of 2006**

Other operating expenses, largely comprised of terminal handling expenses, credit card fees, building rent and maintenance, the cost of ground packages at Air Canada Vacations and miscellaneous fees and services, amounted to $347 million in the fourth quarter of 2007, an increase of $9 million or 3% from the fourth quarter of 2006. Increases included employee injury compensation expenses, bad debt expense, credit card fees, advertising and promotion expenses and the cost of ground packages at Air Canada Vacations as a result of higher passenger volumes. Decreases included terminal handling expenses, joint venture settlements, miscellaneous fees and services, utilities expenses and insurance costs.

**Non-operating expense was unchanged from the fourth quarter of 2006**

Non-operating expense amounted to $52 million in the fourth quarter of 2007, unchanged compared to the fourth quarter of 2006. Factors contributing to the year-over-year fourth quarter change in non-operating expense included:

- An increase in net interest expense of $5 million.
- In the fourth quarter of 2006, Air Canada recorded an impairment provision of $7 million related to a real estate property and recorded other losses on disposal of assets amounting to $3 million. No gains or losses on disposal of assets were recorded in the fourth quarter of 2007.
- Losses relating to fair value adjustment on certain derivatives instruments amounted to $1 million in the fourth quarter of 2007 versus gains of $1 million in the same quarter of 2006.
- A loss of $4 million in other non-operating expense in the fourth quarter of 2007 versus a loss of $1 million in the fourth quarter of 2006.

**Net gains on foreign currency monetary items amounted to $20 million in the fourth quarter of 2007**

Net gains on foreign currency monetary items amounted to $20 million in the fourth quarter of 2007. This compared to losses of $107 million in the fourth quarter of 2006.

**Income tax expense of $2 million**

The income tax expense was $2 million in the fourth quarter of 2007 as income tax was favourably impacted by a credit related to changes in federal corporate income tax rates during the period amounting to $12 million, after consideration of the valuation allowance. In the fourth quarter of 2006, the recovery of income tax was $23 million.

**Net income increased $179 million from the fourth quarter of 2006**

Net income of $35 million was recorded in the fourth quarter of 2007 compared to a net loss of $144 million in the fourth quarter of 2006.

## 5. RESULTS OF OPERATIONS – 2007 VERSUS 2006

Air Canada recorded consolidated operating income of $495 million and net income of $429 million in 2007. The 2007 results included the consolidation of Jazz's operations only up to May 24, 2007. In 2006, Air Canada reported consolidated operating income of $259 million and a net loss of $74 million. The 2006 results included the consolidation of Jazz's operations. Prior to May 24, 2007, Air Canada had two reportable segments: Air Canada Services and Jazz. Effective May 24, 2007, Air Canada no longer consolidates the operations of Jazz. As a result of this change, Air Canada's consolidated results for the full year 2007 are not directly comparable to its consolidated results for the full year 2006. **For comparative purposes, the following table and discussion provides the reader with the results of Air Canada for the full year 2007, excluding the consolidation of Jazz, and the results of Air Canada, excluding the consolidation of Jazz (previously the "Air Canada Services" segment) for the full year 2006.**

| ($ millions) | Year | | Change | |
|---|---|---|---|---|
| | 2007 | 2006 | $ | % |
| **Operating revenues** | | | | |
| Passenger | $ 9,329 | $ 8,887 | $ 442 | 5 |
| Cargo | 550 | 629 | (79) | (13) |
| Other | 767 | 750 | 17 | 2 |
| | **10,646** | **10,266** | **380** | **4** |
| Special charge for Aeroplan miles | **-** | **(102)** | **102** | **(100)** |
| | **10,646** | **10,164** | **482** | **5** |
| **Operating expenses** | | | | |
| Wages, salaries and benefits | 1,920 | 1,816 | 104 | 6 |
| Aircraft fuel | 2,552 | 2,544 | 8 | - |
| Aircraft rent | 282 | 341 | (59) | (17) |
| Airport and navigation fees | 1,022 | 982 | 40 | 4 |
| Aircraft maintenance, materials and supplies | 757 | 768 | (11) | (1) |
| Communications and information technology | 275 | 273 | 2 | 1 |
| Food, beverages and supplies | 313 | 322 | (9) | (3) |
| Depreciation, amortization and obsolescence | 548 | 493 | 55 | 11 |
| Commissions | 201 | 237 | (36) | (15) |
| Capacity purchase with Jazz | 923 | 871 | 52 | 6 |
| Special charge for labour restructuring | - | 20 | (20) | (100) |
| Other | 1,420 | 1,383 | 37 | 3 |
| | **10,213** | **10,050** | **163** | **2** |
| **Operating income** | **433** | **114** | **319** | |
| **Non-operating income (expense)** | | | | |
| Interest income | 92 | 82 | 10 | |
| Interest expense | (348) | (313) | (35) | |
| Interest capitalized | 108 | 62 | 46 | |
| Gain (loss) on disposal of assets | 19 | (6) | 25 | |
| Gain (loss) on financial instruments recorded at fair value | 26 | (18) | 44 | |
| Other | (19) | 2 | (21) | |
| | (122) | (191) | 69 | |
| **Income (loss) before the following items** | **311** | **(77)** | **388** | |
| Non-controlling interest | (9) | (12) | 3 | |
| Foreign exchange gain | 317 | 12 | 305 | |
| Recovery of (provision for) income taxes | (190) | 3 | (193) | |
| **Income (loss) for the period** | **$ 429** | **$ (74)** | **$ 503** | |
| **EBITDAR(1)** | **$ 1,263** | **$ 948** | **$ 315** | |
| **EBITDAR(1), excluding special charges** | **$ 1,263** | **$ 1,070** | **$ 193** | |
| **Earnings per share - Basic(2)** | **$ 4.29** | **$ (0.83)** | **$ 5.12** | |
| **Earnings per share - Diluted(2)** | **$ 4.27** | **$ (0.83)** | **$ 5.10** | |

(1) See section 19 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss) and EBITDAR, excluding special charges to operating income (loss).

(2) Earnings per share – basic and diluted are the consolidated Air Canada figures as reported under GAAP.

Air Canada reported operating income of $433 million in 2007 compared to operating income of $114 million in 2006, an increase of $319 million. EBITDAR of $1,263 million in 2007 reflected an improvement of $315 million over 2006.

In the third quarter of 2006, Air Canada recorded a special charge of $102 million in operating revenues in connection with Air Canada's obligations for the redemption of pre-2002 Aeroplan miles. In the first quarter of 2006, Air Canada recorded a special charge for labour restructuring of $28 million related to a non-unionized workforce reduction program. In the fourth quarter of 2006, the estimated cost of this program was revised which allowed Air Canada to record a favourable adjustment of $8 million to the special charge for labour restructuring, bringing the total cost to $20 million for 2006.

Excluding the special charge for Aeroplan miles and the special charge for labour restructuring in 2006, operating income and EBITDAR for 2007 increased by $197 million and $193 million, respectively, over 2006.

**System passenger revenues increased 5.0% over 2006**

Passenger revenues increased $442 million or 5.0% to $9,329 million in 2007, due to traffic and yield growth. The following factors contributed to the year-over-year change in system passenger revenues:

- A traffic growth of 3.3% on a capacity increase of 2.8%, resulting in a passenger load factor increase of 0.4 percentage points.
- A system yield increase of 1.6% reflecting improvements in all markets with the exception of the Atlantic market.
- A RASM improvement of 2.1% mostly due to the growth in yield but also because of the higher passenger load factor.
- The inclusion of certain ancillary passenger fees effective January 1, 2007 which amounted to $73 million in 2007. These ancillary passenger fees were included in other revenues in 2006.
- The stronger Canadian dollar which had a negative impact on foreign currency denominated revenues. The impact, which was reflected in the last six months of 2007, accounted for a decrease of $40 million to 2007 passenger revenues.

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

| Year 2007 Versus Year 2006 | Passenger Revenue % Change | Capacity (ASMs) % Change | Traffic (RPMs) % Change | Passenger Load Factor pp Change | Yield % Change | RASM % Change |
|---|---|---|---|---|---|---|
| Canada | 7.9 | 3.6 | 5.3 | 1.3 | 2.5 | 4.2 |
| US transborder | 3.2 | 1.5 | 1.5 | - | 1.7 | 1.7 |
| Atlantic | 0.6 | 3.6 | 3.1 | (0.4) | (2.4) | (2.9) |
| Pacific | 2.1 | 0.8 | 0.7 | (0.1) | 1.4 | 1.3 |
| Other | 9.6 | 4.8 | 6.0 | 0.9 | 3.4 | 4.6 |
| **System** | **5.0** | **2.8** | **3.3** | **0.4** | **1.6** | **2.1** |

**Domestic passenger revenues increased 7.9% from 2006**

Domestic passenger revenues of $3,970 million in 2007 increased $291 million or 7.9% from 2006, on both traffic and yield growth. The following factors contributed to the year-over-year change in domestic passenger revenues:

- Traffic growth of 5.3% on a capacity increase of 3.6% resulting in an increase in passenger load factor of 1.3 percentage points. Capacity increases were largely reflected on the transcontinental services but also on the Atlantic Canada services and within western Canada.
- A yield increase of 2.5% largely as a result of stronger market demand in most markets. Aggressive pricing on Rapidair operations between Toronto and Montreal/Ottawa was the only negative factor in the otherwise strong domestic yield performance.
- The inclusion of certain ancillary passenger fees effective January 1, 2007 which contributed 1.4 percentage points to the yield growth.
- RASM growth of 4.2% due to the higher yield and the passenger load factor improvement.

**US transborder passenger revenues increased 3.2% from 2006**
US transborder passenger revenues were $1,884 million in 2007, an increase of $59 million or 3.2% from 2006 mainly due to yield and traffic growth. The following factors contributed to the year-over-year change in US transborder passenger revenues:

- Traffic and capacity growth of 1.5% resulting in a passenger load factor unchanged from 2006. In the early part of 2007, Air Canada shifted capacity from the US transborder market to the Canadian domestic market.
- A yield improvement of 1.7% reflecting stronger market demand and the inclusion of certain ancillary passenger fees effective January 1, 2007.
- RASM growth of 1.7% due to the yield improvement.

**Atlantic passenger revenues increased 0.6% from 2006**
Atlantic passenger revenues of $1,806 million in 2007 increased $11 million or 0.6% from 2006 due to traffic growth. The following factors contributed to the year-over-year change in Atlantic passenger revenues:

- Traffic growth of 3.1% on a capacity increase of 3.6% resulting in a decrease in passenger load factor of 0.4 percentage points. The traffic growth was largely reflected in the United Kingdom market as a result of increased capacity on the Vancouver – London route, the newly launched Edmonton – London service and additional capacity from Atlantic Canada to London. Traffic also grew in the German market due to capacity increases reflecting the addition of the larger Boeing 777 aircraft. Expanded services on the seasonal Montreal – Rome route was also a factor in the traffic growth over 2006.
- A yield decline of 2.4% due to increased competition, particularly in the second and third quarters of 2007, as a result of the new service on British Airways from Calgary to London as well as a substantial increase in competitive fare actions due to a significant capacity increase by low-cost carriers in the Canada – London market.
- A RASM decrease of 2.9% as a result of the decline in yield and, to a much lesser extent, the decrease in passenger load factor.

**Pacific passenger revenues increased 2.1% from 2006**
Pacific passenger revenues of $967 million in 2007 increased $21 million or 2.1% from 2006 due to both yield and traffic growth. The following factors contributed to the year-over-year change in Pacific passenger revenues:

- Traffic growth of 0.7% on a capacity increase of 0.8% resulting in a decline in passenger load factor of 0.1 percentage points. A 28.6% increase in Canada – China capacity was largely offset by the impact of capacity decreases in the Japan and Korea markets and the cancellation of service to India.
- A yield improvement of 1.4% primarily reflecting growth in the Hong Kong and Japan markets.
- A RASM increase of 1.3% reflecting the yield growth.

**Other passenger revenues increased 9.6% from 2006**
Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) of $702 million in 2007 increased $61 million or 9.6% from 2006 due to traffic growth and a yield improvement. The following factors contributed to the year-over-year change in other passenger revenues:

- Traffic growth of 6.0% on a capacity increase of 4.8% resulting in a passenger load factor improvement of 0.9 percentage points. Traffic growth in these markets mainly reflected higher capacity to traditional leisure destinations and, to a lesser extent, to South America.
- A yield improvement of 3.4% largely reflecting growth in South America, the South Pacific and the Caribbean. Increased capacity in the Spanish Caribbean markets resulted in traffic and revenue growth in these markets. However, the highly competitive environment in these markets had a negative impact on the yield.
- A RASM increase of 4.6% due primarily to the yield growth but also to the passenger load factor improvement.

**Cargo revenues declined 13% from 2006**

Total cargo revenues of $550 million in 2007 decreased $79 million or 13% from 2006. Freighter revenues declined $55 million or 39% mainly due to termination of Asian freighter operations. Non-freighter revenues declined $24 million or 5%. System cargo yield per revenue ton mile increased 1%. The following factors contributed to the year-over-year change in cargo revenues were:

- A system cargo traffic decrease of 14% on a 6% reduction to available cargo capacity. Reduced freighter operations accounted for almost three quarters of the traffic reduction.
- In late 2006, the Corporation decided to terminate MD-11 freighter operations to Asia due to inadequate financial returns. One MD-11 freighter was removed in November 2006 and a second freighter was removed at the end of June 2007, bringing an end to Asia freighter operations. Air Canada continues to operate one chartered MD-11 freighter to Europe.
- A decrease in freighter revenues for which operating expenses were down by a greater amount resulting in an improved financial result for freighter aircraft. Freighter revenues per unit of available capacity improved 9% from 2006.
- A decrease in North American non-freighter revenues of $15 million or 10% due in part to reduced cargo capacity and reduced Pacific revenues in the first half of 2007 due to weaker demand.

**Other revenues grew 2% from 2006**

Other revenues of $767 million in 2007 grew $17 million or 2% from 2006. The following factors contributed to the change in other revenues:

- Aircraft sublease revenues from third parties of $26 million in 2007 versus nil in 2006.
- A growth in third party revenues at Air Canada Vacations of $17 million as a result of higher passenger volumes.
- An increase in third party line maintenance revenues of $5 million.
- A growth in third party ground handling revenues of $5 million.
- Additional miscellaneous revenues of $15 million over 2006.
- The increases noted above were almost totally offset by a reduction of $51 million in ancillary fee revenue. Certain ancillary passenger fees were reclassified to passenger revenues effective January 1, 2007. These revenues were recorded in other revenues in 2006.

**Operating expenses increased 2% from 2006**

Operating expenses were $10,213 million in 2007, an increase of $163 million or 2% over 2006. CASM decreased 1.2% while CASM, excluding fuel expense and special charges, was reduced by 0.4%. In our Third Quarter 2007 MD&A dated November 8, 2007, we provided guidance that full year 2007 CASM, excluding fuel expenses, was expected to decrease less than 1% from 2006. The decline in CASM, excluding fuel expense, for 2007 versus 2006 was in line with the guidance provided at that time.

The following table compares Air Canada's operating expenses per ASM for 2007 to Air Canada's operating expenses per ASM for 2006. The stronger Canadian dollar versus the US dollar was a factor in the overall unit cost decrease over 2006, particularly in aircraft fuel.

| | | | Change | |
|---|---|---|---|---|
| (cents per ASM) | 2007 | 2006 | $ | % |
| Wages and salaries | 2.43 | 2.35 | 0.08 | 3.4 |
| Benefits | 0.63 | 0.62 | 0.01 | 1.6 |
| Ownership (DAR) (1) | 1.32 | 1.37 | (0.05) | (3.6) |
| Airport and navigation fees | 1.63 | 1.61 | 0.02 | 1.2 |
| Aircraft maintenance, materials and supplies | 1.21 | 1.26 | (0.05) | (4.0) |
| Communications and information technology | 0.44 | 0.45 | (0.01) | (2.2) |
| Food, beverages and supplies | 0.50 | 0.53 | (0.03) | (5.7) |
| Commissions | 0.32 | 0.39 | (0.07) | (17.9) |
| Capacity purchase with Jazz | 1.47 | 1.43 | 0.04 | 2.8 |
| Other | 2.25 | 2.24 | 0.01 | 0.4 |
| **Operating expense, excluding fuel expense and the special charge for labour restructuring (2)** | **12.20** | **12.25** | **(0.05)** | **(0.4)** |
| Aircraft fuel | 4.06 | 4.17 | (0.11) | (2.6) |
| Special charge for labour restructuring | - | 0.03 | (0.03) | (100.0) |
| **Total operating expense** | **16.26** | **16.45** | **(0.19)** | **(1.2)** |

(1) DAR refers to the combination of Aircraft rent and Depreciation, amortization and obsolescence.

(2) Refer to section 19 "Non-GAAP Financial Measures" in this MD&A for additional information.

**Wages, salaries and benefits amounted to $1,920 million in 2007, an increase of $104 million or 6% from 2006.** Wages and salaries expense totaled $1,525 million in 2007, an increase of $88 million or 6% from 2006. Factors contributing to the year-over-year change in wages and salaries expense included:

- All quarters of 2007 with the exception of the first quarter reflected increases over the same periods in 2006, resulting in a net increase of 298 full-time equivalent ("FTE") employees or 1.3%. The growth in FTE employees was mainly related to pilots, flight attendants and ground handling personnel required to support the 2.8% growth in ASM capacity.
- The total average number of FTEs included an increase of 204 pilots, comparatively at a higher average wage than other groups, driving the overall average salaries up.
- Higher average wage rates established during the wage review process with the Corporation's unionized employees.
- A $9 million increase in provisions for voluntary separation packages.
- An increase of $3 million in overtime expenses.

Employee benefits expense amounted to $395 million in 2007, an increase of $16 million or 4% from 2006. Factors contributing to the year-over-year change in benefits expense included:

- A revised contractual agreement with respect to benefits expenses allocated to ACTS which resulted in an increase of $20 million over 2006.
- An increase of $12 million related to health benefits for active employees.
- A decrease of $8 million in 2006 related to an updated valuation of workers' compensation liabilities.
- Other miscellaneous increases of $4 million over 2006.

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

- A decline of $22 million in pension expense as a result of revised actuarial valuations.
- A decline of $6 million in post-employment benefit expenses as a result of revised actuarial valuations.

**Fuel expense increased $8 million from 2006**

Fuel expense amounted to $2,552 million in 2007, an increase of $8 million over 2006. Factors contributing to the year-over-year change in fuel expense included:

- A higher base fuel price, particularly in the fourth quarter, which accounted for an increase of $177 million.
- The fuel volume consumed in 2007 increased by 2% or $40 million from 2006. The impact of the increase in ASM capacity was partly offset by the replacement of the Airbus A340 aircraft with more fuel efficient Boeing 777 aircraft and a reduction in flying from MD-11 freighter aircraft.

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

- The favourable impact of a stronger Canadian dollar versus the US dollar, particularly in the second half of the year, which accounted for a decrease of $135 million.
- Fuel hedging gains of $31 million in 2007 versus hedging losses of $43 million in 2006, resulting in a favourable variance of $74 million.

The following table provides Air Canada's quarterly fuel price per litre and fuel consumption information for the year 2007.

| 2007 | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Year |
|---|---|---|---|---|---|
| Fuel volume (millions of litres) | 925 | 941 | 1,102 | 905 | 3,873 |
| Fuel price per litre ($ cents) | 62.9 | 67.2 | 64.7 | 67.5 | 65.6 |

**Ownership costs decreased $4 million from 2006**

Ownership costs, comprised of aircraft rent, depreciation, amortization and obsolescence expenses, of $830 million in 2007 decreased $4 million over 2006. Factors contributing to the year-over-year change in ownership costs included:

- The impact of reduced MD-11 freighter flying versus 2006 which accounted for a decrease of $27 million to aircraft rent.
- A $20 million decrease in amortization expenses relating to intangible assets as a result of future income tax adjustments.
- The impact of aircraft lease returns and terminations which accounted for a decrease of $18 million.
- The impact of stronger Canadian dollar versus the US dollar, particularly in the second half of the year, which accounted for a decrease of $11 million.

The above-noted decreases were largely offset by the following:

- The addition of aircraft to Air Canada's operating fleet which accounted for an increase of $46 million.
- Depreciation expense of $21 million in 2007 related to Air Canada's aircraft interior refurbishment program. No depreciation for this program was recorded in 2006.
- Other factors accounting for an increase of $5 million.

**Airport and navigation fees increased 4% from 2006**

Airport and navigation fees of $1,022 million increased $40 million or 4% over 2006. Factors contributing to the year-over-year change in these fees included:

- A 5% increase in aircraft frequencies;
- Higher rates for landing and general terminal fees, primarily at Toronto's Pearson International Airport ("Pearson Airport").
- Rate reductions of 4% and 1.7% for navigation fees in Canada, which became effective in August 2007 and in September 2006, respectively, partially offset the above-noted increases.

**Aircraft maintenance materials and supplies decreased 1% from 2006**

Aircraft maintenance, materials and supplies of $757 million in 2007 decreased $11 million or 1% from 2006. Factors contributing to the year-over-year change in aircraft maintenance materials and supplies expense included:

- A decline in component maintenance expenses of $17 million due to lower rates resulting from a new agreement.
- A $9 million one-time charge in 2006 to transition to a new agreement.
- A decrease in engine maintenance expenses of $17 million due to a decline in Boeing 767 maintenance activity reflecting aircraft returns in 2007 and timing of maintenance events versus 2006.
- A decrease in airframe maintenance expenses of $11 million mainly due to reduced Boeing 767 maintenance activity reflecting aircraft returns in 2007 and maintenance cycle timing.
- The impact of a stronger Canadian dollar versus the US dollar which accounted for a decrease of $11 million in 2007.

These above decreases were largely offset by the following:

- An increase in expense of $39 million related to the preparation of aircraft to return to lessor or for sublease.
- Higher deicing expenses of $15 million over 2006 due more severe weather conditions in 2007 as compared to 2006.

**Food, beverages and supplies decreased 3% from 2006**

Food, beverages and supplies of $313 million in 2007 decreased $9 million or 3% from 2006 despite a passenger traffic growth of 3.3%. Factors contributing to the year-over-year decrease in food, beverages and supplies expense included cost savings initiatives implemented by Air Canada in 2007 partially offset by the higher volume of traffic compared to 2006.

**Commission expense decreased 15% from 2006**

Despite a combined passenger and cargo revenue growth of 4% over 2006, commission expense of $201 million in 2007 decreased $36 million or 15% from 2006. Factors contributing to the year-over-year change in commission expense included:

- The favourable impact of a new commission structure at Air Canada Vacations in 2007.
- Commercial initiatives implemented by Air Canada to lower commission costs.
- An increase in web penetration which lowers distribution costs.

**Capacity purchase fees paid to Jazz increased 6% from 2006**

Capacity purchase fees paid to Jazz pursuant to the Jazz CPA amounted to $923 million in 2007 compared to capacity fees paid to Jazz of $871 million in 2006, an increase of $52 million or 6%. Jazz block hours grew 8% over 2006.

**Other operating expenses increased 3% from 2006**

Other operating expenses, largely comprised of terminal handling expenses, credit card fees, building rent and maintenance, the cost of ground packages at Air Canada Vacations and miscellaneous fees and services, amounted to $1,420 million in 2007, an increase of $37 million from 2006.

An increase of $29 million relating to the cost of ground packages at Air Canada Vacations as a result of higher passenger volumes was a significant factor in the growth in other operating expenses over 2006. The increase in costs was driven by higher passenger volumes mainly in the first quarter of 2007.

**Non-operating expense decreased $69 million from 2006**

Non-operating expense amounted to $122 million in 2007, a decrease of $69 million compared to 2006. Factors contributing to the year-over-year change in non-operating income (expense) included:

- A decrease in net interest expense of $21 million. A $35 million increase in interest expense, largely driven by the financing of additional aircraft, was more than offset by a growth in interest income and a higher amount of capitalized interest relating to new aircraft.
- In 2007, Air Canada recorded gains of $14 million related to a damaged aircraft and gains of $5 million mainly pertaining to the sale of one real estate property.
- In 2006, Air Canada recorded an impairment provision of $7 million relating to one real estate property, other losses on disposal amounting to $4 million and a gain on sale of $5 million pertaining to one of its commercial real estate properties.
- Gains relating to fair value adjustment on certain derivatives instruments amounted to $26 million in 2007 versus losses of $18 million in 2006.

**Net gains on foreign currency monetary items amounted to $317 million in 2007**

Net gains on foreign currency monetary items amounted to $317 million in 2007, attributable to a stronger Canadian dollar at December 31, 2007 compared to December 31, 2006. This compared to gains of $12 million in 2006. The net gains recorded in 2007 were comprised of gains of $541 million relating to the mark-to-market of US denominated monetary items partially offset by losses of $224 million relating to the mark-to-market of foreign currency forward contracts.

**Effective income tax rate is 31%**

The income tax provision was $190 million in 2007 and represented an effective tax rate of 31%. In 2006, the income tax recovery was $3 million.

The effective income tax rate for 2007 was favorably impacted by the capital portion of certain foreign exchange gains reported in the year, which are tax-affected at 50% of the income tax rate. In addition, the favorable impact of a reduction in the federal corporate income tax rate was recognized in 2007. In addition to the federal changes, the Corporation also recorded a current tax expense of $10 million related to the harmonization of Ontario and federal income taxes. This change in tax law results in a tax liability of $10 million payable over a period of five years, beginning in the 2009 taxation year.

**Net income increased $503 million from 2006**

Net income of $429 million was recorded in 2007 compared to a net loss of $74 million in 2006. 2006 results included the special charge for Aeroplan miles of $102 million and a special charge for labour restructuring of $20 million.

## 6. OUR FLEET

Air Canada's operating fleet at December 31, 2007 (excluding aircraft operated by Jazz under the Jazz CPA) was as follows:

| Air Canada | Total Seats | Number of Operating Aircraft(1) | Average Age | Owned(2) | Capital Lease(2) | Consolidated Under AcG-15(2) | Operating Lease |
|---|---|---|---|---|---|---|---|
| Widebody Aircraft | | | | | | | |
| Boeing 777-300 | 349 | 5 | 0.6 | 4 | - | - | 1 |
| Boeing 777-200 | 270 | 3 | 0.3 | 3 | - | - | - |
| Boeing 767-300 | 203-222 | 31 | 14.4 | 1 | 6 | 6 | 18 |
| Boeing 767-200 | 207 | 10 | 20.7 | 10 | - | - | - |
| Airbus A340-300 | 285-286 | 5 | 9.8 | - | 5 | - | - |
| Airbus A330-300 | 274 | 8 | 7.2 | - | 8 | - | - |
| Narrowbody Aircraft | | | | | | | |
| Airbus A321 | 166-174 | 10 | 5.8 | - | - | 5 | 5 |
| Airbus A320 | 140 | 41 | 14.7 | - | - | - | 41 |
| Airbus A319 | 120 | 37 | 9.7 | - | 17 | 15 | 5 |
| Embraer 190 | 93 | 42 | 0.9 | 42 | - | - | - |
| Embraer 175 | 73 | 15 | 2.3 | 15 | - | - | - |
| **Total** | | **207** | **9.0** | **75** | **36** | **26** | **70** |

(1) Excludes aircraft which have been removed from service.

(2) Owned aircraft as well as capital leases and leases consolidated under AcG-15 are carried on Air Canada's statement of financial position. Owned aircraft include aircraft financed under conditional sales agreements.

Pursuant to the Jazz CPA, Jazz operates an operating fleet of 133 aircraft with an average age of 12.5 years comprised of the following aircraft:

- 24 Bombardier CRJ-100 aircraft;
- 33 Bombardier CRJ-200 aircraft;
- 16 Bombardier CRJ-705 aircraft;
- 26 Dash 8-300 aircraft; and
- 34 Dash 8-100 aircraft.

We are implementing our network redesign in the North American market through the increased use of large regional jet aircraft which have lower trip costs than conventional narrowbody aircraft.

- In 2007, we took delivery of 24 Embraer 190 aircraft bringing the total of Embraer 190 aircraft delivered to date to 42 of 45 on order.
- In January 2008, one Embraer 190 was delivered and the remaining two Embraer 190 aircraft are expected to be delivered in the first quarter of 2008.

In order to support the expansion of our international operations and reduce unit costs, we are progressively introducing Boeing 777 aircraft into our fleet.

- In 2007, we introduced five Boeing 777-300ER aircraft and three 777-200LR aircraft into our fleet.
- Since December 31, 2007, an additional Boeing 777-200 aircraft was added to our fleet for a total of 9 Boeing 777 aircraft to date.

At the same time as the new aircraft are being added to our fleet, we are removing older and less efficient aircraft. In 2007, we removed 23 aircraft from our fleet comprised of:

- two Boeing 767-300 aircraft which were returned to lessors;
- eight Airbus A320 aircraft which were returned to lessors, two of which were already removed from service at December 31, 2006;
- one Boeing 767-200 aircraft which was retired from service;
- two Airbus A340-300 aircraft which were subleased to other airlines;
- one Airbus A340-300 aircraft which was returned to the lessor;
- six Airbus A319 aircraft which were subleased to other airlines;
- one Airbus A319 aircraft which was sold;
- two Airbus A340-500 aircraft which were leased to another airline.

The following table provides the existing and planned fleet changes to our fleet (excluding aircraft operated by Jazz):

| | | Actual | | | | | | Planned | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Fleet Plan** | **Year End 2006** | **New Deliveries** | **Sublease to Third Party** | **Lease returns** | **Sales** | **Parked** | **Year End 2007** | **New Deliveries** | **Sublease/lease to Third Party / Sale by Air Canada** | **Lease returns** | **Sales** | **Parked** | **Year End 2008** | **Planned 2009 fleet changes** | **Year End 2009** |
| B777-300 | - | 5 | - | - | - | - | 5 | 6 | - | - | - | - | **11** | **1** | **12** |
| B777-200 | - | 3 | - | - | - | - | 3 | 3 | - | - | - | - | **6** | **-** | **6** |
| B767-300 | 33 | - | - | (2) | - | - | 31 | - | - | (2) | - | - | **29** | **(1)** | **28** |
| B767-200 | 11 | - | - | - | - | (1) | 10 | - | - | - | (4) | (2) | **4** | **-** | **4** |
| A340-500 | 2 | - | (2) | - | - | - | - | - | - | - | - | - | **-** | **-** | **-** |
| A340-300(1) | 10 | - | (3) | (2) | - | - | 5 | - | (5) | - | - | - | **-** | **-** | **-** |
| A330-300 | 8 | - | - | - | - | - | 8 | - | - | - | - | - | **8** | **-** | **8** |
| A321 | 10 | - | - | - | - | - | 10 | - | - | - | - | - | **10** | **-** | **10** |
| A320 | 47 | - | - | (6) | - | - | 41 | - | - | - | - | - | **41** | **-** | **41** |
| A319(2) | 45 | - | (6) | - | (2) | - | 37 | - | - | (2) | - | - | **35** | **-** | **35** |
| EMB 190 | 18 | 24 | - | - | - | - | 42 | 3 | - | - | - | - | **45** | **-** | **45** |
| EMB 175 | 15 | - | - | - | - | - | 15 | - | - | - | - | - | **15** | **-** | **15** |
| **Total** | 199 | 32 | (11) | (10) | (2) | (1) | 207 | 12 | (5) | (4) | (4) | (2) | **204** | **-** | **204** |
| **Average age (years)** | **9.6** | | | | | | **9.0** | | | | | | **9.0** | | **9.9** |

(1) Two Airbus A340-300 aircraft were retired from service prior to December 31, 2007. One of the aircraft is pending its return to the lessor and the second aircraft is pending its sublease to a third party.

(2) One Airbus A319 aircraft was retired from service prior to December 31, 2007 pending its sale.

# 7. FINANCIAL AND CAPITAL MANAGEMENT

## 7.1 FINANCIAL POSITION

Our financial position as at December 31, 2007 does not consolidate the financial position of Jazz. The comparative December 31, 2006 consolidated statement of financial position included the following items related to Jazz:

- Cash and cash equivalents of $135 million and other current assets of $109 million;
- Long-lived assets of $239 million;
- Current liabilities of $213 million;
- Long-term debt of $115 million;
- Non-controlling interest of $162 million; and
- Other long-term liabilities of $71 million

As a result of the deconsolidation of Jazz, the Corporation recorded an adjustment of $82 million as a credit to contributed surplus. This credit consists of the Corporation's initial negative investment in Jazz of $78 million, which had not previously reversed as none of the income of Jazz is distributed to Air Canada, and a future income tax credit of $4 million.

For comparative purposes, the following table and discussion provides the financial position of Air Canada as at December 31, 2007 and the financial position of Air Canada (previously "Air Canada Services"), excluding the consolidation of Jazz, as at December 31, 2006.

| Condensed Statement of Financial Position ($ millions) | December 31, 2007 | December 31, 2006 |
|---|---|---|
| **Assets** | | |
| Cash, cash equivalents and short-term investments | $ 1,239 | $ 2,110 |
| Other current assets | 1,239 | 1,962 |
| Current assets | 2,478 | 4,072 |
| Property and equipment | 7,919 | 5,747 |
| Intangible assets | 952 | 1,185 |
| Other assets | 488 | 384 |
| | **$ 11,837** | **$ 11,388** |
| **Liabilities** | | |
| Current liabilities | $ 2,956 | $ 3,754 |
| Long-term debt and capital leases | 4,006 | 3,081 |
| Pension and other benefits liabilities | 1,824 | 1,867 |
| Other long-term liabilities | 424 | 544 |
| | **9,210** | **9,246** |
| **Non-controlling interest** | **184** | **212** |
| **Shareholders' equity** | **2,443** | **1,930** |
| | **$ 11,837** | **$ 11,388** |

### 7.2 ADJUSTED NET DEBT

The following table reflects Air Canada's net debt balances and net debt to net debt plus equity ratio as at December 31, 2007 and as at December 31, 2006. The information provided below excludes the consolidation of Jazz for both periods.

| ($ millions) | December 31, 2007 | December 31, 2006 | Change |
|---|---|---|---|
| Total long-term debt and capital lease obligations | $ 4,006 | $ 3,081 | $ 925 |
| Current portion of long-term debt and capital lease obligations | 413 | 367 | $ 46 |
| | $ 4,419 | $ 3,448 | $ 971 |
| Non-controlling interest | 184 | 212 | (28) |
| Cash, cash equivalents and short-term investments | (1,239) | (2,110) | 871 |
| **Net debt and non-controlling interest** | **$ 3,364** | **$ 1,550** | **$ 1,814** |
| Capitalized operating leases (1) | 2,115 | 2,558 | (443) |
| **Adjusted net debt and non-controlling interest** | **$ 5,479** | **$ 4,108** | **$ 1,371** |
| Pre-delivery (PDP) financing included in long-term debt | (521) | - | (521) |
| **Adjusted net debt and non-controlling interest, excluding PDP financing** | **$ 4,958** | **$ 4,108** | **$ 850** |
| **Shareholders' equity and non-controlling interest** | **$ 2,627** | **$ 2,142** | **$ 485** |
| **Adjusted net debt to net debt plus equity ratio, excluding PDP financing** | **65.4 %** | **65.7 %** | **(0.3) pp** |

(1) Financial and credit analysts regularly derive a present value debt equivalent from the future stream of aircraft operating lease payments. Common industry practice is to multiply annualized aircraft rent expense by 7.5. Aircraft rent was $282 million for the year 2007 and $341 million for the year 2006. Aircraft rent expense for the year 2007 includes aircraft rent associated with aircraft subleased to third parties. The sublease revenue associated with these aircraft leases is included in "other" revenues on Air Canada's statement of operations. Sublease revenues amounted to $26 million for the year 2007.

On October 30, 2007, the Corporation entered into an agreement with a syndicate of banks for the financing of pre-delivery payments ("PDP") for 10 of the 16 Boeing 777 aircraft contemplated in the Corporation's Purchase Agreement with Boeing. The PDP financing is a series of loans that are aircraft specific with a maximum aggregate commitment of up to $568 million (US$575 million). The PDP loans have a term of five years, but may be prepaid upon the delivery of the aircraft without penalty. Air Canada has already prepaid the PDP loans on the first two aircraft delivered in November 2007 and January 2008. In addition, Air Canada has served notice to the PDP syndicate that it will be prepaying the PDP loans on delivery of aircraft three to eight. Air Canada's intent is to prepay all PDP loans upon delivery of the relevant aircraft, using the committed long-term aircraft financing and leases for the aircraft to be delivered. The tenth and last aircraft in this PDP financing is currently scheduled for delivery in November 2008, at which time, Air Canada expects to have fully repaid the PDP loans. At year-end 2007, the amount drawn on the PDP loans was $521 million (US$528 million). Air Canada is using the PDP financing to settle most of the outstanding pre-delivery payments. This results in a significant shift in capital expenditures from 2008 to 2007 from that which was previously disclosed due to the pre-delivery deposit being recorded as a capital expenditure when paid. Refer to section 6 of this MD&A for additional information on Air Canada's fleet strategy.

At December 31, 2007, adjusted net debt and non-controlling interest, including capitalized operating leases, and excluding PDP financing, increased $850 million from December 31, 2006. The increase was largely the result of additional aircraft financing in 2007, partly offset by the appreciation of the Canadian dollar against the US dollar on Air Canada's US denominated debt. The adjusted net debt to net debt plus equity ratio for Air Canada decreased to 65.4% at December 31, 2007 from 65.7% at December 31, 2006.

### 7.3 LIQUIDITY

The Corporation's principal source of liquidity is cash generated from operations. Such cash generation fluctuates within any given year based on seasonal demand patterns. Positive cash from operations would generally take place in the second and third quarters while negligible or negative cash from operations would generally take place in the other quarters.

Longer term, the Corporation's ability to generate improved cash from operations is generally impacted by its ability to achieve a better combination of capacity, load factors, yields and cost efficiencies. All of these are in turn affected by a number of factors and subject to a number of risks including those relating to general economic conditions, foreign exchange rates, fuel prices, competitive forces and our ability to continuously improve our controllable costs. Cash from operations can also be significantly affected by the fluctuations in the Company's pension deficit which requires funding over time and is likely to grow in circumstances where investment returns on pension assets are declining and pension liabilities increase as a result of the lowering of interest rates (see Section 6.6 – Pension Funding Obligations).

The Corporation also has the ability to fund liquidity requirements through its $400 million revolving credit facility, the issuance of secured debt, the disposal of surplus assets, the monetization of other assets generally through sale and leaseback transactions and an improved management of working capital. The substantial investment in new aircraft over the last couple of years has led to a significant increase in the use of secured debt to maintain liquidity at desired levels. This pattern is expected to continue in 2008 as a result of further new aircraft deliveries. The secured financing for these aircraft is already committed (refer to section 6.7 of this MD&A).

Liquidity could also be impacted by margin calls on fuel and foreign exchange derivative contracts. These margin calls would likely occur in circumstances where fuel prices decline sharply or the Canadian dollar appreciates significantly against the US dollar as compared to current market prices. However both of these events would lead to improved cash from operations which would likely more than offset the impact of the margin calls.

At December 31, 2007, Air Canada had cash, cash equivalents and short-term investments of $1,239 million. Compared to December 31, 2006, cash, cash equivalents and short-term investments have decreased by $871 million primarily due to aircraft acquisitions, net of financing. This significant investment in new aircraft is expected to improve the cash generated from operations in the long term mostly through sustainable lower operating costs.

Air Canada has a secured syndicated 3-year revolving credit facility of $400 million. As of the date hereof, no amounts have been drawn on this credit facility.

Actively managing working capital is key to ensuring cash is available to partially support funding of the Corporation's fleet renewal and refurbishment. The following table provides additional information on our working capital balances at December 31, 2007 as compared to December 31, 2006 excluding the consolidation of Jazz operations (previously "Air Canada Services").

| | December 31, 2007 | December 31, 2006 | Change in Working Capital |
|---|---|---|---|
| Cash and short-term investments | $ 1,239 | $ 2,110 | $ (871) |
| Accounts receivable | 750 | 739 | 11 |
| Other current assets | 489 | 1,223 | (734) |
| Accounts payable and accrued liabilities | (1,243) | (1,430) | 187 |
| Other current liabilities | (1,713) | (2,324) | 611 |
| | **$ (478)** | **$ 318** | **$ (796)** |

The December 31, 2007 working capital deficiency of $478 million has deteriorated by $796 million over December 31, 2006 largely reflecting the utilization of cash to fund the additions to capital assets, net of aircraft-related borrowings received. The change in other current assets and other current liabilities is largely attributable to the settlement of a future income tax asset and related tax payable of $345 million created in 2006 as part of a tax loss strategy that was planned in conjunction with the Air Canada IPO and corporate restructuring. This tax payable arose upon a transaction to transfer tax assets from the Corporation to ACE. This tax payable was recoverable from future income tax assets of the Corporation and was settled in 2007. These balances are also impacted by the drawdown of a prepaid maintenance to ACTS and related note payable to ACTS in the amount of $535 million. Refer to Note 3 to Air Canada's 2007 consolidated financial statements for additional information.

### 7.4 CONSOLIDATED CASH FLOW MOVEMENTS

The following tables provide Air Canada's consolidated cash flow movements for the periods indicated. Prior to May 24, 2007, Air Canada had two reportable segments: Air Canada Services (now referred to as Air Canada) and Jazz. Segment information was used to allow for the separate presentation of Air Canada's financial results as this segment was the primary focus of the Air Canada shareholders. Effective May 24, 2007, Air Canada no longer consolidates the operations of Jazz.

| | Three months ended December 31, 2007 (1) | | | Three months ended December 31, 2006 | | |
|---|---|---|---|---|---|---|
| **($ millions)** | Air Canada | Jazz | Total | Air Canada | Jazz | Total |
| Net cash provided by operating activities | $ 44 | $ - | **$ 44** | $ (32) | $ 41 | **$ 9** |
| Changes in non-cash working capital | (14) | - | **(14)** | (127) | (8) | **(135)** |
| Cash flows from (used for) operating activities | 30 | - | **30** | (159) | 33 | **(126)** |
| Additions to capital assets | (922) | - | **(922)** | (206) | (7) | **(213)** |
| **Free cash flow** | **(892)** | **-** | **(892)** | **(365)** | **26** | **(339)** |
| **Cash flows used for investing activities (excluding additions to capital assets)** | **(15)** | **-** | **(15)** | **(137)** | **-** | **(137)** |
| Aircraft and facility related borrowings | 821 | - | **821** | 76 | - | **76** |
| Reduction of long-term debt and capital lease obligations | (199) | - | **(199)** | (71) | - | **(71)** |
| Other | 20 | - | **20** | 803 | (15) | **788** |
| **Cash flows from (used for) financing activities** | **642** | **-** | **642** | **808** | **(15)** | **793** |
| Net increase (decrease) in cash and cash equivalents | (265) | - | **(265)** | 306 | 11 | **317** |
| Net increase in short term investments | 2 | - | **2** | 382 | - | **382** |
| **Net increase (decrease) in cash, cash equivalents and short term investments** | **$ (263)** | **$ -** | **$ (263)** | **$ 688** | **$ 11** | **$ 699** |

(1) There was no consolidation of Jazz in the fourth quarter of 2007.

| | Year ended December 31, 2007 (1) | | | Year ended December 31, 2006 | | |
|---|---|---|---|---|---|---|
| **($ millions)** | Air Canada | Jazz | Total | Air Canada | Jazz | Total |
| Net cash provided by operating activities | $ 366 | $ 69 | **$ 435** | $ 123 | $ 187 | **$ 310** |
| Changes in non-cash working capital | (4) | (2) | **(6)** | 88 | (5) | **83** |
| Cash flows from operating activities | 362 | 67 | **429** | 211 | 182 | **393** |
| Additions to capital assets | (2,595) | (11) | **(2,606)** | (863) | (25) | **(888)** |
| **Free cash flow** | **(2,233)** | **56** | **(2,177)** | **(652)** | **157** | **(495)** |
| **Cash flows from (used for) investing activities (excluding additions to capital assets)** | **54** | **(137)** | **(83)** | **(371)** | **137** | **(234)** |
| Aircraft and facility related borrowings | 1,914 | - | **1,914** | 397 | - | **397** |
| Reduction of long-term debt and capital lease obligations | (504) | - | **(504)** | (264) | (14) | **(278)** |
| Other | (16) | (54) | **(70)** | 1,202 | (179) | **1,023** |
| **Cash flows from (used for) financing activities** | **1,394** | **(54)** | **1,340** | **1,335** | **(193)** | **1,142** |
| Net increase (decrease) in cash and cash equivalents | (785) | (135) | **(920)** | 312 | 101 | **413** |
| Net increase (decrease) in short term investments | (86) | - | **(86)** | 496 | - | **496** |
| **Net increase (decrease) in cash and cash equivalents and short term investments** | **$ (871)** | **$ (135)** | **$ (1,006)** | **$ 808** | **$ 101** | **$ 909** |

(1) The 2007 results reflect the change in accounting for Jazz whereby Jazz's results from operations and financial condition were consolidated by the Corporation only up to May 24, 2007. There was no consolidation of Jazz in the third and fourth quarters of 2007.

Air Canada's free cash flow, excluding the consolidation of Jazz operations, decreased $527 million from the fourth quarter of 2006 and decreased $1,581 million from the full year 2006. The decrease in free cash flow was largely related to additions to capital assets mainly related to aircraft partly offset by an increase in net cash provided by operating activities during mainly to improved operating results.

In the fourth quarter of 2007, Air Canada's additions to capital assets totaled $922 million and mainly related to the PDP financing discussed in section 7.2 of this MD&A and the addition of eight Embraer 190 aircraft. In the year 2007, additions to capital assets totaled $2,595 million and mainly related to the addition of seven Boeing 777 aircraft, 24 Embraer 190 aircraft and the PDP financing.

### 7.5 CONTRACTUAL OBLIGATIONS

The following table provides our contractual obligations at December 31, 2007 for each of the next five years and after 2012. The table also includes the letters of intent for the sale and lease back transactions concluded by Air Canada in January 2008 which are further described in section 7.7 of this MD&A.

| Contractual Obligations ($ millions) | Total | 2008 | 2009 | 2010 | 2011 | 2012 | Thereafter |
|---|---|---|---|---|---|---|---|
| Long-term debt obligations | $ 2,551 | $ 160 | $ 152 | $ 141 | $ 153 | $ 166 | $ 1,779 |
| Debt consolidated under AcG-15 | 896 | 105 | 51 | 100 | 288 | 73 | 279 |
| Capital lease obligations | 1,394 | 223 | 147 | 142 | 136 | 177 | 569 |
| Operating lease obligations (1) | 2,108 | 339 | 313 | 291 | 230 | 212 | 723 |
| Committed capital expenditures (2) | 4,739 | 555 | 102 | 760 | 891 | 692 | 1,739 |
| **Total contractual obligations (3)** | **$ 11,688** | **$ 1,382** | **$ 765** | **$ 1,434** | **$ 1,698** | **$ 1,320** | **$ 5,089** |
| Pension funding obligations (4) | $ 1,715 | $ 343 | $ 328 | $ 338 | $ 348 | $ 358 | N/A |

(1) Mainly relate to US dollar aircraft operating leases.

(2) Mainly relate to US dollar aircraft-related expenditures. Also include purchases relating to system development costs, facilities and leasehold improvements. See section 6.7 of this MD&A for additional information on Air Canada's planned and committed capital expenditures as well as the related financing arrangements.

(3) Table above excludes commitments for goods and services required in the ordinary course of business. Also excluded are future income taxes and other long-term liabilities mainly due to reasons of uncertainty of timing of cash flows and items which are non-cash in nature.

(4) See section 6.6 of this MD&A for additional information on Air Canada's pension funding obligations.

Air Canada leases and subleases certain aircraft to Jazz on a flow-through basis, which are reported net on Air Canada's statement of operations. These leases and subleases relate to 33 Bombardier CRJ-200 aircraft and 15 Bombardier CRJ-705 aircraft. The subleases with Jazz have the same terms and maturity as Air Canada's corresponding lease commitments to lessors.

The operating lease commitments under these aircraft, which are recovered from Jazz, are not included in the contractual obligations table above but are summarized as follows:

| Operating lease commitments ($ millions) | Total | 2008 | 2009 | 2010 | 2011 | 2012 | Thereafter |
|---|---|---|---|---|---|---|---|
| Aircraft subleased to Jazz | $ 1,067 | $ 84 | $ 84 | $ 76 | $ 75 | $ 75 | $ 673 |

As at December 31, 2007, the future minimum non-cancelable commitments for the next 12 months under the capacity purchase agreements with Jazz is approximately $650 million and with unaffiliated regional carriers is $20 million. The initial term of the Jazz CPA expires December 31, 2015 with two automatic renewal periods of five years each, subject to either party's right not to renew by notice at least one year prior to the expiration of the then applicable term. As the rates under the Jazz CPA are subject to adjustments beginning in 2009, it is not possible to determine the minimum non-cancelable commitments beyond 2008, however, they are not expected to change significantly from the 2008 amount.

Under the terms of their respective land leases, each Fuel Facility Corporation (described in section 11 of this MD&A "Off-Balance Sheet Arrangements") has an obligation to restore the land to vacant condition at the end of the lease and to rectify any environmental damage for which it is responsible. If it were found that the Fuel Facility Corporations had to contribute to any remediation costs, each contracting airline would share pro rata, based on system usage, in the costs. For all Fuel Facility Corporations in Canada in which the Corporation participates, the Corporation has recorded an obligation of $7 million ($44 million undiscounted) representing the present value of the estimated decommissioning and remediation obligations at the end of the lease using an 8% discount rate, with lease term expiry dates ranging from 2032 to 2039. This estimate is based on numerous assumptions including the overall cost of decommissioning and remediation and the selection of alternative decommissioning and remediation approaches. The estimated fair value of the obligation is nil.

### 7.6 PENSION FUNDING OBLIGATIONS

The table below provides projections for Air Canada's pension funding obligations for the years 2008 through to 2012, assuming no change in economic conditions. Changes in the economic conditions, mainly the return on fund assets and changes in interest rates will impact projected required contributions. These funding projections are updated annually. The required contributions disclosed below assume no future gains and losses on plan assets and liabilities over the projection period and do not reflect the economic experience of 2007. Based on preliminary estimates, the solvency deficit on the registered pension plans at January 1, 2008 is expected to increase compared to January 1, 2007 and, as a result, employer contributions determined in accordance with regulations are expected to increase by $90 million in 2008 and $120 million each year thereafter. These preliminary estimates have not been reflected in the table below.

| Air Canada ($ millions) | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| Past service domestic registered plans | $ 91 | $ 92 | $ 93 | $ 93 | $ 93 |
| Current service domestic registered plans | 166 | 171 | 176 | 181 | 186 |
| Other pension arrangements (1) | 86 | 65 | 69 | 74 | 79 |
| **Projected pension funding obligations** | **$ 343** | **$ 328** | **$ 338** | **$ 348** | **$ 358** |

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

The above pension funding requirements are in respect of Air Canada's pension arrangements. For domestic registered pension plans, the funding requirements are based on the minimum past service contributions disclosed in the January 1, 2007 actuarial valuation plus a projection of the current service contributions. Air Canada entered into the *Pension and Benefits Agreement* with ACTS LP and ACTS Aero Technical Support & Services Inc. ("ACTS Aero"). Refer to section 12 of this MD&A ("Related Party Transactions") for additional information.

The net deficit, on an accounting basis, at December 31, 2007 for pension benefits was $403 million compared to $1,377 million at December 31, 2006. The decrease in the accounting deficit was mainly the result of an increase in the discount rate and the funding of past service contributions of $134 million offset by a negligible return on plan assets.

### 7.7 CAPITAL EXPENDITURES AND RELATED FINANCING ARRANGEMENTS

In 2004, Air Canada signed definitive purchase agreements with Empresa Brasileira de Aeronautica S.A. ("Embraer") for the acquisition of regional jet aircraft. In November 2005, Air Canada also concluded agreements with The Boeing Company ("Boeing") for the acquisition of Boeing 777 and Boeing 787 aircraft.

**Boeing**

In November 2005, Air Canada concluded agreements with Boeing for the acquisition of up to 36 Boeing 777 aircraft and up to 60 Boeing 787 Dreamliners. The initial order for the 36 Boeing 777 aircraft was comprised of firm orders for 18 aircraft plus purchase rights for 18 more. The initial order for the Boeing 787 aircraft was comprised of firm orders for 14 aircraft plus purchase rights, options and rolling options for 46 aircraft. In conjunction with the initial agreements, Air Canada received financing commitments from Boeing and the engine manufacturer for all firm aircraft orders covering up to 90% of the capital expenditure. This available financing is based on a floating or fixed rate equivalent and was at 8.70% at December 31, 2007. The term to maturity is 15 years with principal payments made on a mortgage style basis resulting in equal instalment payments of principal and interest over the term to maturity.

During 2007, the Corporation amended agreements with Boeing to cancel orders for two Boeing 777 aircraft scheduled for delivery in 2009. In addition, the Corporation increased its order for Boeing 787 aircraft by 23, bringing its total firm orders to 37 Boeing 787 aircraft. The first delivery of the Boeing 787 firm aircraft is scheduled for 2010 and deliveries of all 37 firm aircraft are scheduled to be completed by 2014. As at December 31, 2007, 18 purchase rights for Boeing 777 aircraft and 23 options for Boeing 787 aircraft remained exercisable. In January, 2008, Boeing announced a delay in the production of its first Boeing 787 aircraft from the end of the first quarter of 2008 to the end of the second quarter of 2008 due to production delays. The Corporation has not been notified that its Boeing 787 deliveries have been affected, however, Air Canada expects to receive an update towards the end of the first quarter of 2008.

In conjunction with the amended agreements, the Corporation received additional financing commitments from Boeing for seven of the additional Boeing 787 aircraft (21 Boeing 787 aircraft in total) on the same terms and conditions as described above. Should the Corporation not utilize any of the financing commitments on the Boeing 777 aircraft, the financing commitments for the Boeing 787 aircraft will be increased to 31 aircraft of which the terms for 28 aircraft would be revised to cover 80% of the aircraft delivery price and the term to maturity would be reduced to 12 years with straight-line principal repayments over the term to maturity.

As at December 31, 2007, seven of the Boeing 777 firm aircraft under the purchase agreement with Boeing have been delivered with the remaining nine firm deliveries expected to be delivered by end of year 2008. The first seven aircraft were financed under loan guarantee support from the Export-Import Bank of the United States ("EXIM"). All of the nine Boeing 777 firm aircraft deliveries expected in 2008 have commitments for loan guarantee support to be provided by EXIM which was signed in January 2008. The loan guarantee, subject to certain conditions, covers a 12-year loan term for 85% of the capital expenditure at an interest rate based on a floating rate. This loan guarantee from EXIM is expected to be used instead of the financing commitments provided by Boeing and the engine manufacturer described above. As a result, it is not expected that any of Boeing's and the engine manufacturer's financing commitments for the Boeing 777 aircraft will be utilized. The firm commitment financing on capital purchase commitments disclosed below reflects this EXIM guarantee support for only five aircraft in 2008 given the Corporation expects to sell and lease back the other four aircraft (see below).

On October 30, 2007, the Corporation entered into an agreement with a syndicate of banks for the financing of pre-delivery payments ("PDP") for 10 Boeing 777 aircraft contemplated in the Corporation's Purchase Agreement with Boeing. The PDP financing is a series of loans that are aircraft specific with a maximum aggregate commitment of up to $568 million (US$575 million). The PDP loans have a term of five years, but may be prepaid upon the delivery of the aircraft without penalty. Air Canada has already prepaid the PDP loans on the first two aircraft delivered in November 2007 and January 2008. In addition, Air Canada has served notice to the PDP syndicate that it will be prepaying the PDP loans on delivery of aircraft three to eight. Air Canada's intent is to prepay all PDP loans upon delivery of the relevant aircraft, using the committed long-term aircraft financing and leases for the aircraft to be delivered. The tenth and last aircraft in this PDP financing is currently scheduled for delivery in November 2008, at which time Air Canada expects to have fully repaid the PDP loans. At year-end 2007, the amount drawn on the PDP loans was $521 million (US$528 million). Air Canada is using the PDP financing to settle most of the outstanding pre-delivery payments. This results in a significant shift in capital expenditures from 2008 to 2007 from that which was previously disclosed due to the pre-delivery deposit being recorded as a capital expenditure when paid.

This PDP financing replaces a significant portion of the pre-delivery financing arrangements that Air Canada had in place with Boeing. This PDP financing was entered into as it offered more attractive terms than the arrangements with Boeing.

In January 2008, Air Canada signed letters of intent for the sale and lease back of four of the nine Boeing 777 scheduled for delivery in 2008. The lease term for two of the Boeing 777 aircraft is 12 years. The other two Boeing 777 aircraft each have 10.5 year lease terms and Air Canada has options to extend each for an additional 18 months. All four leases are at market rates. This replaces an equivalent number of aircraft loan guarantee support commitments provided by EXIM. As a result, the capital expenditure forecast in the table below does not include expenditures relating to these aircraft. These four aircraft deliveries are included in the operating lease commitments table disclosed in section 7.5 of this MD&A. The impact of these leases results in a significant reduction in capital expenditures from what was previously projected. Operating lease commitments have increased as a result of this change.

**Embraer**

The agreement with Embraer covers firm orders for 45 Embraer 190 series aircraft. The purchase agreement also contains rights to exercise options for up to 60 additional Embraer 190 series aircraft as well as providing for conversion rights to other Embraer models. As of December 31, 2007, 31 options remain exercisable.

The Embraer 190 series deliveries commenced in December 2005. As at December 31, 2007, 42 of the Embraer 190 series firm aircraft orders have been completed and an additional aircraft was delivered in January 2008. The final two Embraer 190 series firm aircraft are scheduled for delivery in the first quarter of 2008.

Air Canada has received loan commitments from third parties for the remaining three firm aircraft covering approximately 80% of the capital expenditure to be repaid in quarterly instalments for a 12-year term. Two of these aircraft will be based on floating rates at the 90-day US LIBOR plus 1.90% and one will be based at the fixed rate equivalent of the 90-day US LIBOR plus 1.70%.

**Aircraft Interior Refurbishment Program**

In addition to acquiring new aircraft, Air Canada commenced a major refurbishment of the interior of its existing aircraft in April 2006. Air Canada has completed the refurbishment of 26 Airbus A319 aircraft, 30 Airbus A320 aircraft, 10 Airbus A321 aircraft and 15 Boeing 767-300 aircraft to date, for a total of 81 aircraft. The Embraer and Boeing 777 aircraft are being delivered with the new seats and entertainment systems already installed. The capital expenditures associated with this program, which are committed, are amortized over a five-year period. A significant portion of the remaining capital expenditures relating to this program are included in the capital commitments table below.

**Capital Commitments**

The estimated aggregate cost of the future firm deliveries as well as other capital purchase commitments as at December 31, 2007, including the impact of the sale and lease back transaction described above and the loan guarantee support signed in January 2008, approximates $4,739 million (of which $2,698 million is subject to committed financing, subject to the fulfillment of certain terms and conditions). US dollar amounts are converted using the December 31, 2007 noon day rate of Cdn$0.9881. 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 US 90-day LIBOR rate at December 31, 2007.

**Projected Planned and Committed Capital Expenditures**

The table below provides projections for aircraft expenditures for firm aircraft orders, net of aircraft financing, combined with planned and committed expenditures for aircraft engines, inventory, property and equipment, net of related financing, if applicable, for the years 2008 through to 2012 and thereafter.

In addition to the firm aircraft orders, Air Canada's purchase agreements include options and purchase rights, none of which are included in these projections.

The following table provides Air Canada's current and planned committed capital expenditures and the related financing arrangements as at December 31, 2007. The table also reflects the letters of intent for the sale and lease back of four of the nine Boeing 777 aircraft scheduled for delivery in 2008 as well as the EXIM loan guarantee support, all of which were signed in January 2008.

| Air Canada Projected Planned and Committed Capital Expenditures ($ millions)(1) (2) | 2008 | 2009 | 2010 | 2011 | 2012 | Thereafter |
|---|---|---|---|---|---|---|
| Projected committed expenditures | $ 555 | $ 102 | $ 760 | $ 891 | $ 692 | $ 1,739 |
| Projected planned but uncommitted expenditures | 260 | 205 | 169 | 104 | 70 | |
| Total projected expenditures | 815 | 307 | 929 | 995 | 762 | |
| Projected financing on committed expenditures | (591) | - | (684) | (804) | (619) | |
| **Total projected expenditures, net of financing** | **$ 224** | **$ 307** | **$ 245** | **$ 191** | **$ 143** | |

(1) US dollar amounts are converted using the December 31, 2007 noon day rate of 1US$ = Cdn$0.9881. Final aircraft delivery prices include estimated escalation and interest on deferred delivery payments, which is calculated based on the 90-day USD LIBOR rate at December 31, 2007.

(2) The dollar amounts reflected above do not include obligations pertaining to day-to-day operations.

## 7.8 SHARE INFORMATION

An aggregate of 100 million Class A variable voting shares and Class B voting shares in the capital of Air Canada are issued and outstanding.

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

| | Number of shares | |
|---|---|---|
| | At January 31, 2008 | At December 31, 2006 |
| **Issued and outstanding shares** | | |
| Class A variable voting shares | 16,476,999 | 18,343,095 |
| Class B voting shares | 83,523,001 | 81,656,905 |
| **Total issued and outstanding shares** | **100,000,000** | **100,000,000** |
| **Class A variable voting and Class B voting shares potentially issuable** | | |
| Stock options | 1,720,092 | 1,695,035 |
| **Total shares potentially issuable** | **1,720,092** | **1,695,035** |
| **Total outstanding and potentially issuable shares** | **101,720,092** | **101,695,035** |

## 8. QUARTERLY FINANCIAL DATA

Prior to May 24, 2007, Air Canada had two reportable segments: Air Canada Services (now referred to as Air Canada) and Jazz. Segment information was used to allow for the separate presentation of Air Canada's financial results as this segment was the primary focus of the Air Canada shareholders. Effective May 24, 2007, Air Canada no longer consolidates the operations of Jazz. Refer to Note 15 "Segment Information" to Air Canada's 2007 audited consolidated financial statements for additional information.

The table below summarizes quarterly financial results and major operating statistics for Air Canada, excluding the consolidation of Jazz operations, for the last eight quarters. The amounts in the table below include inter-segment revenues and expenses.

| ($ millions, except per share figures) | Q1 2006 | Q2 2006 | Q3 2006 | Q4 2006 | Q1 2007 | Q2 2007 | Q3 2007 | Q4 2007 |
|---|---|---|---|---|---|---|---|---|
| **Air Canada** | | | | | | | | |
| Operating revenues | $ 2,399 | $ 2,583 | $ 2,861 | $ 2,423 | $ 2,540 | $ 2,639 | $ 2,954 | $ 2,513 |
| Special charge for Aeroplan miles (1) | - | - | (102) | - | - | - | - | - |
| **Operating revenues** | **2,399** | **2,583** | **2,759** | **2,423** | **2,540** | **2,639** | **2,954** | **2,513** |
| Ownership (DAR) (2) | (203) | (208) | (205) | (218) | (207) | (211) | (210) | (202) |
| Other operating expenses | (2,320) | (2,262) | (2,424) | (2,210) | (2,411) | (2,340) | (2,393) | (2,239) |
| **Operating expenses (3)** | **(2,523)** | **(2,470)** | **(2,629)** | **(2,428)** | **(2,618)** | **(2,551)** | **(2,603)** | **(2,441)** |
| **Operating income (loss)** | **(124)** | **113** | **130** | **(5)** | **(78)** | **88** | **351** | **72** |
| Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax | (2) | 39 | (86) | (139) | 44 | 67 | (78) | (37) |
| **Net income (loss)** | **$ (126)** | **$ 152** | **$ 44** | **$ (144)** | **$ (34)** | **$ 155** | **$ 273** | **$ 35** |
| Revenue passenger miles (millions) | 11,240 | 12,248 | 14,345 | 11,160 | 11,814 | 12,580 | 14,789 | 11,446 |
| Available seat miles (millions) | 14,287 | 14,925 | 17,528 | 14,343 | 14,735 | 15,220 | 18,144 | 14,715 |
| Passenger load factor (%) | 78.7 | 82.1 | 81.8 | 77.8 | 80.2 | 82.7 | 81.5 | 77.8 |
| Operating expense per available seat mile (CASM) (cents) | 17.6 | 16.5 | 15.0 | 16.9 | 17.7 | 16.7 | 14.3 | 16.6 |
| CASM, excluding fuel expense (cents) (4) | 13.7 | 12.3 | 10.7 | 12.9 | 13.8 | 12.6 | 10.4 | 12.4 |
| CASM, excluding fuel expense and the special charge for labour restructuring (cents) (4) | 13.5 | 12.3 | 10.7 | 12.9 | 13.8 | 12.6 | 10.4 | 12.4 |
| **EBITDAR (4)** | **$ 79** | **$ 321** | **$ 335** | **$ 213** | **$ 129** | **$ 299** | **$ 561** | **$ 274** |
| **EBITDAR (4), excluding special charges** | **$ 107** | **$ 321** | **$ 437** | **$ 205** | **$ 129** | **$ 299** | **$ 561** | **$ 274** |
| **Earning (loss) per share - Basic and diluted (5)** | **$ (1.43)** | **$ 1.72** | **$ 0.50** | **$ (1.55)** | **$ (0.34)** | **$ 1.55** | **$ 2.73** | **$ 0.35** |

(1) The third quarter of 2006 includes a special charge of $102 million in connection with Air Canada's obligation for the redemption of pre-2002 Aeroplan miles.

(2) DAR refers to the combination of Aircraft rent and Depreciation, amortization and obsolescence expenses.

(3) The first quarter of 2006 includes a special charge for labour restructuring of $28 million. The fourth quarter of 2006 includes a favourable adjustment of $8 million relating to the special charge for labour restructuring recorded in the first quarter of 2006.

(4) See section 19 "Non-GAAP Financial Measures" in this MD&A for additional information.

(5) Earnings per share – basic and diluted are the consolidated Air Canada figures as reported under GAAP.

## Seasonality

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

The table below summarizes quarterly financial results and major operating statistics for Jazz for the last eight quarters. The second quarter of 2007 shows the consolidation of Jazz only up to May 24, 2007. There was no consolidation of Jazz in the third and fourth quarters of 2007.

| ($ millions) | Q1 2006 | Q2 2006 | Q3 2006 | Q4 2006 | Q1 2007 | Q2 2007 | Q3 2007 | Q4 2007 |
|---|---|---|---|---|---|---|---|---|
| **Jazz** | | | | | | | | |
| **Operating revenues** | **$ 320** | **$ 340** | **$ 369** | **$ 352** | **$ 364** | **$ 249** | **-** | **-** |
| Ownership (DAR) (1) | (36) | (40) | (40) | (39) | (40) | (26) | - | - |
| Other operating expenses | (249) | (263) | (290) | (280) | (288) | (197) | - | - |
| **Operating expenses** | **(285)** | **(303)** | **(330)** | **(319)** | **(328)** | **(223)** | **-** | **-** |
| **Operating income** | **35** | **37** | **39** | **33** | **36** | **26** | **-** | **-** |
| Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax | (2) | - | - | (1) | (1) | 1 | - | - |
| **Net income** | **$ 33** | **$ 36** | **$ 39** | **$ 32** | **$ 35** | **$ 27** | **-** | **-** |

(1) DAR refers to the combination of Aircraft rent and Depreciation, amortization and obsolescence expenses.

The table below summarizes quarterly consolidated financial results and major operating statistics for the Corporation and Jazz for the last eight quarters. The second quarter of 2007 shows the consolidation of Jazz only up to May 24, 2007. There was no consolidation of Jazz in the third and fourth quarters of 2007.

| ($ millions, except per share figures) | Q1 2006 | Q2 2006 | Q3 2006 | Q4 2006 | Q1 2007 | Q2 2007 | Q3 2007 | Q4 2007 |
|---|---|---|---|---|---|---|---|---|
| **Consolidated Total** | | | | | | | | |
| Operating revenues | $ 2,376 | $ 2,559 | $ 2,837 | $ 2,395 | $ 2,510 | $ 2,622 | $ 2,954 | $ 2,513 |
| Special charge for Aeroplan miles (1) | - | - | (102) | - | - | - | - | - |
| **Operating revenues** | **2,376** | **2,559** | **2,735** | **2,395** | **2,510** | **2,622** | **2,954** | **2,513** |
| Ownership (DAR) (2) | (239) | (239) | (237) | (247) | (237) | (231) | (210) | (202) |
| Other operating expenses | (2,225) | (2,171) | (2,329) | (2,119) | (2,315) | (2,277) | (2,393) | (2,239) |
| **Operating expenses (3)** | **(2,464)** | **(2,410)** | **(2,566)** | **(2,366)** | **(2,552)** | **(2,508)** | **(2,603)** | **(2,441)** |
| **Operating income (loss)** | **(88)** | **149** | **169** | **29** | **(42)** | **114** | **351** | **72** |
| Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax | (38) | 3 | (125) | (173) | 8 | 41 | (78) | (37) |
| **Net income (loss)** | **$ (126)** | **$ 152** | **$ 44** | **$ (144)** | **$ (34)** | **$ 155** | **$ 273** | **$ 35** |
| **Earning (loss) per share - Basic and diluted (4)** | **$ (1.43)** | **$ 1.72** | **$ 0.50** | **$ (1.55)** | **$ (0.34)** | **$ 1.55** | **$ 2.73** | **$ 0.35** |

(1) The third quarter of 2006 includes a special charge of $102 million in connection with Air Canada's obligation for the redemption of pre-2002 Aeroplan miles.

(2) DAR refers to the combination of Aircraft rent and Depreciation, amortization and obsolescence expenses.

(3) The first quarter of 2006 includes a special charge for labour restructuring of $28 million. The fourth quarter of 2006 includes a favourable adjustment of $8 million relating to the special charge for labour restructuring recorded in the first quarter of 2006.

(4) Earnings per share – basic and diluted are the consolidated Air Canada figures as reported under GAAP.

## 9. SELECTED ANNUAL INFORMATION

The following table provides selected annual consolidated information for the Corporation for the years 2005 through to 2007. The selected annual consolidated information for 2007 only includes the operations of Jazz up to May 24, 2007. As a result, Air Canada's consolidated results for 2007 are not directly comparable to its consolidated results for 2005 and 2006 which included full-year consolidation of Jazz.

| Consolidated total | Year 2007 | Year 2006 | Year 2005 |
|---|---|---|---|
| Operating revenues | $ 10,599 | $ 10,167 | $ 9,458 |
| Special charge for Aeroplan miles (1) | - | (102) | - |
| **Operating revenues** | **$ 10,599** | **$ 10,065** | **$ 9,458** |
| Operating expenses (2) | (10,104) | (9,806) | (9,140) |
| **Operating income** | **495** | **259** | **318** |
| Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax | (66) | (333) | (338) |
| **Net income (loss)** | **$ 429** | **$ (74)** | **$ (20)** |
| **EBITDAR (3)** | $ 1,375 | $ 1,214 | $ 1,157 |
| **EBITDAR excluding special charges (3)** | $ 1,375 | $ 1,336 | $ 1,157 |
| **Earning (loss) per share** | | | |
| **- Basic** | $ 4.29 | $ (0.83) | $ (0.25) |
| **- Diluted** | $ 4.27 | $ (0.83) | $ (0.25) |
| **Cash, cash equivalents and short-term investments** | $ 1,239 | $ 2,245 | $ 1,336 |
| **Total assets** | $ 11,922 | $ 11,749 | $ 10,262 |
| **Total long-term liabilities (4)** | $ 4,755 | $ 4,035 | $ 4,147 |

(1) 2006 includes a special charge of $102 million in connection with Air Canada's obligation for the redemption of pre-2002 Aeroplan miles.

(2) 2006 includes a special charge for labour restructuring of $20 million.

(3) Refer to section 19 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).

(4) Total long-term liabilities include long-term debt (including current portion) and capital leases and other long-term liabilities.

## 10. DERIVATIVES AND FINANCIAL INSTRUMENTS

Air Canada manages its currency risk, interest rate risk and market risk through the use of various foreign exchange, interest rate and fuel derivative financial instruments.

**Fuel Price Risk Management**

To manage its exposure to jet fuel prices and minimize volatility in operating cash flows, Air Canada enters into derivative contracts with financial intermediaries. As at December 31, 2007, Air Canada had mainly collar options and swap structures in place to hedge a portion of its anticipated jet fuel requirement over the 2008, 2009 and 2010 periods. Air Canada uses derivative contracts on jet fuel and also on other crude oil-based commodities, such as heating oil and crude oil, due to the relative limited liquidity of jet fuel derivative instruments on a medium to long term horizon, since jet fuel is not traded on an organized futures exchange. Air Canada does not purchase or hold any derivative financial instruments for trading purposes.

As at December 31, 2007, Air Canada had hedged 20% of its projected fuel requirement for 2008, 3% of its projected fuel requirement for 2009 and 2% of its fuel requirement for 2010. Since December 31, 2007, Air Canada has entered into new hedging positions, using swap and costless collar option structures, which have added 8% coverage to 2008, 3% coverage to 2009 and 1% coverage to 2010. 2008 is hedged at prices that can fluctuate between an average of US$101 to US$103 per barrel for jet-fuel based contracts, an average of US$94 to US$98 per barrel for heating oil-based contracts and an average of US$61 to US$68 per barrel for West Texas Intermediate ("WTI") crude-oil based contracts.

Air Canada designates certain of its fuel derivatives as cash flow hedges and applies hedge accounting as prescribed under CICA section 3865, Hedges. Air Canada also holds certain fuel derivatives instruments that do not qualify for hedge accounting. Management believes that these derivatives constitute good economic hedges in managing Air Canada's exposure to jet fuel prices. These contracts, classified as economic hedges, are recorded at fair value at each balance sheet date and the change in fair value is recognized in non-operating income (expense) when it occurs.

Fuel derivative instruments designated under hedge accounting result in all period changes in the fair value of the hedging items that are considered effective being recorded in Accumulated Other Comprehensive Income ("AOCI") until the underlying jet fuel is consumed. Upon maturity of the hedging item, the effective gains and losses are recorded in fuel expense. The ineffective component of the change in fair value is recorded in non-operating income (expense). Air Canada is exposed to the risk that periodic changes in fair value will not be perfectly effective. As defined by Air Canada's fuel hedging policy, ineffectiveness results when the change in the derivative's fair value does not perfectly offset the change in the intrinsic value of the anticipated jet fuel purchase. The ineffective portion relating to the change in a derivative's intrinsic value is calculated by comparing it to the change in intrinsic value of a proxy perfect hedge based on Air Canada's jet fuel weighted average price. As Air Canada's current policy does not take into account variables affecting fair value such as volatility and time value of money, a significant component of the change in fair value of outstanding fuel derivatives may be recorded as ineffective under the current policy.

Ineffectiveness is inherent in hedging diversified jet fuel purchases with derivative positions in crude oil and related commodities and in the differences between intrinsic values and fair values of the derivative instruments, especially given the magnitude of volatility observed in oil market prices. Air Canada is unable to predict the amount of ineffectiveness that could be recorded for each period. This may result, and has resulted, in increased volatility in the accounting results of Air Canada but has no impact on the underlying cash flows.

The following information summarizes the financial statement impact of derivatives designated under fuel hedge accounting before the impact of tax:

- The fair value of outstanding fuel derivatives under hedge accounting at December 31, 2007 was $67 million in favour of Air Canada.
- The 2007 benefit to fuel expense for the year ended December 31, 2007 was $31 million.
- The non-operating income (expense) for the year ended December 31, 2007 was $12 million. The amount in non-operating income (expense) represents the ineffective portion of the fair value change in items under hedge accounting.
- The effective change in the fair value of derivatives recorded in OCI for the period was $110 million before tax expense of $28 million. OCI amounts for the year ended December 31, 2007 are presented net of this tax expense in Air Canada's consolidated statement of comprehensive income.
- The estimated net amount of existing gains and losses reported in AOCI that is expected to be reclassified to net income during 2008 is $68 million.

The following provides the changes in fair value of derivatives not designated under hedge accounting, but held as economic hedges before the impact of tax during the year ended December 31, 2007:

- The fair value of outstanding fuel derivatives not under hedge accounting at December 31, 2007 was $10 million in favour of Air Canada.
- The non-operating income for the year ended December 31, 2007 was $26 million. The amount in non-operating income (expense) represents the change in fair value of these contracts (realized and unrealized) since December 31 2006.

**Foreign Exchange Risk Management**

Air Canada enters into certain foreign exchange forward contracts or currency swaps to manage the risks associated with foreign currency exchange rates. As at December 31, 2007, Air Canada had entered into foreign currency forward contracts and option agreements on US$2.158 billion and EUR$18 million of future purchases in 2008 and 2009. The fair value of these foreign currency contracts as at December 31, 2007 was $124 million in favour of the counterparties (December 31, 2006 - $25 million in favour of Air Canada on US$503 million of future purchases in 2007). These derivative instruments have not been designated as hedges for accounting purposes. The unrealized loss has been recorded in foreign exchange gain (loss).

Air Canada has entered into currency swap agreements for 16 CRJ operating leases until lease terminations between 2007 and 2011. During 2007, five currency swaps were settled with a fair value of $10 million (which was equal to carrying value) (December 31, 2006 - $10 million in favour of the counterparties). Air Canada has 11 currency swap agreements remaining. These currency swaps with third parties have a nominal fair value in favour of Air Canada as at December 31, 2007 (December 31, 2006 — $3 million favour of Air Canada). The notional amount under these swaps is US$79 million as at December 31, 2007 (December 31, 2006 – US$88 million). These have not been designated as hedges for hedge accounting purposes.

**Interest Rate Risk Management**

Air Canada enters into forward interest rate agreements to manage the risks associated with interest rate movement on US dollar and Canadian dollar floating rate debt. During 2006, Air Canada entered into 19 interest rate swaps with a notional value of US$414 million to receive floating rates and pay a weighted average fixed rate of 5.81% for the debt to be arranged in relation to the financing of Embraer 190 aircraft between June 2006 and February 2008. The swaps have 15-year terms from the expected delivery date of the aircraft and their maturities range from June 2021 to December 2022. Air Canada has been settling the interest rate swaps upon delivery of the related aircraft. Air Canada did not apply hedge accounting to these derivative instruments. As at December 31, 2007, one contract remains outstanding with a fair value of $2 million in favour of the counterparty (December 31, 2006 - $13 million in favour of the counterparty for 12 contracts outstanding). During 2007, 11 contracts were settled at a net loss of $10 million.

Air Canada has entered into two interest rate swap agreements with a term to January 2024 which convert lease payments related to two Boeing 767 aircraft leases consolidated under AcG-15 from fixed to floating rates. These have not been designated as hedges for accounting purposes. As at December 31, 2007, these two swaps have a fair value of $7 million in favour of Air Canada ($4 million in favour of Air Canada as at December 31, 2006). The notional amount under these two swaps is US$104 million as at December 31, 2007 (December 31, 2006 – US$112 million).

**Statement of Consolidated Financial Position - Fair Values of Financial Instruments**
The carrying amounts reported on Air Canada's consolidated statement of financial position for short-term financial assets and liabilities which include cash and short-term investments, accounts receivable and accounts payable, approximate fair values due to the immediate or short-term maturities of these financial instruments. Cash equivalents and short-term investments are classified as held for trading and therefore are recorded at fair value.

The carrying amounts of foreign currency and interest rate swaps and fuel derivatives is equal to the fair value, which is based on the amount at which they could be settled based on estimated current market rates.

The following is a comparison of fair value versus carrying value of Air Canada's long-term debt and capital lease obligations, which was estimated using valuation techniques based on current market rates of interest for similar financial liabilities:

| ($ millions) | Carrying Value | Estimated Fair Value |
|---|---|---|
| Direct Corporation debt | $ 2,551 | $ 2,611 |
| Debt consolidated under AcG-15 | 896 | 933 |
| Capital lease obligations | 972 | 1,127 |
| | **$ 4,419** | **$ 4,671** |

**Concentration of Credit Risk**
Air Canada does not believe it is subject to any significant concentration of credit risk. Cash and short-term investments are in place with major financial institutions, Canadian governments and major corporations. Accounts receivable are generally the result of sales of tickets to individuals, often through the use of major credit cards, through geographically dispersed travel agents, corporate outlets, or other airlines, often through the use of major credit cards.

**Asset-Backed Commercial Paper (ABCP)**
Air Canada holds $37 million ($29 million net of a fair value adjustment) in a non-bank sponsored ABCP, which has been recorded in deposits and other assets on Air Canada's consolidated statement of financial position. These investments, which were scheduled to mature during the third quarter of 2007, were previously recorded in cash and cash equivalents and the transfer to deposits and other assets was reflected as an investing activity on Air Canada's consolidated statement of cash flows. An agreement in principle to restructure the ABCP investments was approved by the Pan-Canadian Committee for Third Party Structured ABCP ("Committee") on December 23, 2007. The approval of the restructuring, subject to a vote by all investors, is anticipated to occur by March 2008. Under the terms of the restructuring, all of the ABCP would be exchanged for longer term notes that will match the maturity of the underlying assets in the proposed structure. Air Canada is not accruing interest on these investments.

During 2007, Air Canada recorded a charge of $8 million ($5 million after tax) in non-operating income (expense). The charge is based on a number of assumptions as to the fair value of the investments including factors such as estimated cash flow scenarios and risk adjusted discount rates. The assumptions used in estimating the fair value of the investments are subject to change, which may result in further adjustments to non-operating results in the future.

## 11. OFF-BALANCE SHEET ARRANGEMENTS

The following is a summary of the more significant off-balance sheet arrangements.

**Guarantees**

Performance Obligations Relating to Aircraft Leasing Agreements

With respect to 45 Air Canada aircraft leases, the difference between the amended rents as a result of the implementation of the Plan of Reorganization, Compromise and Arrangement (the "Plan") under the Companies' *Creditors Arrangement Act* ("CCAA") on September 30, 2004 and amounts due under the original lease contracts will be forgiven at the expiry date of the leases if no material defaults have occurred. If a material default occurs, this difference plus interest will become due and payable and all future rent will be based on the original contracted rates. Rent expense is being recorded on the renegotiated lease agreements and any liability would be recorded only at the time management believes the amount is likely to occur.

Guarantees in Fuel Facilities Arrangements

Air Canada participates in fuel facility arrangements operated through fuel facility corporations ("Fuel Facility Corporations"), along with other airlines that contract for fuel services at various major airports in Canada. The Fuel Facility Corporations operate on a cost recovery basis. The purpose of the Fuel Facility Corporations is to own and finance the system that distributes the fuel to the contracting airlines, including leasing the land rights under the land lease. The aggregate debt of the five Fuel Facility Corporations in Canada that have not been consolidated by Air Canada under AcG-15 was approximately $119 million as at December 31, 2007 ($108 million as at December 31, 2006), which is Air Canada's maximum exposure to loss without taking into consideration any cost sharing that would occur amongst the other contracting airlines. Air Canada's views this loss potential as remote. Each contracting airline participating in a Fuel Facility Corporation shares pro-rata, based on system usage, in the guarantee of this debt.

**Indemnification Agreements**

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

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

When Air Canada, as a customer, enters into technical service agreements with service providers, primarily service providers who operate an airline as their main business, Air Canada has from time to time agreed to indemnify the service provider against liabilities that arise from third party claims, whether or not these liabilities arise out of or relate to the negligence of the service provider, but excluding liabilities that arise from the service provider's gross negligence or willful misconduct.

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

The maximum amount payable under the foregoing indemnities cannot be reasonably estimated. Air Canada expects that it would be covered by insurance for most tort liabilities and certain related contractual indemnities described above.

## 12. RELATED PARTY TRANSACTIONS

At December 31, 2007, ACE had a 75% ownership interest in Air Canada. Air Canada has various related party transactions with ACE and other ACE-related entities, including Aeroplan, Jazz and ACTS Aero Technical Support & Services Inc. ("ACTS Aero"). ACTS Aero conducts the business operated by ACTS LP prior to monetization of ACTS LP announced by ACE and completed on October 16, 2007.

***The Relationship between Air Canada and Aeroplan***

ACE has reported holding a 20.1% ownership interest in Aeroplan Income Fund at December 31, 2007. Aeroplan operates a loyalty program which provides loyalty marketing services to its customers. The transactions between Air Canada and Aeroplan described below are recorded at the exchange amount and are settled by netting amounts payable against amounts receivable in accordance with the intercompany agreements with any outstanding balance paid in the subsequent period. Accordingly, at December 31, 2007 and December 31, 2006, the amounts have been presented on a net basis as the parties intend to settle on a net basis.

*Aeroplan Commercial Participation and Services Agreement (Aeroplan CPSA)*
Air Canada and Aeroplan are parties to the Aeroplan CPSA dated June 9, 2004. Pursuant to the Aeroplan CPSA, Air Canada allocates 8% of the seat capacity to Aeroplan on the flights operated by Air Canada and Jazz and certain other air carriers under the Air Canada code (collectively, the "AC Flights") at a fixed redemption cost. In 2007, the rates charged for such seat capacity were renegotiated in accordance with the Aeroplan CPSA for the period January 1, 2008 through to December 31, 2010. Aeroplan may also purchase an unlimited number of available seats based on published fares with a variable discount depending on the fare product. Any adjustment to this variable discount is based on an identified set of parameters. The Aeroplan CPSA also provides that Aeroplan will be charged the lowest fares charged to any other loyalty program taking into account Aeroplan's volume purchase of Air Canada's seat inventory. The Aeroplan CPSA expires June 29, 2020 with four automatic renewals of five year each, unless either party provides notice of its intention not to renew at least twelve months prior to the expiry of the applicable term.

Air Canada is one of Aeroplan's leading partners and it pays a fee to participate in the Aeroplan program, which fee is based on the Aeroplan miles awarded to Aeroplan members who are Air Canada customers traveling on AC Flights. Aeroplan is required to purchase a minimum number of reward travel seats on AC Flights annually, 2007 - $171 million (2006 - $170 million), which number is a function of Aeroplan's consumption of seats in the three preceding calendar years. Moreover, Air Canada is required to purchase a minimum number of Aeroplan miles annually.

The Aeroplan CPSA also provides that Aeroplan shall, in return for a service fee, manage Air Canada's frequent flyer tier membership program for Air Canada Super Elite™, Elite™ and Prestige™ customers, as well as perform certain marketing and promotion services for Air Canada, including call centre services for the frequent flyer tier membership program.

*Aeroplan Master Services Agreement (Aeroplan MSA)*
Air Canada and Aeroplan are parties to the Aeroplan MSA effective January 1, 2005 pursuant to which Air Canada provides certain services to Aeroplan in return for a fee based on Air Canada's fully-allocated cost of providing such services to Aeroplan plus a mark-up to reflect overhead and administrative costs. Pursuant to the Aeroplan MSA, Air Canada provides Aeroplan with infrastructure support which is mostly administrative in nature, including information technology, human resources, finance and accounting, and legal services.

*Aeroplan General Services Agreement (GSA)*
Air Canada and Aeroplan are parties to the Aeroplan GSA effective January 1, 2005 pursuant to which Air Canada provides Aeroplan with the services of a group of call centre employees of Air Canada. Aeroplan must reimburse Air Canada for all costs, including salary and benefits, related to the call centre employees on a fully-allocated basis. With regard to the shortfall in the pension plan maintained by Air Canada which covers, among others, these call centre employees, Aeroplan has agreed to pay an amount not to exceed $11 million over a six year period to compensate Air Canada for call centre employees' share of the unfunded Air Canada pension liability. Either party may, subject to collective agreements of the employees assigned to Aeroplan, terminate the GSA upon six months notice.

*Trademark License Agreement*
Pursuant to a Trademark License Agreement effective May 13, 2005, Air Canada and Aeroplan have granted each other reciprocal royalty-free, non-exclusive, non-sublicensable, non-assignable rights to use certain of each other's trademarks around the world which incorporate their names or logos, solely in association with the Aeroplan Program.

***The Relationship between Air Canada and Jazz***

ACE reported a 20.1% ownership interest in Jazz Air Income Fund at December 31, 2007. On January 24, 2008, ACE's ownership interest in Jazz Air Income Fund was reported to have been reduced to 9.5%. Air Canada has no ownership interest in Jazz. Jazz is consolidated in Air Canada's consolidated financial statements under AcG-15 up to May 24, 2007. Jazz is still considered to be a variable interest entity to Air Canada however Air Canada is no longer the primary beneficiary under AcG-15. The deconsolidation of Jazz does not impact any of the contractual arrangements between Air Canada and Jazz.

In addition to the agreements summarized below, Air Canada and Jazz are also parties to a number of lease agreements pursuant to which Jazz leases or subleases, from Air Canada, certain premises at airports across Canada.

*Jazz Capacity Purchase Agreement (Jazz CPA)*
Air Canada and Jazz are parties to the Jazz CPA, effective January 1, 2006 pursuant to which Air Canada purchases substantially all of Jazz's fleet capacity based on predetermined rates, in addition to reimbursing Jazz, without mark-up, for certain pass-through costs as defined in the Jazz CPA which include fuel, airport and navigation fees. The fees include both a variable component that is dependent on Jazz aircraft utilization and a fixed component. The initial term of the Jazz CPA expires December 31, 2015. There are two automatic renewal periods of five years each, subject to either party's right not to renew by notice at least one year prior to the expiration of the then applicable term. The rates under the Jazz CPA are subject to periodic adjustment with the next adjustment scheduled for the start of 2009.

*Jazz Master Services Agreement (Jazz MSA)*
Air Canada and Jazz are parties to the Jazz MSA pursuant to which Air Canada provides certain services to Jazz in return for a fee based on the fair market value of the services provided by Air Canada to Jazz. Pursuant to the Jazz MSA, Air Canada provides Jazz with infrastructure support consisting principally of administrative services in relation with information technology, corporate real estate, environmental affairs and legal services. Jazz benefits from certain information technology services available to Air Canada from third parties and from Air Canada's internal information technology resources.

Either Air Canada or Jazz may elect to terminate any services under the Jazz MSA (without terminating the whole Jazz MSA) or the entire Jazz MSA upon one year's prior written notice. The Jazz MSA terminates upon the termination of the Jazz CPA.

*Jazz Trademark License Agreements*
Air Canada and Jazz are parties to the Jazz Trademark License Agreement pursuant to which Air Canada has granted Jazz a royalty-free, non-exclusive, non-sublicensable, non-assignable right to use certain trademarks owned or registered by Air Canada around the world including "Jazz" and certain trademarks which incorporate the Air Canada name, and/or Air Canada's roundel design, solely in association with the Jazz business. The Jazz Trademark License Agreement can be terminated in the event that the Jazz CPA is terminated. However, Air Canada and Jazz have also entered into a Jazz Special Trademark Agreement which would grant all of Air Canada's rights to the Jazz trademark to Jazz (and preclude Air Canada from using the Jazz trademark or licensing the Jazz trademark to third parties) upon the occurrence of certain events involving (i) the expiration or termination of the Jazz CPA if, at such time, Jazz is no longer an affiliate of Air Canada; (ii) the occurrence of a change of control pursuant to which Jazz ceases to be an affiliate of Air Canada if, at or prior to such time, the Jazz CPA has expired or has been terminated; or (iii) the sale or transfer of all or substantially all of the assets or business of Jazz to a third party that is not an affiliate of Air Canada if, at or prior to such time, the Jazz CPA has expired or has been terminated.

***The Relationship between Air Canada and ACTS***

On October 16, 2007, ACE announced the completion of the monetization of ACTS LP pursuant to which ACTS LP sold substantially all of its assets, liabilities and business to ACTS Aero. ACTS Aero conducts the business previously operated by ACTS LP.

The ACTS Maintenance Agreements, the ACTS Master Services Agreement, the ACTS Trademark License Agreement, the Repair Schemes and Non-Compete Agreement and the ACTS General Services Agreements, all between Air Canada and ACTS LP and described below were assigned from ACTS LP to ACTS Aero upon closing of the monetization of ACTS. On closing of the ACTS monetization, Air Canada recorded proceeds of $28 million for the sale of a building to ACTS Aero, $17 million for the settlement of a intercompany note with ACTS, $20 million pursuant to the transfer of repair schemes and as described below and the funding of a letter of credit in the amount of $101 million related to a "*Pension and Benefits Agreement*" as described below. ACTS Aero is a related party to the Corporation due to ACE's investment in both entities.

*ACTS Maintenance Agreements*

ACTS Aero and Air Canada are parties to a general terms and related services agreements effective October 1, 2006, pursuant to which ACTS Aero provides technical services to Air Canada including engine and auxiliary power unit maintenance services, aircraft heavy maintenance services (excluding line and cabin maintenance services which are provided by Air Canada), component maintenance services, paint services, training services and ancillary services. ACTS Aero serves as Air Canada's exclusive repair agency in respect of aircraft heavy maintenance, engine maintenance, auxiliary power unit maintenance services as well as for maintenance services relating to certain components. ACTS Aero serves as Air Canada's non-exclusive repair agency in respect of other services provided. Except for the services agreement relating to aircraft heavy maintenance services which expires in October 2011 and the services agreement relating to paint services which expires in October 2009, each of the agreements referred to above expires in October 2013.

ACTS Aero and Jazz are parties to a component maintenance agreement (the "ACTS-Jazz Agreement") dated August 1, 2005, pursuant to which ACTS Aero provides selected maintenance, repair, overhaul and related services with respect to Jazz's CRJ regional jets. Pursuant to the ACTS-Jazz Agreement, ACTS Aero serves as Jazz's exclusive repair agency to provide component repair and overhaul work on parts which can be removed from the aircraft in respect of CRJ-100/200 and common CRJ-705 parts not performed internally by Jazz employees. The initial term of the ACTS-Jazz Agreement expires in August 2015 and it is renewable for three successive two-year periods. Jazz amounts with ACTS are not reported for the period after Jazz's deconsolidation on May 24, 2007.

*ACTS Master Services Agreement (ACTS MSA)*

ACTS Aero and Air Canada are parties to an amended and restated master services agreement (the "ACTS MSA"), effective January 1, 2007, pursuant to which Air Canada provides ACTS Aero with services including infrastructure support and services which are mostly administrative in nature, including information technology, human resources, finance and accounting, and claims services in return for fees paid by ACTS Aero to Air Canada. ACTS Aero may elect to terminate any services under the ACTS MSA or the entire ACTS MSA upon six months' prior written notice, with the exception of services relating to information technology which ACTS Aero cannot terminate prior to the expiry of the ACTS MSA. Air Canada may elect to terminate any services under the ACTS MSA or the entire ACTS MSA upon 18 months' prior written notice.

*ACTS Trademark License Agreement*

ACTS Aero and Air Canada are parties to a trademark license agreement (the "ACTS Trademark License Agreement"), effective September 30, 2004, pursuant to which Air Canada has granted ACTS Aero a royalty-free, non-exclusive, non-assignable right to use certain Air Canada trademarks which incorporate the Air Canada name, and Air Canada's roundel design, solely in association with the provision of heavy maintenance, component maintenance and supply chain business services in Canada and the United States. The ACTS Trademark License Agreement was amended on closing of the monetization of ACTS LP to provide for the termination of the agreement on October 16, 2008.

*ACTS General Services Agreements*

ACTS Aero and Air Canada are parties to an amended and restated general services agreement (the "ACTS GSA"), effective as of June 22, 2007 pursuant to which Air Canada provides ACTS Aero with the services of a group of unionized employees for which Air Canada is reimbursed by ACTS Aero for all costs, including salary and benefits, on a fully allocated basis. Non-unionized employees, previously assigned to ACTS under another general services agreement, were transferred to ACTS on October 16, 2007. The ACTS GSA may be terminated by either party at any time upon 30 days' prior written notice.

*Real Estate Agreements*
As part of the closing of the monetization of ACTS LP, Air Canada sold a building to ACTS Aero for proceeds of $28 million effective as of October 16, 2007. In connection with the sale, Air Canada and ACTS Aero entered into a land sublease for certain land contiguous with the building and a service contract whereby Air Canada provides ACTS Aero certain services related to the operation of the building.

ACTS Aero and Air Canada are parties to a master lease agreement, effective as of October 1, 2006, pursuant to which ACTS Aero leases space from Air Canada at the Vancouver, Winnipeg, Toronto and Montreal airports.

*Pension and Benefits Agreement*
Air Canada, ACTS LP and ACTS Aero entered into a *Pension and Benefits Agreement* effective as of October 16, 2007 ("*Pension and Benefits Agreement*"), relating to pension and benefits arrangements pertaining to non-unionized and unionized employees of Air Canada who were previously assigned to ACTS LP pursuant to general services agreements between Air Canada and ACTS LP. On October 16, 2007, non-unionized employees of Air Canada who were previously assigned to the ACTS LP operation became employees of ACTS Aero. New defined benefit and defined contribution pension plans as well as other employee and retiree benefit arrangements (including health, life and disability) are to be established by ACTS Aero (the "ACTS Benefit Arrangements"). Upon receipt of regulatory approval where required and based upon valuations of the relevant pension and benefit arrangements of Air Canada (the "Air Canada Benefit Arrangements") as at October 16, 2007, the assets and obligations under the Air Canada Benefit Arrangements pertaining to the transferring non-unionized employees will be transferred to ACTS Aero or the ACTS Benefit Arrangements, as applicable. Any solvency deficiency in the defined benefit pension plans as at October 16, 2007 related to transferring non-unionized employees will be funded by Air Canada through quarterly payments to ACTS Aero until 2014. The accounting liability as at October 16, 2007 in respect of retiree and disability benefits related to transferring non-unionized employees will be funded by Air Canada through quarterly payments to ACTS Aero until 2012. Until such future time as the assets and obligations under the Air Canada Benefit Arrangements pertaining to non-unionized employees may be transferred to ACTS Aero, the current service pension cost and the current service and interest costs for other employee benefits will be expensed by Air Canada with a full offset recorded as an amount charged to affiliates (ACTS Aero).

In addition, the *Pension and Benefits Agreement* contemplates similar asset and liability transfer and compensation arrangements in respect of unionized employees, which arrangements would take effect at such future time as those unionized employees may be transferred from Air Canada to ACTS Aero. However, the solvency deficiencies in respect of transferring unionized employees for which the future quarterly compensation payments would be made are determined as at October 16, 2007, subject to certain adjustments, and the discount rate used to compute the accounting liability for the unionized employees' retiree and disability benefits is fixed as at October 16, 2007. The compensation payments in respect of these solvency deficiencies and accounting liabilities would be made quarterly during the five years beginning after the unionized employees are transferred to ACTS Aero, but only if such a transfer occurs. Until such future time as the assets and obligations under the Air Canada Benefit Arrangements pertaining to unionized employees may be transferred to ACTS Aero, the current service pension cost and the current service and interest costs for other employee benefits in respect of Air Canada employees providing services to ACTS Aero are charged to ACTS Aero.

The *Pension and Benefits Agreement* also required that Air Canada provide letters of credit to ACTS Aero on October 16, 2007, to secure the above-described payment obligations in respect of the solvency deficiencies of the defined benefit pension plans and accounting liabilities for other retiree and disability benefit arrangements. The letters of credit total $101 million, subject to adjustment once the exact amounts of the relevant solvency deficiencies and accounting liabilities as at October 16, 2007 are determined by actuarial valuations. The face amount of the letter of credit in respect of the unionized solvency deficiency is also adjusted annually to recognize past service costs paid by Air Canada to the plan in respect of unionized employees assigned to ACTS Aero. The face amounts of the letters of credit decrease as the related quarterly funding payments described above are made. ACTS Aero may call the letters of credit in whole or in part, in the event of a default as defined in the *Pension and Benefits Agreement*. Collateral equal to the amount of the letters of credit was paid in cash with the asset recorded in deposits and other assets.

*Non-Compete and Repair Schemes Transfer Agreement*
ACTS Aero and Air Canada are parties to a non-compete and repair schemes transfer agreement, effective as of October 16, 2007 (the "Repair Schemes and Non-Compete Agreement"). Generally described, repair schemes are processes and methods which may be used in the maintenance and repair of aircraft and related equipment. The Repair Schemes and Non-Compete Agreement confirmed an arrangement and provides for the sale from Air Canada to ACTS Aero (as successor to ACTS LP) of

an undivided joint ownership interest in repair schemes owned by Air Canada or approved under Air Canada's airworthiness engineering organization as well as the sale from ACTS Aero to Air Canada of an undivided joint ownership interest in the repair schemes owned or developed by ACTS Aero and applicable to airframe heavy maintenance services provided by ACTS Aero to Air Canada under the parties' airframe heavy maintenance services agreement. However, in September 2004, as part of the implementation of the Corporation's plan of arrangement under the Companies' *Creditors Arrangement Act*, the Corporation had already granted ACTS full and exclusive right to these schemes on a royalty-free basis.

The Repair Schemes and Non-Compete Agreement also restricts Air Canada's ability to own any equity interest in an entity (other than entities in which Air Canada previously held interests), or to carry on a business activity, related to the following commercial maintenance, repair and overhaul services in the airline industry, namely, airframe heavy maintenance and paint services, engine and auxiliary power unit ("APU") overhaul maintenance services, and component maintenance services. The applicable non-compete periods are as follows:

- With respect to airframe heavy maintenance services and paint services, the non-compete period ends one year after the current heavy maintenance services agreement is terminated or expires (the current term of the heavy maintenance services agreement expires October 1, 2011);
- With respect to engine and APU overhaul maintenance services, the non-compete period ends on October 1, 2015; and
- With respect to component maintenance services, the non-compete period ends on October 1, 2016.

The Repair Schemes and Non-Compete Agreement does not restrict Air Canada from holding interests in any entities in which it held interests at the time of concluding the agreement nor does it limit Air Canada's line maintenance activities which it continues to operate.

In consideration for the transfer of repair schemes, Air Canada received $20 million in 2007.

*Cash Management System*

Air Canada managed the cash for ACTS LP up to October 16, 2007. All cash collected from billings, and sources other than Air Canada, is recorded by Air Canada on a daily basis. Any payments to pay obligations related to operating and financing costs and capital expenditures other than obligations to Air Canada and other ACE affiliates were made through the Air Canada cash management system. Intercompany accounts receivable and payable include any excess cash (cash proceeds greater than cash expenditures), cash deficiencies (cash expenditures greater than proceeds) or deferrals of receipts of payments. Air Canada's consolidated statement of cash flows reflects the receipt and repayment of excess cash as a financing activity and the disbursement and repayment of cash deficiencies as investing activities.

*Loan and Prepayment Agreements between ACTS and Air Canada*

Pursuant to a Prepayment Agreement dated October 26, 2006, Air Canada prepaid an amount of approximately $595 million to ACTS Limited Partnership (the predecessor to ACTS LP and ACTS Aero) under the ACTS Maintenance Agreements for the estimated equivalent of 12 months of service to be rendered to Air Canada under the ACTS Maintenance Agreements starting on November 1, 2006. The amount of such prepayment was immediately loaned back by ACTS LP to Air Canada pursuant to a loan agreement dated October 26, 2006. Such loan was non-interest bearing and repayable in instalments starting on November 1, 2006. The amount of the instalments was equal to the amount that would otherwise have been payable by Air Canada under the ACTS Maintenance Agreements and became due and payable on the day on which the amount became payable under the ACTS Maintenance Agreements. Repayment of the entire amount of the loan was completed in 2007.

***The Relationship between Air Canada and ACE***

Certain cash payments and notes received from ACE on the transfer of Air Canada's investments in Aeroplan, Jazz and ACTS LP to ACE have been included in Air Canada's consolidated financial statements as a contribution from ACE to Shareholders' Equity.

*Share purchase rights sold by Air Canada to ACE*
During 2007, Air Canada entered into an aircraft transaction with an unrelated third party whereby partial consideration was paid to Air Canada in the form of a right to acquire shares of the unrelated third party. The transaction related to the sale by Air Canada of two Airbus A319 aircraft and the sublease by Air Canada of an additional two Airbus A319 aircraft, all of which was completed in 2007 with the exception of one of the owned A319 aircraft, which was completed in January 2008. Air Canada sold the right to acquire shares received from the unrelated third party to ACE, at fair value, for proceeds of $1 million.

*Warrants purchased from ACE*
On November 26, 2007, Air Canada purchased certain share warrants held by ACE for consideration of $4 million. These warrants are for the purchase of shares of an unrelated third party from which Air Canada purchases services.

*Purchase of Air Canada Vacations*
In 2007, Air Canada purchased from ACE its 49% interest in Air Canada Vacations causing Air Canada Vacations to be 100% owned by Air Canada. Consideration for the units was $10. The consideration is accounted for on Air Canada's statement of financial position in contributed surplus. Air Canada Vacations remains consolidated within the results of the Corporation.

*ACE Master Services Agreement (ACE MSA)*
Air Canada provides certain administrative services to ACE in return for a fee. Such services relate to finance and accounting, information technology, human resources and other administrative services.

The related party balances resulting from the payment obligations in respect of the application of the commercial agreements described above were as follows:

| ($ millions) | December 31, 2007 | December 31, 2006 |
|---|---|---|
| **Accounts receivable** | | |
| ACE | $ 9 | $ - |
| Aeroplan | 20 | 6 |
| ACTS | 75 | 97 |
| Jazz | 85 | - |
| | **$ 189** | **$ 103** |
| **Prepaid Maintenance** | | |
| ACTS | $ 24 | $ - |
| | **$ 24** | **$ -** |
| **Accounts payable and accrued liabilities** | | |
| ACE | $ - | $ 12 |
| ACTS | 88 | 111 |
| Jazz | 71 | - |
| | **$ 159** | **$ 123** |

The related party revenues and expenses with Aeroplan (period from March 14, 2007 to December 31, 2007), Jazz (period from May 24, 2007 to December 31, 2007) and ACTS Aero (period from October 16 to December 31, 2007) are summarized as follows:

| | Three months ended December 31 | | Year ended December 31 | |
|---|---|---|---|---|
| **($ millions)** | **2007** | **2006** | **2007** | **2006** |
| **Revenues** | | | | |
| Passenger revenues from Aeroplan related to Aeroplan rewards, net of purchases of Aeroplan miles | $ 31 | $ 22 | $ 154 | $ 115 |
| Property rental revenues from related parties | 11 | 9 | 46 | 46 |
| Revenues from information technology services to related parties | 7 | 8 | 28 | 27 |
| Revenues from corporate services and other | 3 | 2 | 25 | 14 |
| Aircraft sublease revenues from Jazz | 6 | - | 14 | - |
| Air Canada Ground Handling revenues from related parties | 16 | - | 33 | - |
| Cargo revenues from related parties | - | 1 | 3 | 4 |
| | **$ 74** | **$ 42** | **$ 303** | **$ 206** |
| **Expenses** | | | | |
| Maintenance expense for services from ACTS | $ 127 | $ 158 | $ 631 | $ 614 |
| Expense from CPA with Jazz | 227 | - | 537 | - |
| Pass-through fuel expense from Jazz | 84 | - | 197 | - |
| Pass-through airport expense from Jazz | 49 | - | 120 | - |
| Pass-through other expense from Jazz | 10 | - | 17 | - |
| Other expenses | 3 | 13 | 12 | 49 |
| Recovery of wages, salary and benefit expense for employees assigned to related parties | (97) | (106) | (412) | (413) |
| | **$ 403** | **$ 65** | **$ 1,102** | **$ 250** |
| **Net interest expense (income) from related parties** | **$ -** | **$ 1** | **$ (1)** | **$ 6** |

In addition to the above revenues and expenses with Jazz, the Corporation transfers fuel inventory and subleases certain aircraft to Jazz on a flow through basis, which are reported net on Air Canada's statement of operations.

## 13. CRITICAL ACCOUNTING ESTIMATES

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

The Corporation has identified the following areas that contain critical accounting estimates utilized in the preparation of its consolidated financial statements:

**Passenger and Cargo Revenues**

Airline passenger and cargo advance sales are deferred and included in current liabilities. Advance sales also include the proceeds from the sale of flight tickets to Aeroplan which provides loyalty program services to the Corporation and purchases seats from Air Canada under the Aeroplan CPSA. Passenger and cargo revenues are recognized when the transportation is provided, except for revenue on unlimited flight passes which is recognized on a straight-line basis over the period during which the travel pass is valid. Air Canada has formed alliances with other airlines encompassing loyalty program participation, code sharing and coordination of services including reservations, baggage handling and flight schedules. Revenues are allocated based upon formulas specified in the agreements and are recognized as transportation is provided.

The Corporation performs regular evaluations on the deferred revenue liability which may result in adjustments being recognized as revenue. Due to the complex pricing structures, the complex nature of interline, and other commercial agreements used throughout the industry, historical experience over a period of many years, and other factors including refunds, exchanges and unused tickets, certain relatively small amounts are recognized as revenue based on estimates. Events and circumstances may result in actual results that are different from estimates, however, these differences have historically not been material.

**Employee Future Benefits**

Air Canada maintains several defined benefit and defined contribution plans providing pension, other retirement and post-employment benefits to its employees, including those employees of Air Canada who are contractually assigned to ACTS Aero and Aeroplan. These employees are members of Air Canada's sponsored defined benefit pension plans and also participate in Air Canada's sponsored health, life and disability future benefit plans. The Corporation's audited consolidated financial statements for 2007 include all of the assets and liabilities of all the sponsored plans of the Corporation. Employee benefits expense reflects a cost recovery which is charged to the related parties for those employees currently performing work for their benefit. The cost recovery includes current service costs for pensions along with their portion of post-employment and post-retirement benefits based on the actuarial calculation for their specific employee group. The cost recovery amounted to $40 million for the year ended December 31, 2007.

Management makes a number of assumptions in the calculation of both the accrued benefit obligation as well as the pension costs:

| | December 31, 2007 | December 31, 2006 |
|---|---|---|
| **Weighted average assumptions used to determine accrued benefit obligation** | | |
| Discount rate as at period-end | 5.75% | 5.00% |
| Rate of compensation increase (1) | 2.50% | 2.50% |
| **Weighted average assumptions used to determine pension costs** | | |
| Discount rate as at period-end | 5.00% | 5.00% |
| Expected long-term rate of return on plan assets | 7.15% | 7.50% |
| Rate of compensation increase (2) | 2.50% | 4.00% |

(1) As a result of the pay awards during 2006, a rate of compensation increase of 1.75% was used for the years 2007 and 2008 in determining the net benefit obligation for the pension plan and 2.5% for the remaining years.

(2) A rate of compensation increase of 2% in 2006 and 2% in 2007 was used in determining the net benefit pension expense.

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 approximately match the timing and amount of expected benefit payments.

Expected Return on Assets Assumption

Air Canada's expected long-term rate of return on assets assumption is selected based on the facts and circumstances that exist as of the measurement date and the specific portfolio mix of plan assets. Air Canada's management, in conjunction with its actuaries, reviews anticipated future long-term performance of individual asset categories and considers the asset allocation strategy adopted by Air Canada, including the longer duration in its bond portfolio in comparison to other pension plans. These factors are used to determine the average rate of expected return on the funds invested to provide for the pension plan benefits. While the review considers recent fund performance and historical returns, the assumption is primarily a long-term, prospective rate.

Asset Allocation

The composition of the domestic registered plan assets and the target allocation consists of the following:

| | November 30, 2007 | November 30, 2006 | Target allocation |
|---|---|---|---|
| Equity | 58.9 % | 59.1 % | 59.0 % |
| Bonds and Mortgages | 36.1 % | 34.7 % | 41.0 % |
| Short-term and Other | 5.0 % | 6.2 % | 0.0 % |
| **Total** | **100.0 %** | **100.0 %** | **100.0 %** |

Domestic Registered Plans

For the domestic registered plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Master Trust Fund (Fund). The investment return objective of the Fund is to achieve a total annualized rate of return that exceeds inflation by at least 3.75% over the long term.

In addition to the broad asset allocation, as summarized in the asset allocation section above, the following policies apply to individual asset classes:

- Equity investments can include convertible securities and are required to be diversified among industries and economic sectors. Foreign equities can comprise 37% to 43% of the total market value of the trust. Limitations are placed on the overall allocation to any individual security at both cost and market value. Derivatives are permitted to the extent they are not used for speculative purposes or to create leverage.
- Bond and mortgage investments are oriented toward risk averse, long-term, investment grade securities rated "A" or higher. With the exception of Government of Canada securities, or a province thereof, in which the plan may invest the entire fixed income allocation, fixed income investments are required to be diversified among individual securities and sectors. The target return is comprised of 40% of the total return of the Scotia Capital Universe Bond Index and 60% of the total return of the Scotia Capital Long Term Bond Index.

Similar investment policies are established for the other pension plans sponsored by Air Canada.

Best Estimate of Employer Contributions

Based upon an agreement between Air Canada and representatives of the unionized and non-unionized employees and retirees with respect to the funding of the domestic registered plans, which agreement is subject to approval of the Office of the Superintendent of Financial Institutions (Canada) ("OSFI"), the actual 2006 and 2007 contributions were as follows:

| ($ millions) | 2007 Contributions | 2006 Contributions |
|---|---|---|
| Past service cost for registered pension plans | $ 134 | $ 224 |
| Current service cost for registered pension plans | 160 | 140 |
| Other pension arrangements[(1)] | 84 | 83 |
| **Air Canada[(2)]** | $ 378 | $ 447 |

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

(2) Includes obligations relating to employees who have been assigned to related parties.

Jazz's employer contributions amounted to $8 million in 2006 and $4 million for the period January 1, 2007 up to May 24, 2007.

As previously discussed, the Corporation recovers costs relating to some employees who have been contractually assigned to ACTS Aero and Aeroplan. The cost recovery relating to Air Canada's sponsored defined pension plans amounted to $23 million for 2007 and $33 million for 2006. The cost recovery relating to Air Canada's sponsored future benefit plans amounted to $17 million for 2007 and $23 million for 2006.

Sensitivity Analysis

Sensitivity analysis on the 2007 pension expense based on different actuarial assumptions with respect to discount rate and expected return on plan assets is as follows:

| Impact on 2007 pension expense in $ millions | 0.25 percentage point | |
|---|---|---|
| | Decrease | Increase |
| Discount rate on obligation assumption | $ 12 | $ (12) |
| Long-term rate of return on plan assets assumption | $ 27 | $ (27) |

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 9.25% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2007 (9.75% was assumed for 2006). The rate is assumed to decrease gradually to 5% by 2013. A one percentage point increase in assumed health care trend rates would have increased the service and interest costs by $1 million and the obligation by $16 million. A one percentage point decrease in assumed health care trend rates would have decreased the service and interest costs by $1 million and the obligation by $16 million.

**Income Taxes**

The Corporation utilizes the liability method of accounting for income taxes under which future income tax assets and liabilities are recognized for the estimated future income tax consequences attributable to differences between the financial statement carrying value amount and the tax basis of assets and liabilities. Management uses judgment and estimates in determining the appropriate rates and amounts in recording future taxes, giving consideration to timing and probability. Actual taxes could significantly vary from these estimates as a result of future events, including changes in income tax law or the outcome of reviews by tax authorities and related appeals. The resolution of these uncertainties and the associated final taxes may result in adjustment to the Corporation's tax assets and tax liabilities.

Future income tax assets are recognized to the extent that realization is considered more likely than not. The Corporation considers past results, current trends and outlooks for future years in assessing realization of income tax assets.

**Cash Tax Projections**

As at December 31, 2007, Air Canada has substantial tax attributes largely in the form of undepreciated capital cost and other tax attributes to shelter future taxable income. These tax attributes are expected to continue to increase over the next several years due to capital expenditures related to aircraft acquisitions. Air Canada does not forecast having any significant current taxes payable within the foreseeable future.

**Impairment of Long-Lived Assets**

Long-lived assets are tested for impairment whenever circumstances indicate that the carrying value may not be recoverable. When events or circumstances indicate that the carrying value of long-lived assets, other than indefinite life intangibles, are not recoverable, the long-lived assets are tested for impairment by comparing the estimate of future expected cash flows to the carrying amount of the assets or groups of assets. If the carrying value of long-lived assets is not recoverable from future expected cash flows, any loss is measured as the amount by which the asset's carrying value exceeds fair value and recorded in the period. Recoverability is assessed relative to undiscounted cash flows from the direct use and disposition of the asset or group of assets. Assessing the fair value of intangible assets requires significant management estimates on future cash flows to be generated by the assets, including the estimated useful life of the assets.

**Property and Equipment**

Property and equipment is originally recorded at cost. Property under capital leases and the related obligation for future lease payments are initially recorded at an amount equal to the lesser of fair value of the property or equipment and the present value of those lease payments.

Property and equipment are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Property and equipment under capital leases and variable interest entities are depreciated to estimated residual values over the life of the lease. Air Canada's aircraft and flight equipment, including spare engines and related parts ("rotables"), are depreciated over 20 to 25 years, with 10 to 20% estimated residual values. Aircraft reconfiguration costs are amortized over three to five years. Betterments to owned aircraft are capitalized and amortized over the remaining service life of the aircraft. Betterments to aircraft on operating leases are amortized over the term of the lease.

Buildings are depreciated over their useful lives not exceeding 40 to 50 years on a straight-line basis. An exception to this is where the useful life of the building is greater than the term of the land lease. In these circumstances, the building is depreciated over the life of the lease. Leasehold improvements are amortized over the lesser of the lease term or five years. Ground and other equipment is depreciated over three to 25 years.

Aircraft depreciable life is determined through economic analysis, a review of existing fleet plans and comparisons to other airlines operating similar fleet types. Residual values are estimated based on the Corporation's historical experience with regard to the sale of aircraft and spare parts, as well as forward-looking valuations prepared by independent third parties.

**Intangible Assets**

The identifiable intangible assets of the Corporation were recorded at their estimated fair values at September 30, 2004. Indefinite-life intangible assets are subject to impairment tests under Canadian GAAP on an annual basis or when events or circumstances indicate a potential impairment. If the carrying value of such assets exceeds the fair values, the assets are written down to fair value.

Fair value under Canadian GAAP is defined as "the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act". Assessing the fair value of intangible assets requires significant management estimates on future cash flows to be generated by the assets, including the estimated useful life of the assets.

## 14. CHANGES IN ACCOUNTING POLICIES

**Financial Instruments**

On January 1, 2007, Air Canada adopted CICA accounting handbook section 3855, ***Financial Instruments – Recognition and Measurement***, section 3861, *Financial Instruments and Presentation*, section 3865, *Hedges*, section 1530, *Comprehensive Income* and section 3251, *Equity*.

Section 3861 establishes standards for presentation of financial instruments and non-financial derivatives, and identifies the information that should be disclosed about them. The purpose of the section is to enhance financial statement users' understanding of the significance of financial instruments to an entity's financial position, performance and cash flows.

Section 3855 establishes standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives. Under this standard, all financial instruments are required to be measured at fair value on initial recognition except for certain related party transactions. Measurement in subsequent periods is dependent upon the classification of the financial instrument as held-for-trading, available-for-sale, held-to-maturity, loans and receivables, or other financial liabilities.

The Corporation has implemented the following classifications:

- Cash and cash equivalents are classified as held-for-trading and any period change in fair value is recorded through net income.
- Aircraft-related deposits are classified as held-to-maturity investments and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.
- Accounts receivable are classified as loans and receivables and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.
- Accounts payable, credit facilities and bank loans are classified as other financial liabilities and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.

Derivative instruments are recorded on the consolidated statement of financial position at fair value, including those derivatives that are embedded in financial or non-financial contracts. Changes in the fair values of derivative instruments are recognized in non-operating income (expense) with the exception of foreign exchange risk management contracts and derivatives designated as effective cash flow hedges.

Changes in the fair value of foreign currency forward contracts, option agreements and currency swap agreements used for foreign exchange risk are recorded in foreign exchange gain (loss). These contracts are included in prepaid expenses and other current assets, deposits and other assets, accounts payable and accrued liabilities, or other long-term liabilities as appropriate.

The standards 3865 also provide guidance on accounting for derivatives in hedging relationships. In addition to requiring all derivatives to be fair valued on the consolidated statement of financial position, the standards require the effectiveness of the hedging relationships for the reporting period to be quantified. The effective portion of the change in the fair value of the hedging derivative is recognized in other comprehensive income ("OCI") while the ineffective portion is recognized in non-operating income (expense). Upon maturity of fuel derivatives, the effective gains and losses previously recognized in Accumulated OCI ("AOCI") are recorded in fuel expense. These derivatives are recorded in prepaid expenses and other current assets, deposits and other assets, accounts payable and accrued liabilities, or other long-term liabilities as appropriate.

OCI represents changes in shareholders' equity during a period arising from transactions and other events with non-owner sources that are recognized in comprehensive income, but excluded from net income.

**Impact upon Adoption**

In accordance with the transitional provisions of the standards, prior periods have not been restated for the adoption of these new accounting standards.

The transition adjustments attributable to the re-measurement of financial assets and financial liabilities at fair value, other than financial assets classified as available-for-sale and hedging instruments designated as cash flow hedges, were recognized in the opening deficit of the Corporation as at January 1, 2007. The cumulative effective portion of any gain or loss on the hedging instruments classified as cash flow hedges was recognized in AOCI, while the cumulative ineffective portion was included in the opening deficit of the Corporation as at January 1, 2007.

Upon adoption, the Corporation recorded the following adjustments to the consolidated statement of financial position:

| ($ millions) | Increase / (decrease) |
|---|---|
| Deferred charges | $ (14) |
| Future income taxes ($6 million, net of a valuation allowance of $6 million) | $ - |
| Accounts payable and accrued liabilities | $ 18 |
| Long-term debt and capital leases | $ (14) |
| Deficit, net of nil tax | $ (8) |
| Accumulated other comprehensive income (loss), net of nil tax | $ (26) |

## 15. FUTURE ACCOUNTING STANDARD CHANGES

The Corporation will adopt the following new accounting standards on January 1, 2008:

Capital Disclosures and Financial Instruments – Presentation and Disclosure

The CICA issued three new accounting standards: section 1535, Capital Disclosures, section 3862, Financial Instruments – Disclosures, and section 3863, Financial Instruments – Presentation. These new standards will be effective for fiscal years beginning on or after October 1, 2007 and the Corporation will adopt them on January 1, 2008. The Corporation is in the process of evaluating the disclosure and presentation requirements of the new standards.

Section 1535 establishes disclosure requirements about an entity's capital and how it is managed. The purpose will be to enable users of the financial statements to evaluate the entity's objectives, policies and processes for managing capital.

Sections 3862 and 3863 will replace section 3861, Financial Instruments – Disclosure and Presentation, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements. These new sections will place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks.

Inventories

The CICA issued section 3031, Inventories, which will replace section 3030, Inventories. This new standard is effective for fiscal years beginning on or after July 1, 2007, and the Corporation will adopt this section on January 1, 2008. Section 3031 provides more extensive guidance on measurement, and expands disclosure requirements to increase transparency. The Corporation's accounting policy for inventories is consistent with measurement requirements in the new standard and therefore it is not anticipated that the results of the Corporation will be impacted, however, additional disclosures will be required in relation to inventories carried at net realizable value, the amount of inventories recognized as an expense, and the amount of any write-downs of inventories.

## 16. 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. In order to provide a general guideline, the following table describes, on an indicative basis, the financial impact that changes in operating assumptions would generally have had on Air Canada (previously "Air Canada Services") operating results. These guidelines were derived from 2007 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 vary significantly from actual results due to factors beyond the control of Air Canada. Conversely, an opposite change in the sensitivity factor would have had the opposite effect on operating income.

| ($ millions)<br>Key Variable | 2007 Measure | | Sensitivity factor | Favourable / (Unfavourable) Estimated Operating Income Impact |
|---|---|---|---|---|
| **Revenue Measures** | | | | |
| Passenger yield (cents) | System | 18.4 | 1% increase in yield | $ 89 |
| | Canada | 24.3 | | $ 38 |
| Traffic (RPMs) (millions) | System | 50,629 | 1% increase in traffic | $ 81 |
| | Canada | 16,284 | | $ 34 |
| Passenger load factor | System | 80.6 | 1 percentage point increase | $ 101 |
| RASM (cents) | System | 14.8 | 1% increase in RASM | $ 85 |
| **Cost Measures** | | | | |
| Labour and benefits expenses ($ millions) | | 1,920 | 1% increase | $ (19) |
| Fuel – WTI price (US$/barrel) (1) | | 69.9 | US$1/barrel increase to WTI | $ (26) |
| Fuel – jet fuel price (Cdn cents/litre) (1) | | 66.3 | 1% increase | $ (26) |
| Cost per ASM (cents) | | 16.3 | 1% increase in CASM | $ (102) |

(1) Excludes the impact of fuel surcharges and fuel hedging.

| ($ millions)<br>Key Variable | 2007 Measure | Sensitivity Factor | Favourable / (Unfavourable)<br>Estimated Operating Income Impact | Favourable / (Unfavourable)<br>Estimated Pre-Tax Income Impact (1) |
|---|---|---|---|---|
| **Currency Exchange** | | | | |
| Cdn$ to US$ | 1US$ = Cdn$ 0.99 | 1 cent increase (e.g. $0.99 to $0.98) | $ 25 | $ 72 |

(1) Excludes the impact of foreign exchange forward contracts and currency swaps.

## 17. RISK FACTORS

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

**Risks Relating to the Corporation**

Operating Results

In the past, the Corporation has sustained significant operating losses and may sustain significant losses in the future. On September 30, 2004, the Corporation and certain of its subsidiaries emerged from protection under the CCAA and implemented the Plan. For the three years ended December 31, 2003, Air Canada incurred operating losses before reorganization and restructuring items and non-recurring labour expenses of over $1.6 billion. For the nine-month period ended September 30, 2004, Air Canada realized operating income before reorganization and restructuring items of $120 million and, for the three-month period ended December 31, 2004, the Corporation incurred an operating loss of $59 million. For the years ended December 31, 2007, 2006 and 2005, the Corporation realized operating income of $495 million, $259 million and $318 million, respectively. Despite Air Canada's emergence from creditor protection under the CCAA, the resulting and ongoing business initiatives and efforts at cost reductions and its recent results, the Corporation may not be able to successfully achieve planned business initiatives and cost reductions, including those which seek to offset significant fuel and other expense increases or restore positive net profitability and may sustain significant losses in the future.

Leverage and Liquidity

The Corporation has, and is expected to continue to have, a significant amount of indebtedness, including substantial fixed obligations under aircraft leases and financings. The Corporation may incur additional debt, including secured debt, in the future. The amount of indebtedness that the Corporation currently has and which it may incur in the future could have a material adverse effect on the Corporation, for example, by (i) limiting the Corporation's ability to obtain additional financing , (ii) requiring the Corporation 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 the Corporation more vulnerable to economic downturns, and (iv) limiting the Corporation's flexibility in planning for, or reacting to, competitive pressures or changes in its business environment.

The ability of the Corporation 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. Each of these factors is to a large extent subject to economic, financial, competitive, regulatory, operational and other factors, many of which are beyond the Corporation's control. In addition, as the Corporation incurs indebtedness which bears interest at fluctuating interest rates, to the extent these interest rates increase, its interest expense will increase. There can be no assurance that the Corporation will be able to generate sufficient cash from its operations to pay its debts and lease obligations.

Need for Additional Capital

The Corporation faces a number of challenges in its current business operations, including high fuel prices and increased competition from international, transborder and low-cost domestic carriers. In order to meet such challenges and to support the Corporation's business strategy, significant operating and capital expenditures are, and may in the future be, required. There can be no assurance that the Corporation will continue to be able to obtain on a timely basis sufficient funds on terms acceptable to the Corporation to provide adequate liquidity and to finance the operating and capital expenditures necessary to support its business strategy if cash flows from operations and cash on hand are insufficient.

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

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

Fuel Costs

Fuel costs constituted the largest percentage of the total operating costs of the Corporation in 2007. Fuel prices fluctuate widely depending on many factors including international market conditions, geopolitical events and the Canada/US dollar exchange rate. Air Canada cannot accurately predict fuel prices. During 2005, 2006 and 2007, fuel prices increased and fluctuated near or at historically high levels. Should fuel prices continue at, or continue to increase above, such high levels, fuel costs could have a material adverse effect on the Corporation's business, results from operations and financial condition. Due to the competitive nature of the airline industry, the Corporation may not be able to pass on increases in fuel prices to its customers by increasing its fares. Based on 2007 volumes, Management estimates that a US$1 per barrel movement in the average price of West Texas Intermediate crude oil would have resulted in an approximate Cdn$26 million change in 2007 fuel expense for the Corporation (excluding any impact of fuel surcharges, foreign exchange rates and fuel hedging), assuming flying capacity remained unchanged and that refining spreads between West Texas Intermediate crude oil and jet fuel as well as foreign exchange rates remained constant.

Labour Costs and Labour Relations

Labour costs constitute one of the Corporation's largest operating cost items. There can be no assurance that the Corporation will be able to maintain such costs at levels which do not negatively affect its business, results from operations and financial condition. There can be no assurance that future agreements with employees' unions or the outcome of arbitrations will be on terms consistent with the Corporation's expectations or comparable to agreements entered into by the Corporation's competitors. Any future agreements or outcome of negotiations, mediations or arbitrations including in relation to wages or other labour costs or work rules may result in increased labour costs or other charges which could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Most of the Corporation's employees are unionized and long-term collective agreements were concluded in 2003 and 2004. No strikes or lock-outs may lawfully occur during the term of the collective agreements expiring in 2009. However, there can be no assurance that there will not be a labour conflict that could lead to an interruption or stoppage in the Corporation's service or otherwise adversely affect the ability of the Corporation to conduct its operations, all of which could have a material adverse effect on its business, results from operations and financial condition.

If there is a labour disruption or work stoppage by any of the unionized work groups of Jazz, there could also likely be a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, labour conflicts at the Corporation's Star Alliance® partners could result in lower demand for connecting traffic with the Corporation and, ultimately, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Airport User Fees and Air Navigation Fees

With the privatization of airports and air navigation authorities over the last decade in Canada, new airport and air navigation authorities have imposed significant increases in their fees. If authorities in Canada or elsewhere continue to increase their fees at the rate at which they have increased them in the recent past, the Corporation's business, results from operations and financial condition could be materially adversely affected.

Competition

The Corporation operates within a highly competitive industry. Over the past few years, several carriers have entered or announced their intention to enter into the domestic, the US transborder and international markets in which the Corporation operates.

Canadian low-cost and other carriers have entered and/or expanded or announced their intention to compete in many of the Corporation's key domestic markets and, along with some US carriers have also entered and/or expanded their operations in the US transborder market. Some US carriers, having recently completed substantial reorganizations, have reduced levels of indebtedness and lower operating costs and may be in a position to more effectively compete with the Corporation. The Corporation is also facing increasing competition in international markets as carriers increase their international capacity, both by expansion and by shifting existing domestic capacity to international operations to avoid low-cost domestic competition.

If Canadian low-cost and other carriers are successful in entering or expanding into the Corporation's domestic and the US transborder markets, if additional US carriers are successful in entering the Corporation's transborder market or if carriers are successful in their expansion in international markets of the Corporation, the Corporation's business results from operations and financial condition could be materially adversely affected.

The Corporation also encounters substantial price competition. The expansion of low-cost carriers in recent years, along with the advent of Internet travel websites and other travel products distribution channels, has resulted in a substantial increase in discounted and promotional fares initiated by the Corporation's competitors. The decision to match competitors' fares, to maintain passenger traffic, results in reduced yields which, in turn, could have a material adverse effect on the Corporation's business, results from operations and financial condition. Furthermore, the Corporation's ability to reduce its fares in order to effectively compete with other carriers is dependent on the Corporation's ability to achieve acceptable operating margins and may also be limited by government policies to encourage competition.

In addition, consolidation in the airline industry could result in increased competition as some airlines emerging from such consolidations may be able to compete more effectively against the Corporation which could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Limitations Due to Restrictive Covenants

Some of the financing and other major agreements of the Corporation contain restrictive covenants which affect and, in some cases, significantly limit or prohibit, among other things, the manner in which the Corporation may structure or operate its business, including by limiting the Corporation's ability to incur indebtedness, create liens, sell assets, make capital expenditures and engage in acquisitions, mergers or restructurings. In addition, certain financing arrangements require the Corporation to maintain financial ratios. Any future borrowings may also be subject to similar covenants which limit Air Canada's operating and financial flexibility, which could materially and adversely affect Air Canada's profitability.

A failure by the Corporation to comply with its contractual obligations (including restrictive 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 and lessors, and such defaults could trigger additional defaults under other indebtedness or agreements. In such a situation, it is unlikely that the Corporation would 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 the Corporation which secure the Corporation's obligations.

Strategic, Business, Technology and Other Important Initiatives

In order to operate its business, achieve its goals and remain competitive, the Corporation continuously seeks to identify and devise, invest in and implement strategic, business, technology and other important initiatives, such as those relating to the aircraft fleet restructuring program, the aircraft refurbishment program, the new revenue model, the reservation and airport customer service initiative (which will also support the revenue model), the business process initiatives as well as other initiatives. 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 the Corporation's control. Such factors include the performance of third parties, including suppliers, the implementation and integration of such initiatives into the Corporation's other activities and processes as well as the adoption and acceptance of initiatives by the Corporation's customers, suppliers and personnel. A delay or failure to sufficiently and successfully identify and devise, invest in or implement these initiatives could adversely affect the Corporation's ability to operate its business, achieve its goals and remain competitive and could have a material adverse effect on the Corporation's business, results from operations and financial condition.

For instance, a key component of the Corporation's business plan is the restructuring of its aircraft fleet, including the elimination and replacement of older, less efficient aircraft, the introduction of new regional jet aircraft, and the modernization of its international wide-body fleet through the acquisition of new and more efficient aircraft. A delay or failure in the completion of the Corporation's fleet restructuring, including a delay by the manufacturers in the delivery of the wide-body aircraft, or an inability to remove, as planned, certain aircraft from the fleet in coordination with the planned entry into service of new aircraft, could adversely affect the implementation of the Corporation's business plan which may, in turn, have a material adverse effect on the Corporation's business, results from operations and financial condition.

Another important component of the Corporation's business plan is the replacement of its legacy systems for passenger reservation and airport customer service with a newly developed web-enabled system in order to support the rapid and efficient implementation of the Corporation's revenue model. A delay or failure in the implementation of the Corporation's new system could adversely affect the implementation of the Corporation's business plan which may, in turn, have a material adverse effect on the Corporation's business, results from operations and financial condition.

Dependence on Technology

The Corporation relies 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 the Corporation's telecommunications, websites, computerized airline reservations and airport customer services and flight operations.

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

Key Supplies and Suppliers

The Corporation is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and services in a timely manner, including those required for the Corporation's operations such as fuel, aircraft and related parts and aircraft and engine maintenance services (including maintenance services obtained from ACTS Aero). In certain cases, such goods and services may only be available from a limited number of suppliers. Such failure, refusal or inability may arise as a result of a wide range of causes, many of which are beyond the Corporation's control. Any failure or inability of the Corporation to successfully source goods and services, including by reason of a failure, refusal or inability of a supplier, or to source goods and services on terms and pricing and within the timeframes acceptable to the Corporation, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Aeroplan

Through its relationship with Aeroplan, the Corporation is able to offer its customers who are Aeroplan members the opportunity to earn Aeroplan miles. Based on customer surveys, Management believes that rewarding customers with Aeroplan miles is a significant factor in customers' decision to travel with Air Canada and Jazz and contributes to building customer loyalty. The failure by Aeroplan to adequately fulfill its obligations towards the Corporation under the Aeroplan CPSA and in connection with the Aeroplan program, or other unexpected interruptions of Aeroplan services which are beyond the Corporation's control could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Jazz

Under the Jazz CPA, Jazz provides the Corporation'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 the Corporation's mainline routes. The Corporation reimburses Jazz, without mark-up, for certain pass-through costs incurred directly by Jazz, such as fuel, navigation, landing and terminal fees and certain other costs. Significant increases in such pass-through costs, the failure by Jazz to adequately fulfill its obligations towards the Corporation under the Jazz CPA, or other unexpected interruptions of Jazz's services which are beyond the Corporation's control could have a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, the Jazz CPA requires that Jazz maintain a minimum fleet size and contains a minimum average daily utilization guarantee which requires that the Corporation make certain minimum payments to Jazz regardless of the revenue generated by Jazz.

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).

The solvency liability is influenced primarily by long-term interest rates and by the investment return on plan assets. The interest rate used to calculate benefit obligations for solvency purposes is a prescribed rate derived from the interest rates on long-term Government of Canada bonds. In the current low interest rate environment, the calculation results in a higher present value of the pension obligations, leading to a larger unfunded solvency position.

In May 2004, Air Canada and the Office of the Superintendent of Financial Institutions agreed on a protocol pursuant to which the solvency funding requirements for the Corporation's registered pension plans provided for in the then existing regulations were amended retroactive to January 1, 2004. The Corporation is required to make substantial annual cash contributions, and the level of those contributions will increase in the event of poor pension fund investment performance and/or further declines in long-term Government of Canada bond rates. See "Management's Discussion and Analysis — Critical Accounting Estimates — Employee Future Benefits — Sensitivity Analysis". Underfunded pension plans or a failure or inability by the Corporation to make required cash contributions to its registered pension plans could have a material adverse effect on the Corporation's business, results from operations and financial condition. Refer to section 7.6 of this MD&A for Air Canada's projected cash pension funding obligations.

Star Alliance®

The strategic and commercial arrangements with Star Alliance® members provide the Corporation 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, the Corporation's business, results from operations and financial condition could be materially adversely affected.

Interruptions or Disruptions in Service

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

Foreign Exchange

The Corporation's financial results are sensitive to the changing value of the Canadian dollar. In particular, the Corporation has a significant annual net outflow of US dollars and is affected by fluctuations in the Canada/US dollar exchange rate. Management estimates that during 2007, a $0.01 increase in the Canada/US dollar exchange rate (i.e., $0.99 to $0.98 per US dollar) would have had an estimated $25 million favourable impact on operating income and an estimated $72 million favourable impact on pre-tax income. Conversely, an opposite change in the exchange rate would have had the opposite effect. The Corporation incurs significant expenses in US dollars for such items as fuel, aircraft rental charges, interest payments, debt servicing and computerized reservations system fees, while a substantial portion of its revenues are generated in Canadian dollars. A significant deterioration of the Canadian dollar relative to the US dollar would increase the costs of the Corporation relative to its US competitors and could have a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, the Corporation may be unable to appropriately hedge the risks associated with fluctuations in exchange rates.

Current Legal Proceedings

The European Commission, the United States Department of Justice and the Competition Bureau in Canada, among other competition authorities, are investigating alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including the Corporation, a number of whom, including the Corporation, have received a statement of objections from the European Commission that sets out the European Commission's preliminary assessment in relation to such matter. Competition authorities have sought or requested information from the Corporation as part of their investigations. The Corporation is cooperating with these investigations, which are likely to lead to proceedings against the Corporation and a number of airlines and other cargo operators in certain jurisdictions. The Corporation is also named as a defendant in a number of class action lawsuits that have been filed before the United States District Court and in Canada in connection with these allegations. Management has determined that it is not possible at this time to predict with any degree of certainty the outcome of these proceedings, but these proceedings may result in a material liability to the Corporation.

In February 2006, Jazz commenced proceedings before the Ontario Superior Court of Justice against Porter Airlines Inc. ("Porter") and other defendants (collectively the "Porter Defendants") after Jazz became aware that it would be excluded from operating flights from Toronto City Centre (Island) Airport (the "TCCA"). On October 26, 2007, the Porter Defendants counter-claimed against Jazz and Air Canada alleging various violations of competition law, including that Jazz and Air Canada's commercial relationship contravenes Canadian competition laws, and claiming $850 million in damages. Concurrently with the Ontario Superior Court of Justice proceedings, Jazz commenced judicial review proceedings against the Toronto Port Authority ("TPA") before the Federal Court of Canada relating to Jazz's access to the TCCA. The Porter Defendants were granted intervener and party status in these proceedings. In January of 2008, Porter filed a defence and counterclaim against Jazz and Air Canada making allegations and seeking conclusions similar to those in the Ontario Superior Court counterclaim. Management views Porter's counterclaims in both jurisdictions as being without merit.

In October 2006, ACPA commenced proceedings before the Ontario Superior Court of Justice against Air Canada, ACE and certain members of the board of directors of Air Canada alleging that certain past and future actions are oppressive to it. A variety of remedies were sought against the parties including an injunction to impose, among other things, limits on corporate distributions including those contemplated under the ACE plan of arrangement which became effective on October 10, 2006. Following a hearing in December, 2006, Mr. Justice Cumming of the Ontario Superior Court of Justice dismissed ACPA's application for an injunction and granted respondents' cross-motion to dismiss ACPA's claim. ACPA has not appealed the dismissal of the injunction application but has appealed the order dismissing its claim and the appeal is scheduled to be heard by the Ontario Court of Appeal in March 2008. Management is of the view that the ACPA claim is without merit.

The Canadian Union of Public Employees ("CUPE"), which represents the Corporation's flight attendants, has a complaint before the Canadian Human Rights Commission where it alleges gender-based wage discrimination. CUPE claims the predominantly female flight attendant group should be paid the same as the predominantly male pilot and mechanics groups because their work is of equal value. The complaint dates from 1991 but has not been investigated on the merits because of a legal dispute over whether the three groups work in the same "establishment" within the meaning of the Canadian Human Rights Act. On January 26, 2006, the Supreme Court of Canada ruled that they do work in the same "establishment" and sent the case back to the Canadian Human Rights Commission, which may now proceed to assess the merits of CUPE's complaint. On March 16, 2007, the Canadian Human Rights Commission referred the complaint against the Corporation for investigation. The Corporation considers that any investigation will show that it is complying with the equal pay provisions of the Canadian Human Rights Act; however, management has determined that it is not possible at this time to predict with any degree of certainty the final outcome of the Commission's investigation.

On January 10, 2008, a decision was rendered by the Canadian Transportation Agency (Decision No. 6-AT-A-2008) following an application pursuant to subsection 172(1) of the Canada Transportation Act, S.C., 1996, c. 10, as amended, against the Corporation and other air carriers and parties concerning the fares and charges to be paid by persons with disabilities who require additional seating to accommodate their disabilities to travel by air on domestic air services. Management has determined that it is not possible at this time to predict with any degree of certainty the outcome of any proceedings which may be taken on appeal of the CTA decision or the final effects thereof.

Key Personnel

The Corporation is dependent on the experience and industry knowledge of its executive officers and other key employees to execute its business plan. If Air Canada were to experience a substantial turnover in its leadership or other key employees, Air Canada's 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**

Economic and Geopolitical Conditions

Airline operating results are sensitive to economic and geopolitical conditions which can have a significant impact on the demand for air transportation. Airline fares and passenger demand have fluctuated significantly in the past and may fluctuate significantly in the future. The Corporation is not able to predict with certainty market conditions and the fares that the Corporation 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. A downturn in economic growth in North America, as well as geopolitical instability in various areas of the world, increased concerns about the environmental impacts of air travel and tendencies towards "green" travel initiatives where consumers reduce their travel activities, could have the effect of reducing demand for air travel in Canada and abroad and, together with the other factors discussed herein, could materially adversely impact the Corporation's profitability. Especially in light of the Corporation's substantial fixed cost structure, any prolonged or significant weakness of the Canadian, US or world economies could reduce the demand for air transportation which in turn could have a material adverse effect on the Corporation's business, results from operations and financial condition.

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

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

Terrorist Attacks and Security Measures

The September 11, 2001 terrorist attacks and subsequent terrorist activity, notably in the Middle East, Southeast Asia and Europe, caused uncertainty in the minds of the traveling public. The occurrence of a major terrorist attack (whether domestic or international and whether involving the Corporation or another carrier or no carrier at all) and increasingly restrictive security measures, such as the current restrictions on the content of carry-on baggage and current or proposed passenger identification document requirements, could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on the Corporation's flights. It could also lead to a substantial increase in insurance, airport security and other costs. Any resulting reduction in passenger revenues and/or increases in insurance, security or other costs could have a material adverse effect on the Corporation's business, results from operations and financial condition.

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

As a result of the international outbreaks of Severe Acute Respiratory Syndrome (SARS) in 2003, the World Health Organization (the "WHO") issued on April 23, 2003 a travel advisory, which was subsequently lifted on April 30, 2003, against non-essential travel to Toronto, Canada. The seven day WHO travel advisory relating to Toronto, the location of the Corporation's primary hub, and the international SARS outbreak had a significant adverse effect on passenger demand for air travel in the Corporation's markets and resulted in a major negative impact on traffic on the entire network. The WHO warns that there is a substantial risk of an influenza pandemic within the next few years. An outbreak of SARS or of another epidemic disease such as influenza (whether domestic or international) or a further WHO travel advisory (whether relating to Canadian cities or regions or other cities, regions or countries) could have a material adverse effect on passenger demand for air travel. Any resulting reduction in traffic in the markets served by the Corporation could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Casualty Losses

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

Seasonal Nature of the Business, Other Factors and Prior Performance

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

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

Regulatory Matters

The airline industry is subject to extensive Canadian and foreign government regulations relating to, among other things, security, safety, licensing, competition, noise levels and the environment and, in some measure, pricing. Additional laws and regulations may be proposed, and decisions rendered, from time to time which could impose additional requirements or restrictions on airline operations. The implementation of additional regulations or decisions by Transport Canada, the Competition Bureau and/or the Competition Tribunal, the Canadian Transportation Agency or other domestic or foreign governmental entities may have a material adverse effect on the Corporation's business, results from operations and financial condition. The Corporation cannot give any assurances that new regulations or revisions to the existing legislation, or decisions, will not be adopted or rendered. The adoption of such new laws and regulations or revisions, or the rendering of such decisions, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

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

In July 2000, the Government of Canada amended the CTA, the Competition Act and the Air Canada Public Participation Act to address the competitive airline environment in Canada and ensure protection for consumers. This legislation included airline-specific provisions concerning "abuse of dominance" under the Competition Act, later supplemented by creating "administrative monetary penalties" for a breach of the abuse of dominance provisions by a dominant domestic air carrier.

In July 2003, the Competition Tribunal released its reasons and findings in a proceeding between the Commissioner of Canada and the Corporation which had considered the approach to be taken in determining whether the Corporation was operating below "avoidable costs" in violation of one of the new airline-specific abuse of dominance provisions. The Competition Tribunal applied a very broadly crafted cost test in its decision. In September 2004, the Commissioner of Competition published a letter describing the enforcement approach that would be taken in future cases involving the airline-specific abuse of dominance provisions, which included a statement that the Tribunal's approach to avoidable costs remains relevant.

On November 2, 2004, the Minister of Industry tabled amendments to the Competition Act in Bill C-19 which, if enacted, would have removed the airline-specific "abuse of dominance" provisions from the Competition Act. However, on November 29, 2005, the 38th Parliament of Canada was dissolved. As a result, the legislative process relating to the adoption of Bill C-19 was terminated. On October 16, 2007, private Bill C-454 containing provisions to remove the airline-specific "abuse of dominance" provisions from the Competition Act, was tabled for first reading in the House of Commons. Management cannot predict if or when such proposed legislation will come into force.

If the Commissioner of Competition commences inquiries or brings similar applications with respect to significant competitive domestic routes and such applications are successful, it could have a material adverse effect on the Corporation's business, results from operations and financial condition.

The Corporation is subject to domestic and foreign laws regarding privacy of passenger and employee data, including advance passenger information and access to airline reservation systems, which are not consistent in all countries in which the Corporation operates. Compliance with these regulatory regimes is expected to result in additional operating costs and could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Increased Insurance Costs

Since September 11, 2001 the aviation insurance industry has been continually reevaluating the terrorism risks that it covers and this activity may adversely affect some of the Corporation's existing insurance carriers or the Corporation's ability to obtain future insurance coverage. To the extent that the Corporation'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, the Corporation's insurance costs may increase further and may result in the Corporation being in breach of regulatory requirements or contractual arrangements requiring that specific insurance be maintained, which may have a material adverse effect on the Corporation's business, results from operations and financial condition.

Third Party War Risk Insurance

There is a risk that the Government of Canada may not continue to provide an indemnity for third party war risk liability coverage, which it currently provides to the Corporation and certain other carriers in Canada. In the event that the Government of Canada does not continue to provide such indemnity or amends such indemnity, the Corporation and other industry participants would have to turn to the commercial insurance market to seek such coverage. The Corporation estimates that such coverage would cost the Corporation approximately $15 million per year. Alternative solutions, such as those envisioned by the International Civil Aviation Organization ("ICAO") and the International Air Transport Association ("IATA"), have not developed as planned, due to actions taken by other countries and the recent availability of supplemental insurance products. ICAO and IATA are continuing their efforts in this area, however, the achievement of a global solution is not likely in the immediate or near future. The US federal government has set up its own facility to provide war risk coverage to US carriers, thus removing itself as a key component of any global plan.

Furthermore, the London aviation insurance market has introduced a new standard war and terrorism exclusion clause which is applicable to aircraft hull and spares war risk insurance, and intends to introduce similar exclusions to airline passenger and third party liability policies. Such clause excludes claims caused by the hostile use of a dirty bomb, electromagnetic pulse device, or biochemical materials. The Government of Canada indemnity program is designed to address these types of issues as they arise, but the Government of Canada has not yet decided to extend the existing indemnity to cover this exclusion. Unless and until the Government of Canada does so, the loss of coverage exposes the Corporation to this new uninsured risk and may result in the Corporation being in breach of certain regulatory requirements or contractual arrangements, which may have a material adverse effect on the Corporation's business, results from operations and financial condition.

**Risks Related to the Corporation's Relationship with ACE**

Control of the Corporation and Related Party Relationship

ACE owns shares of Air Canada representing 75% of the voting interests in Air Canada. Voting control will enable ACE to determine substantially all matters requiring security holder approval as a result of its voting interest in Air Canada. ACE may exercise control over corporate transactions submitted to Air Canada's board of directors and/or Air Canada's security holders for approval. ACE effectively has sufficient voting power to prevent a change in control of Air Canada. This voting control may discourage transactions involving a change of control of Air Canada, including as a result, transactions in which the public shareholders of Air Canada might otherwise receive a premium for their shares over the then-current market price.

The interests of ACE may conflict with those of other shareholders.

Future Sales of Shares by or for ACE

Sales of substantial amounts of Air Canada's shares by ACE, or the possibility of those sales by ACE, could adversely affect the market price of the shares and impede Air Canada's ability to raise capital through the issuance of equity securities.

ACE has no contractual obligation to retain any of the Air Canada shares. The registration rights agreement that Air Canada entered into with ACE concurrently with the Air Canada IPO granted ACE the right to require Air Canada to file a prospectus and otherwise assist with a public offering of shares that ACE holds in specified circumstances. In addition, Air Canada could issue and sell shares. Any sale by ACE or Air Canada of shares in the public market, or the perception that sales could occur could adversely affect prevailing market prices of the shares.

## 18. CONTROLS AND PROCEDURES

**Disclosure Controls and Procedures**

Disclosure controls and procedures within Air Canada have been designed to provide reasonable assurance that all relevant information is identified to its Disclosure Policy Committee to ensure appropriate and timely decisions are made regarding public disclosure.

Internal controls over financial reporting have been designed to provide reasonable assurance regarding the reliability of Air Canada's financial reporting and its preparation of financial statements for external purposes in accordance with Canadian Generally Accepted Accounting Principles ("GAAP").

Air Canada filed certifications, signed by the President and Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO"), with the Canadian Securities Administrators upon filing of Air Canada's 2007 annual filings. In those filings, Air Canada's CEO and CFO certify, as required by Multilateral Instrument 52-109, the appropriateness of the financial disclosure, the design and effectiveness of Air Canada's disclosure controls and procedures and the design of internal controls over financial reporting. Air Canada's CEO and CFO also certify the appropriateness of the financial disclosures in Air Canada's interim filings with Securities Regulators. In those interim filings, Air Canada's CEO and CFO also certify the design of Air Canada's disclosure controls and procedures and the design of internal controls over financial reporting.

Air Canada has evaluated the effectiveness of its disclosure controls and procedures as at December 31, 2007, and based on its evaluation, it has concluded that they are effective. This evaluation took into consideration Air Canada's Corporate Disclosure Policy and the functioning of its Disclosure Policy Committee. In addition, the evaluation covered Air Canada's processes, systems and capabilities relating to regulatory filings, public disclosures and the identification and communication of material information.

Air Canada has designed internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. There has been no changes to the Corporation's internal controls over financial reporting that occurred during the year ended December 31, 2007 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting, except for remediation of the material weakness in the Corporations' internal controls over financial reporting as at December 31, 2006 with respect to accounting for income taxes. The Corporation has added qualified income tax professionals with the appropriate knowledge and experience which addressed the weakness.

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

## 19. NON-GAAP FINANCIAL MEASURES

**EBITDAR**

EBITDAR (earnings before interest, taxes, depreciation, amortization and obsolescence and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before aircraft rent and depreciation, amortization and obsolescence as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets.

EBITDAR is not a recognized measure for financial statement presentation under Canadian GAAP and does not have a standardized meaning and is therefore not likely to be comparable to similar measures presented by other public companies.

EBITDAR and EBITDAR excluding the special charge for Aeroplan miles and the special charge for labour restructuring for Air Canada (previously "Air Canada Services") is reconciled to operating income (loss) as follows:

| ($ millions) | Fourth Quarter 2007 | Fourth Quarter 2006 | $ Change | Year 2007 | Year 2006 | $ Change |
|---|---|---|---|---|---|---|
| **Air Canada** | | | | | | |
| GAAP operating income (loss) | $ 72 | $ (5) | $ 77 | $ 433 | $ 114 | $ 319 |
| Add back: | | | | | | |
| Aircraft rent | 62 | 83 | (21) | 282 | 341 | (59) |
| Depreciation, amortization and obsolescence | 140 | 135 | 5 | 548 | 493 | 55 |
| **EBITDAR** | **$ 274** | **$ 213** | **$ 61** | **$ 1,263** | **$ 948** | **$ 315** |
| Add back: | | | | | | |
| Special charge for Aeroplan Miles | - | - | - | - | 102 | (102) |
| Special charge for labour restructuring | - | (8) | 8 | - | 20 | (20) |
| **EBITDAR excluding special charges** | **$ 274** | **$ 205** | **$ 69** | **$ 1,263** | **$ 1,070** | **$ 193** |

**Operating Income excluding the Special Charge for Aeroplan Miles and the Special Charge for Labour Restructuring**

Air Canada uses operating income excluding the special charge for Aeroplan miles and the special charge for labour restructuring to assess the operating performance of its ongoing business without the effects of these special charges. These items are excluded from Air Canada's results as they could potentially distort the analysis of trends in business performance. The special charge for Aeroplan miles is the full and final settlement between the parties in connection with Air Canada's obligations for the redemption of pre-2002 miles. The special charge for labour restructuring is the total cost of the 20% non-unionized workforce reduction plan announced in February 2006. The special charge for Aeroplan miles and the special charge for labour restructuring are not reflective of the underlying financial performance of Air Canada from ongoing operations.

The following measure is not a recognized measure for financial statement presentation under Canadian GAAP and does not have a standardized meaning and is therefore not likely to be comparable to similar measures presented by other public companies.

Operating income (loss) excluding the special charge for Aeroplan miles and the special charge for labour restructuring for Air Canada (previously "Air Canada Services") is reconciled to operating income (loss) as follows:

| ($ millions) | Fourth Quarter 2007 | Fourth Quarter 2006 | $ Change | Year 2007 | Year 2006 | $ Change |
|---|---|---|---|---|---|---|
| **Air Canada** | | | | | | |
| GAAP operating income (loss) | $ 72 | $ (5) | $ 77 | $ 433 | $ 114 | $ 319 |
| Add back: | | | | | | |
| Special charge for Aeroplan Miles | - | - | - | - | 102 | (102) |
| Special charge for labour restructuring | - | (8) | 8 | - | 20 | (20) |
| **Operating income (loss), excluding special charges** | **$ 72** | **$ (13)** | **$ 85** | **$ 433** | **$ 236** | **$ 197** |

**Operating Expense excluding Fuel Expense and the Special Charge for Labour Restructuring**
Air Canada uses operating expense excluding fuel expense and the special charge for labour restructuring to assess the operating performance of its ongoing business without the effects of fuel expense and the special charge for labour restructuring. These items are excluded from Air Canada's results as they could potentially distort the analysis of trends in business performance. Fuel expense fluctuate widely depending on many factors including international market conditions, geopolitical events and the Canada/US exchange rate and excluding this expense from GAAP results allows Air Canada to compare its operating performance on a consistent basis. The special charge for labour restructuring which relates to a non-unionized workforce reduction plan announced in February 2006 is not reflective of the underlying financial performance of Air Canada from ongoing operations.

The following measure is not a recognized measure for financial statement presentation under Canadian GAAP and does not have a standardized meaning and is therefore not likely to be comparable to similar measures presented by other public companies.

Operating expense, excluding fuel expense and the special charge for labour restructuring for Air Canada (previously "Air Canada Services") is reconciled to operating expense as follows:

| ($ millions) | Fourth Quarter 2007 | Fourth Quarter 2006 | $ Change | Year 2007 | Year 2006 | $ Change |
|---|---|---|---|---|---|---|
| **Air Canada** | | | | | | |
| GAAP operating expense | $ 2,441 | $ 2,428 | $ 13 | $ 10,213 | $ 10,050 | $ 163 |
| Remove: | | | | | | |
| Aircraft fuel | (615) | (583) | (32) | (2,552) | (2,544) | (8) |
| **Operating expense, excluding fuel expense** | **$ 1,826** | **$ 1,845** | **$ (19)** | **$ 7,661** | **$ 7,506** | **$ 155** |
| Remove: | | | | | | |
| Special charge for labour restructuring | - | 8 | - | - | (20) | 20 |
| **Operating expense, excluding fuel expense and the special charge for labour restructuring** | **$ 1,826** | **$ 1,853** | **$ (27)** | **$ 7,661** | **$ 7,486** | **$ 175** |

## 20. GLOSSARY

**Available Seat Miles or ASMs** — A measure of passenger capacity calculated by multiplying the total number of seats available for passengers by the miles flown;

**CASM** — Operating expense per ASM;

**EBITDAR** — EBITDAR is earnings before interest, taxes, depreciation, amortization and obsolescence and aircraft rent and is a non-GAAP financial measure commonly used in the airline industry to view operating results before aircraft rent and depreciation, amortization and obsolescence as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets;

**Passenger Load Factor** — A measure of passenger capacity utilization derived by expressing Revenue Passenger Miles as a percentage of Available Seat Miles;

**Passenger Revenue per Available Seat Mile or RASM** — Average passenger revenue per ASM;

**Revenue Passenger Miles or RPMs** — A measure of passenger traffic calculated by multiplying the total number of revenue passengers carried by the miles they are carried;

**Subsidiary or subsidiaries** — refers to, in relation to Air Canada, to any entity, including a corporation or a limited partnership, which is controlled, directly or indirectly, by Air Canada.

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

## MANAGEMENT'S REPORT

The consolidated financial statements have been prepared by management. Management is responsible for the fair presentation in the consolidated financial statements of financial position, results of operations and cash flows in conformity with generally accepted accounting principles. Management is responsible for the selection of accounting policies and making significant accounting judgements and estimates. Management is also responsible for all other financial information included in the annual report and for ensuring that this information is consistent, where appropriate, with the information contained in the consolidated financial statements.

Management is responsible for establishing and maintaining adequate internal control over financial reporting which includes those policies and procedures that provide reasonable assurance as to the completeness, fairness and accuracy of the consolidated financial statements and other financial information.

The Audit, Finance and Risk Committee reviews the quality and integrity of the Corporation's financial reporting and recommends approval to the Board of Directors; oversees management's responsibilities as to the adequacy of the supporting systems of internal controls; provides oversight of the independence, qualifications and appointment of the external auditor; and, pre-approves audit and audit-related fees and expenses. The Board of Directors approves the Corporation's consolidated financial statements, management's discussion and analysis and annual report disclosures prior to their release. The Audit, Finance and Risk Committee meets with management, the internal auditors and external auditors at least four times each year to review and discuss financial reporting issues and disclosures, auditing and other matters.

The external auditors, PricewaterhouseCoopers LLP, conduct an independent audit of the consolidated financial statements and internal control over financial reporting in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States) and express their opinion thereon. Those standards require that the audit is planned and performed to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. The external auditors have unlimited access to the Audit, Finance and Risk Committee and meet with the Committee on a regular basis.

**Michael Rousseau**
Executive Vice President &
Chief Financial Officer

**Montie Brewer**
President &
Chief Executive Officer

## INDEPENDENT AUDITORS' REPORT

**TO THE SHAREHOLDERS OF AIR CANADA**

We have audited the consolidated statements of financial position of Air Canada as at December 31, 2007 and December 31, 2006 and the consolidated statements of operations, shareholders' equity, comprehensive income and cash flows for the years then ended. These consolidated financial statements are the responsibility of the company's management. Our responsibility is to express and opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the consolidated financial position of the company as at December 31, 2007 and December 31, 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

**Chartered Accountants**
Montreal, Quebec
February 6, 2008

## CONSOLIDATED STATEMENT OF OPERATIONS

| **For the year ended December 31**<br>**(Canadian dollars in millions except per share figures)** | | **2007*** | **2006** |
|---|---|---|---|
| | | | (Note 3) |
| **Operating revenues** | | | |
| Passenger | | $ 9,329 | $ 8,887 |
| Cargo | | 550 | 629 |
| Other | | 720 | 651 |
| | | 10,599 | 10,167 |
| Special charge for Aeroplan Miles | Note 22 | - | (102) |
| | | 10,599 | 10,065 |
| **Operating expenses** | | | |
| Wages, salaries and benefits | | 2,059 | 2,127 |
| Aircraft fuel | | 2,553 | 2,545 |
| Aircraft rent | | 323 | 441 |
| Airport and navigation fees | | 1,021 | 982 |
| Aircraft maintenance, materials and supplies | | 799 | 855 |
| Communications and information technology | | 277 | 278 |
| Food, beverages and supplies | | 319 | 335 |
| Depreciation, amortization and obsolescence | Notes 4, 6 & 15 | 557 | 514 |
| Commissions | | 201 | 237 |
| Capacity purchase with Jazz | Note 19 | 537 | - |
| Special charge for labour restructuring | Note 11 | - | 20 |
| Other | | 1,458 | 1,472 |
| | | 10,104 | 9,806 |
| **Operating income** | | **495** | **259** |
| **Non-operating income (expense)** | | | |
| Interest income | | 94 | 87 |
| Interest expense | | (351) | (321) |
| Interest capitalized | | 108 | 61 |
| Gain (loss) on disposal of assets | Note 4 | 19 | (6) |
| Gain (loss) on financial instruments recorded at fair value | Note 17 | 26 | (18) |
| Other | | (18) | 1 |
| | | (122) | (196) |
| **Income before the following items** | | **373** | **63** |
| Non-controlling interest | | (71) | (152) |
| Foreign exchange gain | | 317 | 12 |
| Recovery of (provision for) income taxes | | | |
| Current | Note 9 | (16) | - |
| Future | Note 9 | (174) | 3 |
| **Income (loss) for the year** | | **$ 429** | **$ (74)** |
| **Earnings (loss) per share** | | | |
| Basic | Note 14 | $ 4.29 | $ (0.83) |
| Diluted | Note 14 | $ 4.27 | $ (0.83) |

* Effective May 24, 2007, the results and financial position of Jazz are not consolidated within Air Canada (Note 1).
The accompanying notes are an integral part of the consolidated financial statements.

## CONSOLIDATED STATEMENT OF FINANCIAL POSITION

| As at December 31 (Canadian dollars in millions) | | 2007* | 2006 |
|---|---|---|---|
| **ASSETS** | | | |
| **Current** | | | |
| Cash and cash equivalents | Note 2P | $ 527 | $ 1,447 |
| Short-term investments | Note 2Q | 712 | 798 |
| | | 1,239 | 2,245 |
| Restricted cash | Note 2R | 124 | 109 |
| Accounts receivable | Note 19 | 750 | 688 |
| Spare parts, materials and supplies | | 112 | 148 |
| Prepaid expenses and other current assets | Note 19 | 253 | 124 |
| Prepaid maintenance to ACTS | Note 3 | - | 535 |
| Future income taxes | Note 9 | - | 345 |
| | | 2,478 | 4,194 |
| Property and equipment | Note 4 | 7,919 | 5,946 |
| Deferred charges | Note 5 | 51 | 103 |
| Intangible assets | Note 6 | 952 | 1,194 |
| Deposits and other assets | Note 7 | 437 | 312 |
| | | **$ 11,837** | **$ 11,749** |
| **LIABILITIES** | | | |
| **Current** | | | |
| Accounts payable and accrued liabilities | Note 19 | $ 1,243 | $ 1,521 |
| Advance ticket sales | | 1,245 | 1,019 |
| Aeroplan miles obligation | Note 22 | 55 | 58 |
| Current portion of long-term debt and capital leases | Note 8 | 413 | 367 |
| Note payable to ACTS | Note 3 | - | 535 |
| Current taxes payable | Note 9 | - | 345 |
| | | 2,956 | 3,845 |
| Long-term debt and capital leases | Note 8 | 4,006 | 3,196 |
| Future income taxes | Note 9 | 88 | 134 |
| Pension and other benefit liabilities | Note 10 | 1,824 | 1,876 |
| Other long-term liabilities | Note 11 | 336 | 472 |
| | | 9,210 | 9,523 |
| Non-controlling interest | | 184 | 374 |
| **SHAREHOLDERS' EQUITY** | | | |
| Share capital | Note 13 | 274 | 274 |
| Contributed surplus | | 1,791 | 1,693 |
| Retained earnings (deficit) | | 322 | (115) |
| Accumulated other comprehensive income | Note 2M | 56 | - |
| | | 2,443 | 1,852 |
| | | **$ 11,837** | **$ 11,749** |

* Effective May 24, 2007, the results and financial position of Jazz are not consolidated within Air Canada (Note 1).
The accompanying notes are an integral part of the consolidated financial statements.Commitments (Note 16); Contingencies, Guarantees and Indemnities (Note 18)

On behalf of the Board of Directors:

*Signed*
**David I. Richardson**
Chairman

*Signed*
**Robert G. Long**
Chair of the Audit, Finance and Risk Committee

## CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

| For the year ended December 31 (Canadian dollars in millions) | | 2007 | 2006 |
|---|---|---|---|
| | | | (Note 3) |
| **Common shares** | | | |
| Beginning of year | | $ 562 | $ - |
| Issue of common shares, net | Note 3 | - | 187 |
| Conversion of Special common shares and Preferred shares into Common shares | Note 3 | - | 375 |
| End of year | | 562 | 562 |
| **Special common shares** | | | |
| Beginning of year | | - | 325 |
| Conversion of Special common shares into Common shares | Note 3 | - | (325) |
| End of year | | - | - |
| Adjustment to shareholders' equity | Note 13 | (288) | (288) |
| **Total share capital** | | 274 | 274 |
| **Contributed surplus** | | | |
| Balance, beginning of year | | 1,693 | 1,037 |
| Fair value of stock options issued to Corporation employees recognized as compensation expense | Note 12 | 15 | 6 |
| Contribution from ACE on transfer of investments | Note 3 | - | 1,156 |
| Allocation of corporate costs | Note 3 | - | 11 |
| Allocation of reduction to intangible assets | Note 9 | - | (340) |
| Utilization of future income tax assets | Note 9 | - | (177) |
| Purchase of Air Canada Vacations and other assets from parent | Notes 1 & 19 | (14) | - |
| Proceeds from Repair Schemes and Non-Compete Agreement with ACTS | Note 20 | 15 | - |
| Deconsolidation of Jazz | Note 1 | 82 | - |
| **Total contributed surplus** | | 1,791 | 1,693 |
| **Retained earnings (deficit)** | | | |
| Balance, beginning of year | | (115) | (41) |
| Cumulative effect of adopting new accounting policies | Note 2M | 8 | - |
| | | (107) | (41) |
| Net income (loss) for the year | | 429 | (74) |
| **Retained earnings** | | 322 | (115) |
| **Accumulated other comprehensive income (loss)** | | | |
| Balance, beginning of year | | - | - |
| Cumulative effect of adopting new accounting policies | Note 2M | (26) | - |
| Other comprehensive income | | 82 | - |
| **Total accumulated other comprehensive income** | | 56 | - |
| **Total retained earnings and accumulated other comprehensive income** | | 378 | (115) |
| **Total shareholders' equity** | | **$ 2,443** | **$ 1,852** |

The accompanying notes are an integral part of the consolidated financial statements.

## CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

| For the year ended December 31 (Canadian dollars in millions) | | 2007* | 2006 |
|---|---|---|---|
| **Comprehensive income (loss)** | | | |
| Net income (loss) for the year | | $ 429 | $ (74) |
| Other comprehensive income, net of taxes: | | | |
| Unrealized period change in fair value of fuel derivatives under hedge accounting (net of taxes of (29)) | Note 17 | 88 | - |
| Reclassification of net realized losses (gains) on fuel derivatives to income (net of taxes of 1) | Note 17 | (6) | - |
| | | 82 | - |
| **Total comprehensive income (loss)** | | **$ 511** | **$ (74)** |

* Effective May 24, 2007, the results and financial position of Jazz are not consolidated within Air Canada (Note 1).
The accompanying notes are an integral part of the consolidated financial statements.

## CONSOLIDATED STATEMENT OF CASH FLOW

| For the year ended December 31<br>(Canadian dollars in millions) | | 2007* | 2006 |
|---|---|---|---|
| | | | (Note 3) |
| **Cash flows from (used for)** | | | |
| **Operating** | | | |
| Net income for the year | | $ 429 | $ (74) |
| Adjustments to reconcile to net cash from operations | | | |
| Depreciation, amortization and obsolescence | | 557 | 514 |
| Loss (gain) on disposal of assets | | (19) | 6 |
| Foreign exchange loss (gain) | | (387) | 6 |
| Future income taxes | | 174 | (3) |
| Excess of employee future benefit funding over expense | | (205) | (228) |
| Decrease in Aeroplan miles obligation | | (79) | (108) |
| Non-controlling interest | | 71 | 152 |
| Special charge for Aeroplan miles | Note 22 | - | 102 |
| Allocation of corporate expenses | Note 3 | - | 11 |
| Aircraft lease payments in excess of rent expense | | (14) | (16) |
| Capitalized interest | | (108) | (61) |
| Changes in non-cash working capital balances | | (6) | 83 |
| Other | | 16 | 9 |
| | | 429 | 393 |
| **Financing** | | | |
| Issue by Air Canada of share capital | Note 3 | - | 187 |
| Issue of Jazz units | Note 21 | - | 218 |
| Transfer of ACTS investment to ACE | Note 3 | - | 673 |
| Transfer of Jazz investment to ACE | Note 3 | - | 483 |
| Promissory note paid by Jazz to ACE | Note 21 | - | (424) |
| Jazz – Credit facility borrowings | Note 8 | - | 113 |
| Aircraft and facility related borrowings | Note 8 | 1,914 | 397 |
| Settlement of notes payable to ACE | Note 3 | - | (140) |
| Distributions paid to non-controlling interest | | (54) | (86) |
| Reduction of long-term debt and capital lease obligations | | (504) | (278) |
| Other | Notes 8 & 20 | (16) | (1) |
| | | 1,340 | 1,142 |
| **Investing** | | | |
| Short-term investments | | 86 | (496) |
| Additions to capital assets | | (2,606) | (888) |
| Reduction of note receivable from ACE | | - | 186 |
| Proceeds from sale of assets | Note 4 | 119 | 40 |
| Deconsolidation of Jazz cash | Note 1 | (138) | - |
| Cash management with related parties | Note 19 | (1) | 32 |
| Funding of ACTS Aero letter of credit | Note 20 | (101) | - |
| Purchase of Air Canada Vacations | Note 1 | (10) | - |
| Other | Note 17 | (38) | 4 |
| | | (2,689) | (1,122) |
| **Increase (decrease) in cash and cash equivalents** | | **(920)** | **413** |
| Cash and cash equivalents, beginning of year | | 1,447 | 1,034 |
| **Cash and cash equivalents, end of year** | | **$ 527** | **$ 1,447** |

* Effective May 24, 2007, the results and financial position of Jazz are not consolidated within Air Canada (Note 1).

*Cash and cash equivalents exclude Short-term investments of $712 as at December 31, 2007 ($798 as at December 31, 2006).*
*The accompanying notes are an integral part of the consolidated financial statements.*

**For the Years Ended December 31, 2007 and 2006 (Currencies in millions – Canadian dollars)**

## 1. BASIS OF PRESENTATION AND NATURE OF OPERATIONS

The accompanying consolidated financial statements are of Air Canada (the "Corporation"), a majority-owned subsidiary of ACE Aviation Holdings Inc. ("ACE"). The term "Corporation" refers to, as the context may require, Air Canada and / or one or more of Air Canada's subsidiaries.

### A) INITIAL PUBLIC OFFERING

In November 2006 Air Canada completed an initial public offering (the "Air Canada IPO") of an aggregate of 9,523,810 variable voting shares and voting shares for gross proceeds of $200 ($187 net of offering costs of $13) and a secondary offering by ACE of an aggregate of 15,476,190 variable voting shares and voting shares for gross proceeds of $325 ($304 net of offering costs of $21). Refer to Note 3 for additional information.

### B) BASIS OF PRESENTATION

These consolidated financial statements include the financial position, results of operations and cash flows of:

- Air Canada, which provides transportation services;
- AC Cargo Limited Partnership ("Air Canada Cargo"), a wholly owned subsidiary of Air Canada, which, along with Air Canada, provides cargo services;
- ACGHS Limited Partnership ("Air Canada Ground Handling Services" or "ACGHS"), a wholly owned subsidiary of Air Canada, which provides ground handling services;
- Touram Limited Partnership ("Air Canada Vacations"), which provides tour operator services and leisure vacation packages. The Corporation purchased from ACE its 49% interest in Air Canada Vacations causing Air Canada Vacations to be wholly owned by the Corporation. Consideration for the interest was $10 and was accounted for within contributed surplus. Refer to Note 19;
- Air Canada Capital Ltd., a wholly owned subsidiary of Air Canada, which owns and leases certain aircraft which are leased or subleased to Air Canada, Jazz and unrelated third parties;
- Simco Leasing Ltd., a wholly owned subsidiary of Air Canada, which owns certain flight equipment which is leased to Air Canada;
- Jazz Air LP ("Jazz") for the period up to May 24, 2007. Jazz provides both domestic and transborder services for Air Canada under a capacity purchase agreement, which is consolidated within Air Canada for the period up to May 24, 2007. (refer below for additional information on the accounting for Jazz); and
- Certain aircraft and engine leasing entities and fuel facility corporations, which are consolidated under Accounting Guideline of the CICA Handbook, Consolidation of Variable Interest Entities ("AcG-15"), as Air Canada has been determined to be the primary beneficiary.

The activities of these operations are described further below in part C) Nature of Operations. These consolidated financial statements also include certain limited partnerships that are holding companies of the limited partnerships and the general partners of the limited partnerships described above; these entities do not carry on any active business.

Prior to the deconsolidation of Jazz, as described below, Air Canada had two business segments: Air Canada Services and Jazz. Subsequent to the deconsolidation of Jazz, Air Canada has one reportable segment. Air Canada Services is now referred to as Air Canada or the Air Canada Segment.

These consolidated financial statements are expressed in millions of Canadian dollars and are prepared in accordance with generally accepted accounting principles ("GAAP") in Canada.

In accordance with the Canadian Institute of Chartered Accountants' Emerging Issue Committee Abstract No. 89, Exchange of Ownership Interests between Enterprises under Common Control – Wholly and Partially-Owned Subsidiaries, the 2006 comparative financial statements of Air Canada combine the assets and liabilities, results of operations and cash flows of Air Canada and all of the affiliates combined with Air Canada as noted above as if they had been combined from September 30, 2004, the date Air Canada and the affiliates emerged from proceedings under the Companies' *Creditors Arrangement Act* (the "CCAA"). The shareholders' equity reflects the shareholders' equity of Air Canada adjusted for the above transactions, as applicable. Refer to Note 3 for additional information.

Accounting for Jazz

Air Canada is party to a capacity purchase agreement with Jazz (the "Jazz CPA") as described in Note 19. Under the Jazz CPA, the Corporation provides a minimum daily utilization guarantee and a minimum capacity guarantee to Jazz, pays certain variable costs of operating Jazz aircraft and is obligated to cover the costs of certain aircraft return obligations related to Jazz aircraft covered under the Jazz CPA. The Corporation does not hold any partnership units of Jazz. Due to the terms of the Jazz CPA, Jazz is deemed to be a variable interest entity. The Corporation was deemed to be the primary beneficiary of Jazz up until May 24, 2007. As a result, the consolidated financial statements of the Corporation include the results of Jazz up until that date, as a business segment of Air Canada.

As a result of ACE's distribution of units of Jazz Air Income Fund on May 24, 2007 ACE's ownership interest in Jazz Air Income Fund was reported to be reduced from 58.8% to 49.0%. This ownership interest was, as reported, further reduced to 20.1% on October 16, 2007 and to 9.5% on January 24, 2008. Jazz Air Income Fund holds all of the outstanding units of Jazz. The May 24, 2007 distribution by ACE gave rise to a reconsideration of who should consolidate Jazz, and as a result, Jazz Air Income Fund was deemed to be the primary beneficiary of Jazz under AcG-15 Consolidation of Variable Interest Entities. As of the May 24, 2007 distribution date, the Corporation therefore no longer consolidates Jazz. Prospective from the date of deconsolidation, the Corporation has one reportable segment.

The Consolidated statement of financial position as at December 31, 2007 does not include the financial position of Jazz. The comparative December 31, 2006 Consolidated statement of financial position included the following items related to Jazz:

- Cash and cash equivalents of $135 and Other current assets of $109;
- Long-lived assets of $239;
- Current liabilities of $213;
- Long-term debt of $115;
- Non-controlling interest of $162; and
- Other long-term liabilities of $71.

As a result of the deconsolidation of Jazz, the Corporation recorded an adjustment of $82 as a credit to contributed surplus. This credit consists of the Corporation's initial negative investment in Jazz of $78, which had not previously reversed as none of the income of Jazz is distributed to Air Canada, and a future income tax credit of $4.

The cash flow impact during 2007 of the Corporation's deconsolidation of Jazz of $138 reflects the Jazz cash being removed from the Consolidated statement of financial position of the Corporation and classified as a cash outflow from investing activities.

Notwithstanding that the Corporation is no longer the primary beneficiary of Jazz effective May 24, 2007, Air Canada continues to hold a significant variable interest in Jazz through the contractual arrangements with Jazz as described in Note 16 (Commitments) and Note 19 (Related Party Transactions).

### C) NATURE OF OPERATIONS

Air Canada is Canada's largest domestic and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-US transborder market as well as the international markets to and from Canada. Certain of the scheduled passenger services offered on domestic and Canada-US transborder routes are provided by Jazz through the Jazz CPA. Through Air Canada's global route network, virtually every major market throughout the world is served either directly or through the Star Alliance network. In addition, Air Canada provides certain charter services.

Air Canada and Air Canada Cargo provide air cargo services on domestic, US transborder and international flights. Air Canada Cargo is a major domestic and US transborder air cargo carrier and uses the entire cargo capacity on aircraft operated by Air Canada and Jazz on domestic and transborder routes. Air Canada offers cargo services on its international flights and currently uses one chartered all freighter aircraft to supplement Canada-Europe services.

Air Canada Ground Handling Services provides passenger handling services to Air Canada, Jazz and other airlines with a primary focus on Canadian stations. Services covered include passenger check-in, gate management, baggage and cargo handling and processing, cabin cleaning, de-icing as well as aircraft ramp services.

Air Canada Vacations is one of Canada's leading tour operators. Based in Montreal and Toronto, Air Canada Vacations is a 100% subsidiary of Air Canada and operates its business in the outgoing leisure travel market (Caribbean, Mexico, Europe, South America and USA) through developing, marketing and distributing vacation travel packages and services through a network of independent travel agencies in Canada as well as Air Canada Vacations website, aircanadavacations.com.

Jazz is the largest regional airline and the second largest airline in Canada, after Air Canada, based on fleet size and number of routes operated. Pursuant to the Jazz CPA, Jazz provides service to Air Canada's customers in lower density markets and in higher density markets at off-peak times throughout Canada and to certain destinations in the United States. Jazz focuses on flight operations and customer service and Air Canada is responsible for scheduling, marketing, pricing and related commercial activities of the regional operations. Under the Jazz CPA, Air Canada records expenses based upon fees relating to flight operations performed, passengers carried and other items covered by the agreement. Prior to May 24, 2007 these inter-company transactions were eliminated in these consolidated financial statements. The segment previously referred to as the "Air Canada Services" segment recorded the revenue on flights operated under the Jazz CPA in Passenger revenue. However, since all distributions from Jazz are made to Jazz Air Income Fund, all income from Jazz was allocated to the non-controlling interest in the Consolidated statement of operations. Distributions for the period ended May 24, 2007 of $54 are reflected as a reduction of the non-controlling interest on the balance sheet. As noted above under B), effective May 24, 2007, the results and financial position of Jazz are no longer consolidated within Air Canada.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### A) BASIS OF VALUATION

In accordance with Section 1625 of the CICA Handbook, Comprehensive Revaluation of Assets and Liabilities ("CICA 1625"), Air Canada adopted fresh start reporting on September 30, 2004. As a result of the financial reorganization under CCAA, the assets and liabilities of the consolidated entity, excluding goodwill, were comprehensively revalued to fair values and a revaluation adjustment of $4,234 was recorded as a credit to share capital.

As described in Note 3, for the periods prior to the initial public offering of shares of the Corporation, which closed on November 24, 2006 (the "Air Canada IPO"), the financial statements of the Corporation are combined to include the financial position, results of operations and cash flows of a number of entities that subsequently became subsidiaries of the Corporation in conjunction with the Air Canada IPO.

### B) PRINCIPLES OF CONSOLIDATION

These consolidated financial statements include the accounts of the operations described in Note 1B above, with adjustments for non-controlling interests. The consolidated financial statements of the Corporation include the accounts of variable interest entities for which the Corporation is the primary beneficiary. All inter-company balances and transactions are eliminated.

### C) USE OF ESTIMATES

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

### D) PASSENGER AND CARGO REVENUES

Airline passenger and cargo advance sales are deferred and included in current liabilities. Advance sales also include the proceeds from the sale of flight tickets to Aeroplan, a related party that provides loyalty program services to Air Canada and purchases seats from Air Canada under the Commercial Participation and Services Agreement ("CPSA" — refer to Note 2F). Passenger and cargo revenues are recognized when the transportation is provided, except for revenue on unlimited flight passes which is recognized on a straight-line basis over the period during which the travel pass is valid. The Corporation has formed alliances with other airlines encompassing loyalty program participation, code sharing and coordination of services including reservations, baggage handling and flight schedules. Revenues are allocated based upon formulas specified in the agreements and are recognized as transportation is provided.

The Corporation performs regular evaluations on the deferred revenue liability which may result in adjustments being recognized as revenue. Due to the complex pricing structures; the complex nature of interline and other commercial agreements used throughout the industry; historical experience over a period of many years; and other factors including refunds, exchanges and unused tickets, certain relatively small amounts are recognized as revenue based on estimates. Events and circumstances may result in actual results that are different from estimates; however these differences have historically not been material.

### E) CAPACITY PURCHASE AGREEMENTS – JAZZ & TIER III CARRIERS

Air Canada has capacity purchase agreements with certain unaffiliated regional carriers, which are referred to as Tier III carriers, operating aircraft of 18 seats or less. Air Canada also has a capacity purchase agreement with Jazz, a related party to the Corporation (refer to Note 19 for additional information). Under these agreements, Air Canada is responsible for the marketing, ticketing and commercial arrangements relating to these flights and records the revenue it earns under passenger revenue. Operating expenses under capacity purchase agreements include the capacity purchase fees and pass-through costs, which are non-marked-up costs charged to the Corporation, which include fuel, airport and user fees and other; these expenses are recorded in the applicable category within the operating expenses.

For the year ended December 31, 2007, passenger revenues under capacity purchase agreements with Tier III carriers amounted to $71 ($68 - 2006). Refer to Note 19 for related party transaction amounts with Jazz.

**F) AEROPLAN LOYALTY PROGRAM**

Air Canada is an Aeroplan partner providing certain of Air Canada's customers with Aeroplan Miles, which can be redeemed by customers for air travel or other rewards acquired by Aeroplan.

Under the Commercial Participation and Services Agreement ("CPSA") between the Corporation and Aeroplan, Aeroplan purchases passenger tickets from Air Canada to meet its obligation for the redemption of Aeroplan Miles for air travel. The proceeds from the sale of passenger tickets to Aeroplan are included in Advance ticket sales. Revenue related to these passenger tickets is recorded in passenger revenues when transportation is provided.

For Aeroplan Miles earned by Air Canada customers, Air Canada purchases Miles from Aeroplan in accordance with the terms of the CPSA. The cost of purchasing Aeroplan Miles from Aeroplan is accounted for as a sales incentive and charged against passenger revenues when the points are issued, which is upon the qualifying air travel being provided to the customer.

Under the CPSA, for a specified number of Aeroplan Miles issued prior to January 1, 2002, the Corporation is responsible for providing air travel rewards at no charge to Aeroplan. Upon implementation of the Corporation's plan of arrangement under the Companies' *Creditors Arrangement Act* (the "Plan"), this obligation was recorded at the estimated fair value of air travel rewards expected to be issued to the Aeroplan members and was adjusted in 2006 (Note 22). On redemption of these Aeroplan Miles, a proportion of the liability is transferred to Advance ticket sales with revenue recorded in passenger revenues when the transportation is provided.

**G) OTHER REVENUES**

Other revenue includes revenues from the sale of the ground portion of vacation packages, ground handling services and other airline related services. Vacation package revenue is recognized as services are provided over the period of the vacation. Other airline related service revenues are recognized as the products are sold to passengers or the services are provided.

Other revenue also includes revenue related to the lease or sublease of aircraft to third parties. Lease or sublease revenues are recognized on a straight line basis over the term of the lease or sublease.

The Corporation provides certain services to related parties consisting principally of administrative services in relation to information technology, human resources, finance and accounting, treasury and tax services, corporate real estate, environmental affairs and legal services. Administrative service revenues are recognized as services are provided. Real estate rental revenues are recognized on a straight line basis over the term of the lease.

**H) EMPLOYEE FUTURE BENEFITS**

The cost of pensions, other post-retirement and post-employment benefits earned by employees is actuarially determined using the projected benefit method prorated on service, market interest rates, and management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees and expected health care costs.

A market-related valuation method is used to value plan assets for the purpose of calculating the expected return on plan assets. Under the selected method, the differences between investment returns during a given year and the expected investment returns are amortized on a straight line basis over 4 years.

Past service costs arising from plan amendments are amortized on a straight-line basis over the average remaining service period of employees active at the date of amendment. This period does not exceed the average remaining service period of such employees up to the full eligibility date. The average remaining service life of active employees (or average remaining life expectancy of former members for plan with no active members) is between 7 and 16 years for pension plans and between 10 and 11 years for post retirement and post employment benefit plans.

Cumulative unrecognized net actuarial gains and losses in excess of 10% of the greater of the projected benefit obligation or market-related value of plan assets at the beginning of the year are amortized over the remaining service life of active employees.

As described in Note 10, some of the Corporation's employees perform work for ACE, and others are contractually assigned to ACTS Aero Technical Support & Services Inc. ("ACTS Aero") or Aeroplan Limited Partnership ("Aeroplan"). These employees are members of the Corporation's sponsored defined benefit pension plans and also participate in the Corporation's sponsored health, life and disability future benefit plans. These consolidated financial statements include all of the assets and liabilities of all sponsored plans of the Corporation. Pension expenses are recorded net of costs recovered from related parties pertaining to employees assigned by the Corporation to the related parties based on an agreed upon formula. The cost recovery reduces the Corporation's benefit cost with an offset to related party receivables.

**I) EMPLOYEE PROFIT SHARING PLAN**

The Corporation has an employee profit sharing plan. Payments are calculated annually on full calendar year results and recorded throughout the year as a charge to salary and wage expense based on the estimated annual payment under the plan.

**J) STOCK-BASED COMPENSATION PLANS**

Certain employees of the Corporation, for the relevant periods, participate in ACE, Air Canada and/or Jazz stock based compensation plans, as described in Note 12.

The fair value of stock options or units granted to Corporation employees is recognized as compensation expense and a credit to contributed surplus on a straight line basis over the applicable vesting period. For a stock option or unit award attributable to an employee who is eligible to retire at the grant date, the fair value of the stock option or unit award is expensed on the grant date. For a stock option or unit award attributable to an employee who will become eligible to retire during the vesting period, the fair value of the stock option or unit award is recognized over the period from the grant date to the date the employee becomes eligible to retire. The amount of compensation cost recognized at any date at least equals the value of the vested portion of the options at that date. Refer to Note 12 for a discussion of the accelerated vesting of ACE options.

ACE, Air Canada, and Jazz also maintain employee share and unit purchase plans for shares and units. Under these plans, contributions by the Corporation's employees are matched to a specific percentage by the Corporation. These contributions are included in salaries, wages and benefits expense. Upon the closing of the Air Canada IPO described in Note 3, Air Canada employees are limited to participating in the Air Canada plan and not the ACE plan.

**K) MAINTENANCE AND REPAIRS**

Maintenance and repair costs for both leased and owned aircraft, including line maintenance, component overhaul and repair, and maintenance checks, are charged to operating expenses as incurred, with the exception of maintenance and repair costs related to return conditions on short-term aircraft leases, which are accrued over the term of the lease. Line maintenance consists of routine daily and weekly scheduled maintenance inspections and checks, overhaul and repair involves the inspection or replacements of major parts, and maintenance checks consist of more complex inspections and servicing of the aircraft.

**L) OTHER OPERATING EXPENSES**

Included in other operating expenses are expenses related to building rent and maintenance, terminal handling, professional fees and services, crew meals and hotels, advertising and promotion, insurance costs, credit card fees, ground costs for Air Canada Vacations packages, and other expenses. Expenses are recognized as incurred.

**M) FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING**

Under the Corporation's risk management policy derivative financial instruments are used only for risk management purposes and not for generating trading profits.

On January 1, 2007, the Corporation adopted CICA accounting handbook section 3855, ***Financial Instruments – Recognition and Measurement***, section 3861, ***Financial Instruments – Disclosure and Presentation,*** section 3865, ***Hedges***, section 1530, ***Comprehensive Income***, and section 3251, ***Equity***.

Financial assets and financial liabilities, including derivatives, are recognized on the consolidated statement of financial position when the Corporation becomes a party to the contractual provisions of the financial instrument or non-financial derivative contract. All financial instruments are required to be measured at fair value on initial recognition except for certain related party transactions. Measurement in subsequent periods is dependent upon the classification of the financial instrument as held-for-trading, held-to-maturity, available-for-sale, loans and receivables, or other financial liabilities. The held-for-trading classification is applied when an entity is "trading" in an instrument or alternatively the standard permits that any financial instrument be irrevocably designated as held-for-trading. The held-to-maturity classification is applied only if the asset has specified characteristics and the entity has the ability and intent to hold the asset until maturity. For financial instruments classified as other than held-for-trading, transaction costs are added to the initial fair value of the related financial instrument. Transaction costs related to the revolving line of credit which are not drawn are deferred and amortized straight line over the term of the credit facility.

Financial assets and financial liabilities classified as held-for-trading are measured at fair value with changes in those fair values recognized in non-operating income (expense). Financial assets classified as held-to-maturity, loans and receivables, or other financial liabilities are measured at amortized cost using the effective interest method of amortization. Financial assets classified as available-for-sale are measured at fair value with unrealized gains and losses, including changes in foreign exchange rates, being recognized in Other Comprehensive Income ("OCI"), as described below.

Derivative instruments are recorded on the consolidated statement of financial position at fair value, including those derivatives that are embedded in financial or non-financial contracts. Changes in the fair values of derivative instruments are recognized in non-operating income (expense) with the exception of foreign exchange risk management contracts and derivatives designated as effective cash flow hedges, as further described below.

For financial instruments measured at amortized cost, transaction costs or fees, premiums or discounts earned or incurred are recorded, at inception, net against the fair value of the financial instrument. Interest expense is recorded using the effective interest method. For any guarantee issued that meets the definition of a guarantee pursuant to Accounting Guideline 14, ***Disclosure of Guarantees***, the inception fair value of the obligation relating to the guarantee is recognized and amortized over the term of the guarantee. It is the Corporation's policy to not re-measure the fair value of the financial guarantee unless it qualifies as a derivative.

The Corporation has implemented the following classifications:

- Cash and cash equivalents are classified as held-for-trading and any period change in fair value is recorded through net income.
- Aircraft related deposits are classified as held-to-maturity investments and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.
- Accounts receivable are classified as loans and receivables and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.
- Accounts payable, credit facilities, and bank loans are classified as other financial liabilities and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.

Changes in the fair value of foreign currency forward contracts, option agreements and currency swap agreements used for foreign exchange risk management but not designated as hedges for accounting purposes, are recorded in foreign exchange gain (loss). These contracts are included in the consolidated statement of financial position at fair value in Prepaid expenses and other current assets, Deposits and other assets, Accounts payable and accrued liabilities, or Other long-term liabilities as appropriate.

The Corporation from time to time enters into interest rate swaps to manage the risks associated with interest rate movement on US and Canadian floating rate debt, including anticipated debt transactions. Changes in the fair value of these swap agreements, which are not designated as hedges for accounting purposes, are recognized in income in Other non-operating income. These contracts are included in the consolidated statement of financial position at fair value in Prepaid expenses and other current assets, Deposits and other assets, Accounts payable and accrued liabilities, or Other long-term liabilities as appropriate.

Fuel Derivatives Under Hedge Accounting

The Corporation has designated certain of its fuel derivatives as cash flow hedges. In a cash flow hedging relationship, the effective portion of the change in the fair value of the hedging derivative is recognized in OCI while the ineffective portion is recognized in non-operating income (expense). Upon maturity of the fuel derivatives, the effective gains and losses previously recognized in Accumulated OCI ("AOCI") are recorded in fuel expense. The derivatives are recorded on the consolidated statement of financial position in Prepaid expenses and other current assets, Deposits and other assets, Accounts payable and accrued liabilities, or Other long-term liabilities as appropriate.

Hedge accounting is discontinued prospectively when the derivative no longer qualifies as an effective hedge, or the derivative is terminated or sold, or upon the sale or early termination of the hedged item. The amounts previously recognized in AOCI are reclassified to fuel expense during the periods when the derivative matures. If the derivative is sold prior to its maturity, the amounts previously recognized in AOCI are reclassified to non-operating income (expense). The Corporation does not have a practice of selling fuel derivatives prior to maturity. Refer to Note 17.

Comprehensive Income

OCI represents changes in Shareholders' equity during a period arising from transactions and other events with non-owner sources that are recognized in Comprehensive income, but excluded from net income. Period changes in the fair value of the effective portion of cash flow hedging instruments are recorded in OCI. Commencing in the first quarter of 2007 interim consolidated financial statements include the consolidated statement of comprehensive income; items affecting OCI are recorded prospectively commencing from January 1, 2007, including the transition adjustments. Cumulative changes in OCI are included in AOCI, which is presented as a new category within Shareholders' equity on the consolidated statement of financial position. OCI and AOCI are presented net of tax.

**Impact Upon Adoption of CICA accounting handbook sections 3855, 3861, 3865, 1530, and 3251**

In accordance with the transitional provisions of the standards, prior periods have not been restated for the adoption of CICA Sections 3855, ***Financial Instruments – Recognition and Measurement***, 3861, ***Financial Instruments – Disclosure and Presentation,*** section 3865 – ***Hedges,*** section 1530, ***Comprehensive Income,*** and 3251 – ***Equity***.

The transition adjustments attributable to the re-measurement of financial assets and financial liabilities at fair value, other than financial assets classified as available-for-sale and hedging instruments designated as cash flow hedges, were recognized in the opening Deficit of the Corporation as at January 1, 2007.

For the Corporation's fuel-hedging relationship classified as a cash flow hedge, which qualifies for hedge accounting under the new standard, the effective portion of any gain or loss on the hedging instruments was recognized in AOCI and the cumulative ineffective portion was included in the opening Deficit of the Corporation as at January 1, 2007.

Upon adoption the Corporation recorded the following adjustments to the Consolidated statement of financial position:

| | Increase (decrease) |
|---|---|
| Deferred charges | $ (14) |
| Future income taxes ($6, net of valuation allowance $6) | - |
| Accounts payable and accrued liabilities | 18 |
| Long-term debt and capital leases | (14) |
| Deficit, net of nil tax | (8) |
| Accumulated other comprehensive income (loss), net of nil tax | (26) |

**N) FOREIGN CURRENCY TRANSLATION**

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at rates of exchange in effect at the date of the consolidated statement of financial position. Non-monetary assets, non-monetary liabilities, revenues and expenses arising from transactions denominated in foreign currencies, are translated at rates of exchange in effect, which are based on averages for the month. Adjustments to the Canadian dollar equivalent of foreign denominated monetary assets and liabilities due to the impact of exchange rate changes are classified on the consolidated statement of operations as a foreign exchange gain or loss.

**O) INCOME TAXES**

The Corporation utilizes the liability method of accounting for income taxes under which future income tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amount and the tax basis of assets and liabilities. Future income tax assets and liabilities are measured using substantively enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in earnings in the period when the change is substantively enacted. Future income tax assets are recognized to the extent that realization is considered more likely than not. The benefit of future income tax assets that existed at fresh start, and for which a valuation allowance is recorded, will be recognized first to reduce to nil any remaining intangible assets (on a pro-rata basis) that were recorded upon fresh start reporting with any remaining amount as a credit to shareholders' equity. The benefit of future income tax assets that arise after fresh start will be recognized in the income statement.

As the income of excluded inter-company investments held by Air Canada (Note 3) has been excluded from these consolidated financial statements, the future income tax expense resulting from the utilization of the losses accumulated prior to the date of the Air Canada IPO has been allocated to Shareholders' Equity.

**P) CASH AND CASH EQUIVALENTS**

Cash includes $411 pertaining to investments with original maturities of three months or less at December 31, 2007 (2006 - $1,330). Investments include bankers' acceptances, bankers discount notes, and commercial paper, which may be liquidated promptly and have original maturities of three months or less. The weighted average interest rate on investments as at December 31, 2007 is 4.68 % (2006 - 4.31%). Refer to Note 7 for a discussion of non-bank sponsored Asset-Backed Commercial Paper ("ABCP") reclassified to Deposits and other assets as it is not expected that these amounts are collectible within one year.

**Q) SHORT-TERM INVESTMENTS**

Short-term investments, comprised of bankers' acceptances and bankers' discount notes, have original maturities over three months, but not more than one year. The weighted average interest rate on short-term investments as at December 31, 2007 is 4.61% (2006 - 4.38%).

**R) RESTRICTED CASH**

The Corporation has recorded $124 (2006 - $109) in restricted cash, under current assets, representing funds held in trust by Air Canada Vacations in accordance with regulatory requirements governing advance ticket sales, recorded under current liabilities, for certain travel related activities.

Restricted cash with maturities greater than one year from the balance sheet date is recorded in Deposits and other assets.

**S) SPARE PARTS, MATERIALS AND SUPPLIES**

Spare parts, materials and supplies includes repairable and expendable spare parts and fuel inventories and are valued at the lower of average cost and net realizable value.

**T) PROPERTY AND EQUIPMENT**

Property and equipment is initially recorded at cost. Property under capital leases and the related obligation for future lease payments are initially recorded at an amount equal to the lesser of fair value of the property or equipment and the present value of those lease payments.

Property and equipment are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Property and equipment under capital leases and variable interest entities are depreciated to estimated residual values over the life of the lease. Aircraft and flight equipment, including spare engines and related parts ("rotables") are depreciated over 20 to 25 years, with 10% to 20% estimated residual values. Aircraft reconfiguration costs are amortized over 3-5 years. Betterments to owned aircraft are capitalized and amortized over the remaining service life of the aircraft. Betterments to aircraft on operating leases are amortized over the term of the lease.

Buildings are depreciated over their useful lives not exceeding 40 to 50 years on a straight line basis. An exception to this is where the useful life of the building is greater than the term of the land lease. In these circumstances, the building is depreciated over the life of the lease. Leasehold improvements are amortized over the lesser of the lease term or 5 years. Ground and other equipment is depreciated over 3 to 25 years.

**U) INTEREST CAPITALIZED**

Interest on funds used to finance the acquisition of new flight equipment and other property and equipment is capitalized for periods preceding the dates that the assets are available for service. Capitalized interest related to the acquisition of new flight equipment and other property and equipment is included in purchase deposits within Property and equipment (refer to Note 4). Capitalized interest also includes financing costs charged by the manufacturer on capital commitments as described in Note 16.

**V) INTANGIBLE ASSETS**

As a result of the application of fresh start reporting, intangible assets were recorded at their estimated fair values at September 30, 2004. For periods subsequent to September 30, 2004, intangible assets are initially recorded at cost. Indefinite life assets are not amortized while assets with finite lives are amortized on a straight line basis to nil over their estimated useful lives.

| | Estimated Useful Life |
|---|---|
| International route rights and slots | Indefinite |
| Air Canada trade name | Indefinite |
| Other marketing based trade names | Indefinite |
| Star Alliance membership | 25 years |
| Other contract and customer based intangible assets | 10 to 15 years |
| Technology based intangible assets | 1 to 5 years |

**W) IMPAIRMENT OF LONG-LIVED ASSETS**

Long-lived assets are tested for impairment whenever circumstances indicate that the carrying value may not be recoverable. When events or circumstances indicate that the carrying amount of long-lived assets, other than indefinite life intangibles, are not recoverable, the long-lived assets are tested for impairment by comparing the estimate of future expected cash flows to the carrying amount of the assets or groups of assets. If the carrying value is not recoverable from future expected cash flows, any loss is measured as the amount by which the asset's carrying value exceeds fair value and recorded in the period. Recoverability is assessed relative to undiscounted cash flows from the direct use and disposition of the asset or group of assets.

Indefinite life intangible assets are subjected to impairment tests on an annual basis or when events or circumstances indicate a potential impairment. If the carrying value of such assets exceeds the fair values, the assets are written down to fair value.

**X) AIRCRAFT LEASE PAYMENTS IN EXCESS OF OR LESS THAN RENT EXPENSE**

Total aircraft operating lease rentals over the lease term are amortized to operating expense on a straight-line basis. Included in deferred charges and long-term liabilities is the difference between the straight line aircraft rent expense and the payments as stipulated under the lease agreement.

**Y) ASSET RETIREMENT OBLIGATIONS**

The Corporation records an asset and related liability for the costs associated with the retirement of long-lived tangible assets when a legal liability to retire such assets exists. The fair value of a liability for an asset retirement obligation is recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and then amortized over its estimated useful life. In subsequent periods, the asset retirement obligation is adjusted for the passage of time through charges to income and any changes in the amount of the underlying cash flows through increases or decreases to the asset retirement obligation and related asset. A gain or loss may be incurred upon settlement of the liability.

**Z) RELATED PARTY TRANSACTIONS**

Related party transactions not in the normal course of operations are measured at the exchange amount when the change in ownership interest in the item transferred is substantive and the exchange amount is supported by independent evidence; otherwise it is recorded at the carrying amount. Related party transactions in the normal course of operations are measured at the exchange amount.

**AA) VARIABLE INTEREST ENTITIES**

Aircraft and Engine Leasing Transactions

The Corporation has aircraft and engine leasing transactions with a number of special purpose entities that are variable interest entities (a "VIE") under Accounting Guideline 15 of the CICA Handbook, Variable Interest Entities ("AcG-15"). As a result of the Corporation being the primary beneficiary of these VIEs, the Corporation consolidates leasing entities covering 44 aircraft and 22 engines.

Fuel Facilities Arrangements

The Corporation participates in fuel facilities arrangements operated through fuel facility corporations (the "Fuel Facility Corporations"), along with other airlines to contract for fuel services at various major Canadian airports. The Fuel Facility Corporations are organizations incorporated under federal or provincial business corporations acts in order to acquire, finance and lease assets used in connection with the fuelling of aircraft and ground support equipment. The Fuel Facilities Corporations operate on a cost recovery basis.

Under AcG-15, the Corporation is the primary beneficiary of three of the Fuel Facilities Corporations in Canada. Five of the Fuel Facility Corporations in which Air Canada participates in Canada that have not been consolidated have assets of approximately $141 and debt of approximately $119, which is the Corporation's maximum exposure to loss without taking into consideration any cost sharing and asset retirement obligations that would occur amongst the other contracting airlines. The Corporation considers this loss potential as remote.

**BB) FUTURE ACCOUNTING STANDARD CHANGES**

The following is an overview of accounting standard changes that the Corporation will be required to adopt in future years:

Capital Disclosures and Financial Instruments – Presentation and Disclosure

The CICA issued three new accounting standards: section 1535, ***Capital Disclosures***, section 3862, ***Financial Instruments – Disclosures***, and section 3863, ***Financial Instruments – Presentation***. These new standards will be effective for fiscal years beginning on or after October 1, 2007 and the Corporation will adopt them on January 1, 2008. The Corporation is in the process of evaluating the disclosure and presentation requirements of the new standards.

Section 1535 establishes disclosure requirements about an entity's capital and how it is managed. The purpose will be to enable users of the financial statements to evaluate the entity's objectives, policies and processes for managing capital.

Sections 3862 and 3863 will replace section 3861, ***Financial Instruments – Disclosure and Presentation***, revising and enhancing its disclosure requirements, and carrying forward unchanged its presentation requirements. These new sections will place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks.

Inventories

The CICA issued section 3031, ***Inventories***, which will replace section 3030, ***Inventories***. This new standard is effective for fiscal years beginning on or after July 1, 2007, and the Corporation will adopt this section on January 1, 2008. Section 3031 provides more extensive guidance on measurement, and expands disclosure requirements to increase transparency. The Corporation's accounting policy for inventories is consistent with measurement requirements in the new standard and therefore it is not anticipated that the results of the Corporation will be impacted; however, additional disclosures will be required in relation to inventories carried at net realizable value, the amount of inventories recognized as an expense, and the amount of any write downs of inventories.

**CC) COMPARATIVES**

Certain comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year.

## 3. INITIAL PUBLIC OFFERING

The Air Canada IPO consisted of an offering by Air Canada of an aggregate of 9,523,810 variable voting shares and voting shares for gross proceeds of $200 ($187 net of offering costs of $13) and a secondary offering by ACE of an aggregate of 15,476,190 variable voting shares and voting shares for gross proceeds to ACE of $325 ($304 net of offering costs of $21). The offering costs incurred were allocated between ACE and Air Canada on a pro rata basis in relation to size of the aggregate offering. Air Canada did not receive any proceeds from the secondary offering from ACE.

Other transactions in conjunction with the Air Canada IPO, which closed on November 24, 2006, are as follows:

- Prior to the Air Canada IPO and in connection with internal planning by the ACE group of entities, Air Canada prepaid an amount of approximately $595 to ACTS, for the estimated equivalent of 12 months of service to be rendered by ACTS starting on November 1, 2006.

  The amount of such prepayment was immediately loaned back by ACTS to Air Canada through a non-interest bearing loan. The loan was repayable in instalments equal to the amount that would otherwise be payable by Air Canada to ACTS for services to be rendered, starting on November 1, 2006. This is considered to be a non-cash transaction in substance and has been excluded from the Consolidated statement of cash flows. This amount was repaid by the Corporation during the year ended December 31, 2007.
- ACE transferred to Air Canada all of its interests in Air Canada Ground Handling, all of its interests in Air Canada Cargo and 51% of its interests in Air Canada Vacations in consideration for the issuance to ACE of additional common shares of Air Canada. In addition, ACE exchanged all the preferred shares it held in Air Canada for common shares of Air Canada at an exchange ratio equal to the price of shares sold in the Air Canada IPO resulting in the issuance of additional common shares. No effect is given to this transaction in the 2006 comparative consolidated financial statements as the preferred shares would be classified as equity. Following these transactions, ACE held 90,476,190 common shares in the restructured Air Canada immediately prior to the offering.
- For consideration of $673, special investments in ACTS were transferred to ACE from Air Canada and were recorded in Contributed surplus (refer to Excluded Inter-company Investments section below).
- Inter-company accounts between ACE and Air Canada were settled that resulted in an increase to Cash and cash equivalents of $170, a reduction to Deposits and other assets of $269 (consisting of an advance of $186 and a note receivable on the transfer of the Jazz investment of $83), a reduction to Accounts receivable of $41 and a reduction of Long-term debt of $140.

Allocation of Corporate Expenses

For the period prior to November 24, 2006, the consolidated financial statements include an allocation of the general corporate expenses incurred by ACE based upon the proportion of the Corporation's consolidated revenues compared to ACE's consolidated revenues. The allocation of general corporate expenses to the Corporation includes its proportionate share of such general corporate expenses incurred by ACE, including executive management, legal, investor relations, treasury, finance, financial reporting, tax, internal audit and human resources services as well as costs of governance, professional fees and regulatory filings, all of which amounted to $11 for the year ended December 31, 2006. This allocation of corporate expenses was recorded within what was then referred to as the "Air Canada Services" segment and as a credit to Contributed surplus. The allocation of general corporate expenses ceased on November 24, 2006.

For the period prior to November 24, 2006, the consolidated financial statements do not include an allocation of additional interest expense on corporate debt issued by ACE which had a weighted average effective interest rate of 12% for the period ended November 24, 2006. In conjunction with the Air Canada IPO, as described above, the Corporation settled the outstanding loans due to ACE and its affiliates of $140. The weighted average effective interest rates on these inter-company loans amounted to 9.36% for the period ended November 24, 2006. Management of the Corporation believes that the inter-company debt and the rates thereon were appropriate in the circumstances.

Excluded Inter-company Investments

Prior to the Air Canada IPO, Air Canada held, for tax planning purposes, certain investments in limited partnerships of which ACE owned directly or indirectly all of the limited partner units. These investments and related income and income tax effects have been excluded from these consolidated statements of financial positions and operations of the Corporation, as these activities did not relate to the operations of the Corporation. These investments were transferred to ACE during 2005 and 2006 in exchange for cash and a note receivable. For purposes of these consolidated financial statements, these exchanges of the investments for cash and a note receivable were recorded as related party transactions resulting in a contribution of cash and notes receivable to the Corporation. These contributions of cash have been reflected as financing activities in the Consolidated statement of cash flows. During 2006 the Corporation received cash from ACE of $673 for the investments in ACTS and $483 for the investments in Jazz.

During 2006, Jazz settled a Note payable outstanding to a subsidiary of ACE of $200 in connection with the initial public offering of Jazz Air Income Fund (Note 21).

Income Taxes

As part of a tax loss utilization strategy that was planned in conjunction with the Air Canada IPO and corporate restructuring, a current tax payable of $345 was created in 2006. This tax payable arose upon a transaction to transfer tax assets from the Corporation to ACE. This tax payable was recoverable from future income tax assets of the Corporation and was settled during the first quarter of 2007. The Corporation recorded interest expense of $6, which was due on the tax balance prior to its recovery in current income taxes on the Consolidated statement of operations.

## 4. PROPERTY AND EQUIPMENT

| | | 2007 | | 2006 |
|---|---|---|---|---|
| **Cost** | | | | |
| Flight equipment, including spare engines (a) | $ | 5,433 | $ | 3,666 |
| Assets under capital leases (b) | | 1,899 | | 1,813 |
| Buildings, including leasehold improvements | | 603 | | 662 |
| Ground and other equipment | | 136 | | 122 |
| | | 8,071 | | 6,263 |
| **Accumulated depreciation and amortization** | | | | |
| Flight equipment, including spare engines (a) | | 685 | | 476 |
| Assets under capital leases (b) | | 438 | | 285 |
| Buildings, including leasehold improvements | | 118 | | 95 |
| Ground and other equipment | | 35 | | 24 |
| | | 1,276 | | 880 |
| | | **6,795** | | **5,383** |
| Purchase deposits, including capitalized interest (c) | | 1,124 | | 563 |
| **Property and equipment at net book value (d)** | **$** | **7,919** | **$** | **5,946** |

(a) Included in flight equipment as at December 31, 2007 are rotable parts, including spare engines with a cost of $560 (2006 - $450) less accumulated depreciation of $121 (2006 - $70) for a net book value of $439 (2006 - $380). Also included in flight equipment are 33 aircraft which are leased to Jazz (Note 16) and third parties with a cost of $753 (2006 - $763) less accumulated depreciation of $152 (2006 - $100) for a net book value of $601 (2006 - $663).

(b) Included in capital leases as at December 31, 2007 are 39 aircraft (2006 - 37) with a cost of $1,825 (2006 - $1,739) less accumulated depreciation of $409 (2006 - $265) for a net book value of $1,416 (2006 - $1,474), computer equipment with a cost of $28 (2006 - $28) less accumulated depreciation of $23 (2006 - $16) for a net book value of $5 (2006 - $12) and facilities with a cost of $46 (2006 - $46) less accumulated depreciation $6 (2006 - $4) for a net book value of $40 (2006 - $42).

(c) Includes $867 (2006 - $287) for Boeing B777/787 aircraft, $26 (2006 - $66) for Empresa Brasileira de Aeronautica S.A. ("Embraer") aircraft, $205 (2006 - $175) for the aircraft interior refurbishment program and $26 (2006 - $35) for equipment purchases and internal projects. Refer to Note 8(c) relating to the financing of Boeing predelivery payments.

(d) Net book value of Property and equipment includes $973 (2006 - $1,137) consolidated for aircraft and engine leasing entities, $123 (2006 - $111) consolidated for fuel facility corporations, and nil (2006 - $199) consolidated for Jazz; all of which are consolidated under AcG-15 (Jazz ceased to be consolidated effective May 24, 2007 as described in Note 1).

As at December 31, 2007, flight equipment included 12 aircraft (2006 - 28), that are retired from active service with a net carrying value of $5 (2006 - $5), which approximates fair value.

Interest capitalized during 2007 amounted to $108 (2006 - $61) with $63 at an interest rate of 3 month US LIBOR plus 3.0%, $5 at an interest rate of 30 day LIBOR plus 1.14%, and $40 at an interest rate of 8.34%.

During 2007:

- The Corporation sold an in-service aircraft for proceeds of $23 with a book value of $21, resulting in a gain on sale of $2 (loss of $2 net of tax).
- The Corporation sold a building to ACTS Aero for proceeds of $28 which was equal to the carrying value of the asset (refer to Note 20).
- A CRJ-100 aircraft owned by Air Canada and leased to Jazz was damaged beyond repair. As a result of insurance proceeds of $21, Air Canada recorded a gain on disposal of $14 ($10 net of tax).
- The Corporation sold one of its commercial real estate properties for net proceeds of $42 with a carrying value of $37, resulting in a gain on sale of $5 ($4 net of tax).
- The Corporation sold 18 parked aircraft for proceeds of $2 with a nil book value, resulting in a gain on sale of $2 ($1 net of tax).

During 2006:

- The Corporation sold one of its buildings with a carrying value of $35, for proceeds of $40 resulting in a gain on sale of $5.
- The Corporation recorded an impairment loss of $7 on one of its buildings being held for sale, which was sold to ACTS Aero in 2007 (refer to Note 20).

## 5. DEFERRED CHARGES

| | | 2007 | 2006 |
|---|---|---|---|
| Aircraft lease payments in excess of rent expense - Air Canada | Note 2X | $ 47 | $ 55 |
| Financing costs - Air Canada | | 4 | 18 |
| Aircraft lease payments in excess of rent expense - Jazz | Note 2X | - | 28 |
| Financing costs - Jazz | | - | 2 |
| | | **$ 51** | **$ 103** |

## 6. INTANGIBLE ASSETS

| | 2007 | 2006 |
|---|---|---|
| **Indefinite life assets** | | |
| International route rights and slots | $ 327 | $ 430 |
| Air Canada trade name | 298 | 393 |
| Other marketing based trade names | 31 | 50 |
| | **656** | **873** |
| **Finite life assets** | | |
| Star Alliance membership | 131 | 158 |
| Other contract and customer based | 144 | 157 |
| Technology based | 186 | 130 |
| | 461 | 445 |
| Accumulated depreciation and amortization | | |
| Star Alliance membership | (27) | (22) |
| Other contract and customer based | (81) | (65) |
| Technology based | (57) | (37) |
| | (165) | (124) |
| **Finite life assets, net** | **296** | **321** |
| | **$ 952** | **$ 1,194** |

As a result of recognizing the benefit during the year ended December 31, 2007 of future income tax assets that existed at fresh start, and for which a valuation allowance was recorded intangible assets were reduced on a pro-rata basis by $252 (2006 - $554). In addition, amortization of intangible assets amounted to $41 (2006 - $54)

The carrying value of intangible assets includes nil (2006 - $5) related to Jazz, which ceased to be consolidated under AcG-15 effective May 24, 2007.

## 7. DEPOSITS AND OTHER ASSETS

| | | 2007 | 2006 |
|---|---|---|---|
| Aircraft related deposits (a) | | $ 150 | $ 168 |
| Restricted cash (b) | | 84 | 83 |
| Deposit related to the Pension and Benefits Agreement | Note 20 | 101 | - |
| Asset-backed commercial paper (c) | | 29 | - |
| Other deposits | | 56 | 50 |
| Other | | 17 | 11 |
| | | **$ 437** | **$ 312** |

(a) The amount of deposits with lessors for the lease of aircraft and flight simulators.

(b) Restricted cash relates to funds on deposit with various financial institutions as collateral for letters of credit and other items.

(c) The Corporation has $37 ($29 net of a fair value adjustment) in non-bank sponsored ABCP which has been recorded in Deposits and other assets. These investments, which were scheduled to mature during the third quarter 2007, were previously recorded in Cash and cash-equivalents and the transfer to Deposits and other assets is reflected as an investing activity on the Consolidated statement of cash flows. An agreement in principle to restructure the ABCP investments was approved by the Pan-Canadian Committee for Third Party Structured ABCP ("Committee") on December 23, 2007. The approval of the restructuring, subject to a vote by all investors, is anticipated to occur by March 2008. Under the terms of the restructuring, all of the ABCP would be exchanged for longer-term notes that will match the maturity of the underlying assets in the proposed structure. Air Canada is not accruing interest on these investments.

During 2007, Air Canada recorded a charge of $8 ($5 after tax) in non-operating income (expense). The charge is based on a number of assumptions as to the fair value of the investments including factors such as estimated cash flow scenarios and risk adjusted discount rates. The assumptions used in estimating the fair value of the investments are subject to change, which may result in further adjustments to non-operating results in the future.

## 8. LONG-TERM DEBT AND CAPITAL LEASES

| | Final Maturity | Stated Interest Rate | 2007 | 2006 |
|---|---|---|---|---|
| Embraer aircraft financing (a) | 2017 - 2021 | 6.61 - 8.49 | $ 1,138 | $ 776 |
| Boeing aircraft financing (b) | 2019 | 5.13 - 5.69 | 647 | - |
| Predelivery financing (c) | 2008 - 2013 | 6.16 | 521 | - |
| Conditional sales agreements (d) | 2019 | 7.74 - 7.97 | 149 | 184 |
| Lufthansa cooperation agreement (e) | 2009 | 6.50 | 25 | 44 |
| GE loan (f) | 2015 | 10.58 | 38 | 48 |
| Revolving credit facility (g) | | | - | - |
| Canadian Regional Jet (h) | 2012 | 6.43 | 33 | - |
| Other | | | - | 5 |
| **Direct Corporation debt** | | | **2,551** | **1,057** |
| Jazz - senior syndicated credit facility (i) | | | - | 115 |
| Aircraft and engine leasing entities - debt (j) | | | 771 | 1,051 |
| Fuel facility corporations - debt (k) | | | 125 | 59 |
| **Debt consolidated under AcG-15** | | | **896** | **1,225** |
| **Capital lease obligations (l)** | | | **972** | **1,281** |
| **Total debt and capital leases** | | | **4,419** | **3,563** |
| Current portion | | | (413) | (367) |
| **Long-term debt and capital leases** | | | **$ 4,006** | **$ 3,196** |

The Stated Interest Rate in the table above is the rate as of December 31, 2007

Principal repayment requirements as at December 31, 2007 on long-term debt and capital lease obligations, and aircraft, engine and fuel facility debt consolidated as variable interest entities under AcG-15 are as follows:

| | 2008 | 2009 | 2010 | 2011 | 2012 | Thereafter | Total |
|---|---|---|---|---|---|---|---|
| Direct Corporation debt | $ 160 | $ 152 | $ 141 | $ 153 | $ 166 | $ 1,779 | $ 2,551 |
| Debt consolidated under AcG-15 | 105 | 51 | 100 | 288 | 73 | 279 | 896 |
| Capital lease principal obligation | 148 | 80 | 83 | 84 | 132 | 445 | 972 |
| **Total** | **$ 413** | **$ 283** | **$ 324** | **$ 525** | **$ 371** | **$ 2,503** | **$ 4,419** |

(a) Embraer aircraft financing amounts to US$1,151 as at December 31, 2007 (US$666 as at December 31, 2006). Principal and interest is repaid quarterly until maturity. The loan is secured by the 57 delivered Embraer aircraft, including 2005 to 2007 deliveries, with a carrying value of $1,651.

(b) Boeing aircraft financing amounts to US$655 as at December 31, 2007, which is financed under loan guarantee support provided by the Export-Import Bank of the United States ("EXIM"), as described below. Principal and interest is repaid quarterly until maturity. The loan is secured by the 7 delivered aircraft with a carrying value of $992.

On April 19, 2007, the Corporation received a final commitment for loan guarantee support, subject to the fulfillment of certain terms and conditions, from EXIM covering seven Boeing 777 aircraft under the Corporation's purchase agreement with Boeing (the "Boeing Purchase Agreement"), to be delivered in 2007. During 2007, the Corporation took delivery of eight Boeing 777 aircraft, seven of which were acquired under the Boeing Purchase Agreement and financed under the loan guarantee support provided by EXIM, the other one being subject to an operating lease agreement with International Lease Finance Corporation ("ILFC").

(c) On October 30, 2007, the Corporation entered into an agreement with a syndicate of banks for the financing of pre-delivery payments ("PDP") for 10 of the 16 Boeing B777 aircraft contemplated in the Boeing Purchase Agreement. The PDP financing is a series of loans that are aircraft specific with a maximum aggregate commitment of up to $568 (US$575). The PDP loans have a term of five years, but may be prepaid upon the delivery of the aircraft without penalty. The Corporation drew $533 (US$540) in October 2007. The Corporation prepaid in November 2007, the PDP loan of $64 (US$65) on the first Boeing 777 delivered under the PDP financing agreement. In addition, the Corporation has served notice to the PDP syndicate that it will be repaying the PDP loans on delivery of the second through eighth aircraft. Air Canada's intent is to prepay all PDP loans upon delivery of the relevant aircraft, using the committed long-term aircraft financing for the aircraft to be delivered. The last aircraft in this PDP financing is currently scheduled for delivery in November 2008, at which time, Air Canada expects to have fully repaid the PDP loans. At year-end 2007, the balance outstanding on the PDP loans was $521 (US$528), which includes two additional draws of $26 (US$26) each. The long-term financing is included within Long-term debt and capital leases within the Consolidated statement of financial position. The year to date capitalized interest relating to this financing is $5 at an interest rate of 30 day LIBOR plus 1.14% (6.16% as at December 31, 2007). As the loans are not due until 2013, the principal repayment is shown in the thereafter amount in the table above.

(d) US$151 principal outstanding on acquisitions of two A340-500 aircraft financed through conditional sales agreements. Principal and interest is paid quarterly until maturity in 2019. The purchase price instalments bear interest at a three month LIBOR rate plus 2.9% (7.74% - 7.97% as at December 31, 2007 and 8.27% as at December 31, 2006). The carrying value of the two A340-500 aircraft provided as security under the conditional sales agreements is $265 as at December 31, 2007.

(e) US$25 principal outstanding to mature in 2009, with semi-annual repayments, at a fixed interest rate of 4.50% plus an annual 2.0% guarantee fee.

(f) US$38 principal outstanding to mature in 2015, with quarterly repayments, at a floating interest rate equal to the six month LIBOR rate plus 5.75% pre-payable on any interest payment date after December 23, 2007. The next interest payment date is March 20, 2008. The debt is secured by certain flight training equipment with a current carrying value of $47.

(g) The revolving credit facility is a $400 senior secured revolving credit facility (the "Credit Facility"). The Credit Facility has a three year term that can be extended at Air Canada's option for additional one-year periods on each anniversary of the closing of the Air Canada IPO, subject to prior approval of Lenders holding no less than two thirds of the total commitments under the Credit Facility. The total amount available for borrowing under the Credit Facility is subject to a borrowing base restriction based on certain percentages of the values of eligible accounts receivable and eligible real estate. The Credit Facility is secured by a first priority security interest and hypothec over the present and after-acquired personal property of Air Canada, subject to certain exclusions and permitted liens, and by a first priority charge and hypothec over certain owned and leased real property of Air Canada. Air Canada's obligations are guaranteed by 1209265 Alberta Ltd., a subsidiary of Air Canada, which provides a first priority security interest over its present and after-acquired personal property, subject to certain exclusions and permitted liens, as security for its guarantee obligations. The Credit Facility contains customary representations and warranties and is subject to customary terms and conditions (including negative covenants, financial covenants and events of default). The interest rate margin ranges from LIBOR plus 2.25% to 3.25% or prime plus 1.25% to 2.25% (based on Air Canada's earnings before interest, taxes, depreciation, amortization and obsolescence and aircraft rent). As at December 31, 2007, no amount was drawn under this facility.

(h) During 2007, the Corporation refinanced five Canadair Regional Jet ("CRJ") aircraft. The refinancing included a payment of other obligations under the leasing arrangement to third parties of $36. During 2007 the debt of $9 relating to one of the CRJ aircraft was repaid. As at December 31, 2007, the principal outstanding is $33 on the four CRJ aircraft. Principal and interest are paid quarterly to maturity in 2012. The financing bears interest at a floating rate of the 3 month Canadian Banker's Acceptance rate plus 1.7%. The loan is secured by the five delivered aircraft with a carrying value of $29.

(i) At December 31, 2006, Jazz reported senior secured syndicated credit facility in the amount of $150. On closing of the Jazz IPO, $115 was drawn under the credit facility ($113 net of fees). The facility bears interest at floating rates and had a three year term maturing in 2009. The outstanding credit facility was secured by substantially all the present and future assets of Jazz. Jazz had entered into swap agreements with third parties with a notional value of $115 to receive floating rates and pay fixed rates of 7.09%. Subsequent to December 31, 2006, the original term of this facility was extended to 2010. Effective May 24, 2007, the results and financial position of Jazz are not consolidated within Air Canada (refer to Note 1).

(j) The Corporation has entered into aircraft and engine lease transactions with several special purpose entities that qualify as VIEs. The debt has a weighted average effective interest rate of approximately 8% (2006 - 8%). These aircraft and engines have a carrying value of $973 and are charged as collateral against the debt by the owners thereof. The creditors under these leasing arrangements have recourse to the Corporation, as lessee, in the event of default or early termination of the lease. Aircraft related debt amounting to US$780 ($771) [2006 - US$902 ($1,051)] is summarized as follows:

| | Final Maturity | 2007 | 2006 |
|---|---|---|---|
| Canadian Regional Jet | 2010 - 2011 | $ 218 | $ 316 |
| Boeing 767-300 | 2011 - 2016 | 163 | 211 |
| Engines | 2008 | 54 | 71 |
| Airbus 319 | 2011 - 2014 | 215 | 304 |
| Airbus 321 | 2017 | 121 | 149 |
| **Total** | | **$ 771** | **$ 1,051** |

(k) Under AcG-15, the Corporation is the primary beneficiary of certain of the Fuel Facility Corporations in Canada. The debt is comprised of bankers' acceptances with interest rates ranging from 5.72% - 6.93%, bank loans at prime plus 0.25% to prime plus 1.5%, and bonds payable with an interest rate of 5.09%. $110 of debt is due in 2032 with equal semi-annual payments of principal and interest. The remaining debt has varying maturities. The debt is secured by a general security agreement covering all assets of the Fuel Facility Corporations. The carrying value of the fuel facilities debt is $123 as at December 31, 2007.

(l) Capital lease obligations, related to computer equipment, facilities and 39 aircraft, total $972 ($71 and US$912) [2006 total $1,281 ($80 and US$1,030)]. The debt has a weighted average effective interest rate of approximately 8% and final maturities range from 2008 to 2027. During 2007, the Corporation recorded interest expense on capital lease obligations of $96 (2006 - $101).

Certain aircraft lease agreements contain a fair value test, beginning on July 1, 2009, and annually thereafter until lease expiry. This test relates to 26 aircraft under lease of which 23 are accounted for as capital leases. Under the test, the Corporation may be required to prepay certain lease amounts, based on aircraft fair values, as of the date of the test. Any amounts prepaid would be recorded as a reduction of the lease obligation. The Corporation contracts with certain third parties to provide residual value support for certain aircraft. If the Corporation is required under the loan to value test to prepay lease obligations, these amounts are recoverable from the third party residual value support provider upon lease expiry to the extent that the adjusted obligation taking into account prepayments is less than the residual value support. The maximum amount payable on July 1, 2009, assuming the related aircraft are worth nil, is $722 (US$731). This amount declines over time to nil upon lease expiry. As the Corporation does not expect to have to prepay any amounts based upon expectations of aircraft fair values into the future, the amortized cost of these capital lease obligations reflects the scheduled payments over the term to final maturity.

As at December 31, 2007, obligations under capital leases for future minimum lease payments are as follows:

| | |
|---|---|
| 2008 | $ 223 |
| 2009 | 147 |
| 2010 | 142 |
| 2011 | 136 |
| 2012 | 177 |
| Thereafter | 569 |
| Total minimum lease payments | 1,394 |
| Less amount representing interest | (422) |
| **Total obligation under capital leases** | **$ 972** |

The above minimum lease payments include residual value guarantees, except for those for which the Corporation has obtained residual value support.

Interest paid on long-term debt and capital lease obligations in 2007 by the Corporation was $263 (2006 - $251).

## 9. FUTURE INCOME TAXES

The following income tax related amounts appear in the Corporation's Consolidated statement of financial position:

| | 2007 | 2006 |
|---|---|---|
| Future income tax asset recorded in current assets (a) | $ - | $ 345 |
| Current tax payable (a) | $ - | $ (345) |
| Long-term tax payable (a) | $ (10) | $ - |
| Future income tax liability (c) | $ (88) | $ (134) |

**a) Current Taxes Payable**

As part of a tax loss utilization strategy that was planned in conjunction with the initial public offering of Air Canada and corporate restructuring, a current tax payable of $345 was created in 2006. This tax payable arose upon a transaction to transfer tax assets from Air Canada to ACE. This tax payable was recoverable from future income tax assets of Air Canada and was settled in 2007. The Corporation recorded current tax expense of $6 in 2007, which was related to the interest on the tax balance prior to its recovery.

During 2007, Air Canada recorded a current income tax expense of $10 resulting from the Federal and Ontario harmonization of corporate taxes. Air Canada will have a cash tax payable of $10 that will be payable over a five year period beginning in 2009. This amount is included in Other long-term liabilities.

**b) Valuation Allowance**

The Corporation has determined that it is more likely than not that future income tax assets of $843 are not recoverable and have been offset by a valuation allowance. However, the future tax deductions underlying the future tax assets remain available for use in the future to reduce taxable income.

Subsequent to the completion of the Air Canada IPO in 2006, the future income tax accounting of Air Canada is independent from ACE, and as such, Air Canada's intangible assets and shareholders' equity are not affected by ACE accounting events. For periods subsequent to the Air Canada IPO, the benefit of future income tax assets that existed at fresh start, and for which a valuation allowance is recorded, is recognized first to reduce to nil any remaining intangible assets (on a pro-rata basis) that were recorded upon fresh start reporting. The benefit of future income tax assets that arise after fresh start are recognized in the income statement.

Prior to the completion of the Air Canada IPO in 2006, it was determined that a portion of valuation allowance recorded by ACE should be reversed as it was more likely than not that certain future income tax assets of $504, which a valuation allowance had been recorded against at the time of fresh start reporting, would be realized. Consistent with the income tax accounting policy of Air Canada while it was wholly owned by ACE, the reversal of the valuation allowance by ACE resulted in a reduction of Air Canada's intangible assets (on a pro-rata basis) of $374 in 2006.

For periods when Air Canada was wholly owned by ACE, the benefit of future income tax assets that existed at fresh start, including the benefit recognized by affiliates of the Corporation, and for which the valuation allowance has been reversed, are recognized on a pro rata basis as a reduction of intangible assets of the Corporation and a debit or credit to shareholders' equity. The pro rata allocation of the reversal of the valuation allowance was based on the aggregate carrying value of intangible assets of the Corporation and other entities of ACE on the basis that under the plan of arrangement under the Companies' *Creditors Arrangement Act*, these intangible assets were transferred to the other entities from Air Canada. The accumulated debit to shareholders' equity as at December 31, 2006 was $291.

As described in Note 3, the income of certain inter-company investments held by Air Canada is excluded from these consolidated financial statements. The income from these investments resulted in the utilization of non-capital losses carried forward of Air Canada and, as a result, the related future income tax expense was charged to shareholders' equity. The accumulated debit to shareholders' equity as at December 31, 2006 was $282.

**c) Future Income Tax Liability**

It has been assumed that certain intangibles and other assets with nominal tax cost and a carrying value of approximately $661, have indefinite lives and accordingly, the associated future income tax liability is not expected to reverse until the assets are disposed of or become amortizable, resulting in the reporting of a future income tax liability of $88.

| | 2007 | 2006 |
|---|---|---|
| **Future tax assets** | | |
| Loss carry forwards | $ 52 | $ 27 |
| Post-employment obligations | 556 | 685 |
| Accounting provisions not currently deductible for tax | 129 | 180 |
| Tax basis of capital assets over book basis | 187 | 278 |
| Eligible capital expenditures | 2 | 10 |
| Unearned revenues | 13 | 393 |
| Other | 60 | 50 |
| **Total future tax assets** | **999** | **1,623** |
| **Future tax liabilities** | | |
| Intangible assets | 135 | 210 |
| Other | 109 | 33 |
| **Total future tax liabilities** | **244** | **243** |
| **Net future tax assets** | 755 | 1,380 |
| Less valuation allowance (b) | 843 | 1,169 |
| **Net recorded future income tax asset (liability)** (1) | **$ (88)** | **$ 211** |

(1) As at December 31, 2007, the future income tax liability of $88 is recorded in long-term liabilities. As at December 31, 2006 the net recorded future income tax asset is comprised of a future income tax asset of $345 recorded in current assets (refer to (a) above) and a future income tax liability of $134 recorded in long-term liabilities.

The reconciliation of income tax attributable to continuing operations, computed at the statutory tax rates, to income tax expense (recovery) is as follows:

| | 2007 | 2006 |
|---|---|---|
| Provision (recovery) based on combined federal and provincial rates | $ 206 | $ (25) |
| Non-taxable portion of capital gains | (32) | 1 |
| Non-deductible expenses | 17 | 14 |
| Effect of tax rate changes on future income taxes | (3) | 2 |
| Effect of statutory tax rates substantively enacted during the year | 67 | 64 |
| Other | 11 | 2 |
| | **266** | **58** |
| Valuation allowance | (76) | (61) |
| **Provision for (recovery of) income taxes** | **$ 190** | **$ (3)** |

Significant components of the provision for income taxes attributable to continuing operations are as follows:

| | 2007 | 2006 |
|---|---|---|
| Current tax expense | $ 16 | $ - |
| Future income tax expense (recovery) relating to changes in temporary differences | 183 | (6) |
| Future income tax expense from tax rate changes | 67 | 64 |
| Valuation allowance | (76) | (61) |
| **Provision for (recovery of) income taxes** | **$ 190** | **$ (3)** |

In addition to the above items impacting the provision for income taxes, a future income tax expense of $5 was recorded in contributed surplus related to the proceeds from repair schemes and non-compete agreement with ACTS (refer to Note 20). Refer to Note 17 for future income taxes recorded in other comprehensive income related to fuel derivatives designated under fuel hedge accounting.

Income taxes paid in 2007 by the Corporation were $6. No income taxes were paid in 2006 by the Corporation.

The balances of tax attributes as at December 31, 2007, namely the balances of non-capital loss carry forwards, vary amongst different taxing jurisdictions. The following are the Federal tax loss expiry dates:

| | Tax Losses |
|---|---|
| 2010 | $ 8 |
| 2014 | 16 |
| 2027 | 90 |
| | **$ 114** |

There are $61 of net capital losses that have no expiry date.

## 10. PENSION AND OTHER BENEFIT LIABILITIES

The Corporation maintains several defined benefit and defined contribution plans providing pension, other post-retirement and post-employment benefits to its employees, including those employees of the Corporation who are contractually assigned to ACTS Aero and Aeroplan.

The Corporation is the administrator and sponsoring employer of ten Domestic Registered Plans ("Domestic Registered Plans") under the Pension Benefits Standard Act, 1985 (Canada). The US plan, UK plan and Japan plan are international plans covering employees in those countries. In addition, the Corporation maintains a number of supplementary pension plans, which are not registered. The defined benefit pension plans provide benefits upon retirement, termination or death based on the member's years of service and final average earnings for a specified period.

The other employee benefits consist of health, life and disability. These benefits consist of both post-employment and post-retirement benefits. The post-employment benefits relate to disability benefits available to eligible active employees, while the post-retirement benefits are comprised of health care and life insurance benefits available to eligible retired employees.

Certain Corporation employees perform work for ACE and others are contractually assigned to ACTS Aero or Aeroplan. These employees are members of Corporation-sponsored defined benefit pension plans and also participate in Corporation-sponsored health, life and disability future benefit plans. These consolidated financial statements include all of the assets and liabilities of all Corporation-sponsored plans. The employee benefit expense in these consolidated financial statements includes the expenses for all employees participating in the plans less a cost recovery which is charged to the related parties for those employees assigned. The cost recovery includes current service costs for pensions along with their portion of post-employment and post-retirement benefits, based on the actuarial calculation for their specific employee group. This cost recovery amounted to $40 for the year ended December 31, 2007 (2006 - $56).

The measurement date used for financial reporting on the pension and other benefit obligations is November 30.

As described in Note 20, Air Canada and ACTS Aero are parties to a Pension and Benefits Agreement covering the future transfer of certain pension and benefit assets and obligations to ACTS Aero.

**Benefit Obligation and Plan Assets**

The following tables present financial information related to the changes in the pension and other post-employment benefits plans:

| | Pension Benefits | | Other Employee Future Benefits | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| **Change in benefit obligation** | | | | |
| Benefit obligation at beginning of year | $ 13,235 | $ 12,921 | $ 966 | $ 940 |
| Current service cost | 254 | 254 | 69 | 77 |
| Interest cost | 649 | 640 | 49 | 48 |
| Employees' contributions | 88 | 89 | - | - |
| Benefits paid | (648) | (627) | (51) | (60) |
| Other benefits | 2 | - | - | - |
| Actuarial (gain) loss | (1,278) | (74) | (119) | (38) |
| Deconsolidation of Jazz | (100) | - | - | - |
| Foreign exchange | (52) | 32 | (15) | (1) |
| | 12,150 | 13,235 | 899 | 966 |
| **Change in plan assets** | | | | |
| Fair value of plan assets at beginning of year | 11,858 | 10,421 | 8 | 14 |
| Actual return on plan assets | 197 | 1,493 | - | 1 |
| Employer contributions | 382 | 455 | 43 | 47 |
| Employees' contributions | 88 | 89 | - | - |
| Benefits paid | (648) | (627) | (51) | (54) |
| Deconsolidation of Jazz | (81) | - | - | - |
| Foreign exchange | (49) | 27 | - | - |
| | 11,747 | 11,858 | - | 8 |
| **Deficit at end of year** | **403** | **1,377** | **899** | **958** |
| Employer contributions after measurement date | (7) | (7) | (5) | (6) |
| Unrecognized net actuarial gain (loss) | 497 | (221) | 149 | 46 |
| Valuation allowance against accrued benefit | 1 | - | - | - |
| **Net benefit obligation** | **$ 894** | **$ 1,149** | **$ 1,043** | **$ 998** |
| Weighted average assumptions used to determine the accrued benefit liability | | | | |
| Discount rate | 5.75 % | 5.00 % | 5.75-6.00 % | 5.00-5.50 % |
| Rate of compensation increase (a) | 2.50 % | 2.50 % | | |

(a) As a result of pay awards during 2006, a rate of compensation increase of 1.75% was used for years 2006 to 2008 in determining the net benefit obligation for the pension plan and 2.5% for the remaining years.

Under the terms of the domestic registered and supplementary plans, there is no indexation provided after January 1, 2007.

The pension benefit deficit of only those plans that are not fully funded at the end of the year is as follows:

| | 2007 | 2006 |
|---|---|---|
| Domestic registered plans (a) | $ 35 | $ 556 |
| US, UK, and Japan | 17 | 55 |
| Supplementary plans | 665 | 766 |
| | **$ 717** | **$ 1,377** |

(a) Includes nil (2006 - $19) related to Jazz, which was consolidated until May 24, 2007 under AcG-15.

The net deficit, on an accounting basis, at December 31, 2007 for pension benefits was $403 compared to $1,377 at December 31, 2006. The decrease in the accounting deficit is mainly the result of an increase in the discount rate and funding of past service employer contributions of $134, offset by a negligible return on plan assets.

The net benefit obligation is recorded in the statement of financial position is as follows:

| | 2007 | 2006 |
|---|---|---|
| Pension benefits | $ 894 | $ 1,149 |
| Other employee future benefits | 1,043 | 998 |
| **Net benefit obligation** | **1,937** | **2,147** |
| Current portion | (113) | (271) |
| **Pension and other benefits liability** | **$ 1,824** | **$ 1,876** |

The current portion of Pension benefits represents past service contributions for the Domestic Registered Plans, scheduled to be paid during 2008 while the current portion of Other employee future benefits is an estimate of the claims to be incurred during 2008. The current portion is included in Accounts payable and accrued liabilities.

Total cash payments for 2007, consisting of cash contributed by the Corporation to its defined benefit plans, cash payments to beneficiaries for post-employment and post-retirement plans, and cash contributed to its defined contribution plans were $428 (2006 - $520).

**Pension and Other Employee Future Benefit Expense**

The Corporation has recorded net defined benefit pension and other employee future benefits expense as follows:

| | Pension Benefits | | Other Employee Future Benefits | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| **Components of Net Periodic Pension Cost** | | | | |
| Current service cost | $ 254 | $ 254 | $ 69 | $ 77 |
| Interest cost | 649 | 640 | 49 | 48 |
| Actual return on plan assets | (148) | (1,515) | - | (1) |
| Actuarial (gain) loss | (1,278) | (47) | (119) | (43) |
| Other benefits | 2 | - | - | - |
| **Costs arising in the year** | **(521)** | **(668)** | **(1)** | **81** |
| **Differences between costs arising in the year and costs recognized in the year in respect of:** | | | | |
| Return on plan assets | (622) | 774 | - | - |
| Actuarial loss (gain) | 1,285 | 65 | 103 | 26 |
| Increase (decrease) in valuation allowance provided against accrued benefit asset | 1 | - | - | - |
| **Net periodic benefit cost of plans** | **143** | **171** | **102** | **107** |
| Amount charged to affiliates | (23) | (33) | (17) | (23) |
| **Net defined benefit pension and other employee benefits expense (a)** | **$ 120** | **$ 138** | **$ 85** | **$ 84** |
| Weighted average assumptions used to determine the accrued benefit cost | | | | |
| Discount rate | 5.00 % | 5.00 % | 5.00 - 5.50 % | 5.00 - 5.50 % |
| Expected long-term rate of return on plan assets | 7.15 % | 7.50 % | n/a | 7.50 % |
| Rate of compensation increase (b) | 2.50 % | 4.00 % | | |

(a) Includes $4 of Pension Benefits related to Jazz (2006 - $10), which was consolidated until May 24, 2007 under AcG-15.

(b) A rate of compensation increase of 2% in 2006 and 2% in 2007 was used in determining the net benefit pension expense and 4% for the remaining years.

**Other Benefits — Sensitivity Analysis**

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 9.25% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2007 (2006 - 9.75%). The rate is assumed to decrease gradually to 5% by 2013. A one percentage point increase in assumed health care trend rates would have increased the service and interest costs by $1 and the obligation by $16. A one percentage point decrease in assumed health care trend rates would have decreased the service and interest costs by $1 and the obligation by $16.

**Pension Plan Cash Funding Obligations**

As at December 31, 2007 and based on the January 1, 2007 solvency valuation, the table below provides projections for the Corporation's cash pension plan funding obligations for 2008. The final funding obligation for 2008 will be determined based on the January 1, 2008 valuation.

| | 2008 |
|---|---|
| Past service domestic registered plans | $ 91 |
| Current service domestic registered plans | 166 |
| Other pension arrangements | 86 |
| | **$ 343** |

The most recent actuarial valuation is as at January 1, 2007 and the effective date of the next required actuarial valuation is January 1, 2008. For domestic registered pension plans, the funding requirements are based on the minimum past service contributions disclosed in the January 1, 2007 actuarial valuations plus a projection of the current service contributions based upon the January 1, 2007 actuarial valuation used for the purpose. Based on a funding outlook, employer contributions determined in accordance with regulations are expected to increase by approximately $90 in 2008.

On August 9, 2004, the Government of Canada adopted the Air Canada Pension Plan Solvency Deficiency Funding Regulations (the "Pension Regulations"). The Pension Regulations allow Air Canada to fund the solvency deficiencies in its Domestic Registered Plans as of January 1, 2004 over ten years, rather than the five years required under the ordinary rules, and to pay down such deficiencies by way of an agreed schedule of variable annual contributions rather than by way of equal annual contributions as required under the ordinary rules. The Pension Regulations came into force upon Air Canada's emergence from CCAA protection on September 30, 2004, on which date Air Canada issued subordinated secured promissory Notes in an aggregate amount of approximately $347 in favour of the pension plan trustee. Such Notes will be reduced as the principal amount of the solvency deficiencies is paid down, and will only be called on the occurrence of certain specified events of default. The amount of secured promissory Notes outstanding as at December 31, 2007 is $89 (2006 - $219). The effect of the issuance of the subordinated security promissory Notes is included within the value of the obligation for pension benefits as reflected in the Corporation's balance sheet. The funding of the notes is included, on a discounted basis, in all future expected cash flows required to fund the benefit obligation.

The composition of the Domestic Registered Plan assets and the target allocation consist of the following:

| | 2007 | 2006 | Target Allocation |
|---|---|---|---|
| Equity securities | 58.9 % | 59.1 % | 59.0 % |
| Bonds and mortgages | 36.1 % | 34.7 % | 41.0 % |
| Cash and temporary investments | 5.0 % | 6.2 % | 0.0 % |
| | **100.0 %** | **100.0 %** | **100.0 %** |

*Domestic Registered Plans*
For the Domestic Registered Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Master Trust Fund. The investment return objective of the fund is to achieve a total annualized rate of return that exceeds inflation by at least 3.75% over the long term.

In addition to the broad asset allocation, as summarized in the asset allocation section above, the following policies apply to individual asset classes:

- Equity investments can include convertible securities, and are required to be diversified among industries and economic sectors. Foreign equities can comprise 37% to 43% of the total market value of the trust. Limitations are placed on the overall allocation to any individual security at both cost and market value. Derivatives are permitted to the extent they are not used for speculative purposes or to create leverage.

- Bond and Mortgage investments are oriented toward risk averse, long term, investment grade securities rated "A" or higher. With the exception of Government of Canada securities or a province thereof, in which the plan may invest the entire fixed income allocation, these investments are required to be diversified among individual securities and sectors. The target return is comprised of 40% of the total return of the Scotia Capital Universe Bond Index and 60% of the total return of the Scotia Capital Long Term Bond Index.

Similar investment policies are established for the other pension plans sponsored by the Corporation.

The Corporation's expected long-term rate of return on assets assumption is selected based on the facts and circumstances that exist as of the measurement date, and the specific portfolio mix of plan assets. Management reviewed anticipated future long-term performance of individual asset categories and considered the asset allocation strategy adopted by the Corporation, including the longer duration in its bond portfolio in comparison to other pension plans. These factors are used to determine the average rate of expected return on the funds invested to provide for the pension plan benefits. While the review considers recent fund performance and historical returns, the assumption is primarily a long-term, prospective rate.

**Defined Contribution Plans**
The Corporation's management, administrative and certain unionized employees may participate in defined contribution plans. Contributions range from 3% to 6% for those employees in Canada and 3% - 7% for those participants in the United Kingdom. The Corporation contributes an equal amount. The Corporation's expense for defined contribution plans amounted to $4 for the year ended December 31, 2007 (2006 - $7).

## 11. OTHER LONG-TERM LIABILITIES

| | | 2007 | 2006 |
|---|---|---|---|
| Aeroplan miles obligations (a) | | $ 29 | $ 105 |
| Unfavourable contract liability on aircraft leases (b) | | 54 | 77 |
| Aircraft rent in excess of lease payments (c) | Note 2X | 54 | 121 |
| Long-term employee liabilities (d) | | 47 | 54 |
| Workplace safety and insurance board liabilities | | 45 | 45 |
| Other (e) | | 107 | 70 |
| | | **$ 336** | **$ 472** |

(a) Air Canada has a liability related to Aeroplan Miles which were issued by Air Canada prior to January 1, 2002. Refer to Note 22 for a description of the Special charge for Aeroplan Miles in 2006. As of December 31, 2007 a liability for approximately 7 billion miles, or $84, remains in Air Canada, of which $55 is included in current liabilities (total liability of 15 billion Miles, or $163, as at December 31, 2006). The amount of the additional liability was determined by valuing the incremental Miles at the current fair value.

(b) The unfavourable contract liability on aircraft leases represents the net present value of lease payments in excess of estimated market rents related to lease arrangements that existed on fresh start reporting.

(c) Included in this balance is nil as at December 31, 2007 (2006 - $59) related to Jazz, which was consolidated under AcG-15 until May 24, 2007.

(d) The following table outlines the changes to labour related provisions which are included in long-term employee liabilities for balances that existed upon the implementation of fresh start reporting on September 30, 2004:

| | 2007 | 2006 |
|---|---|---|
| Beginning of year | $ 77 | $ 121 |
| Interest accretion | 5 | 8 |
| Amounts disbursed | (38) | (52) |
| Deconsolidation of Jazz | (4) | - |
| End of year | 40 | 77 |
| Current portion | (6) | (32) |
| | **$ 34** | **$ 45** |

The following table outlines the changes to labour related provisions which are included in long-term employee liabilities for balances that have been created subsequent to the implementation of fresh start reporting on September 30, 2004 (current portion included in Accounts payable and accrued liabilities):

| | 2007 | 2006 |
|---|---|---|
| Beginning of year | $ 29 | $ 13 |
| Special charge for labour restructuring | - | 20 |
| Charges recorded in wages, salaries, and benefits | 14 | 7 |
| Amounts disbursed | (17) | (11) |
| End of year | 26 | 29 |
| Current portion | (13) | (20) |
| | **$ 13** | **$ 9** |

The Corporation offers certain severance programs to certain employees from time to time. The cost of these programs is recorded within operating expenses.

During 2006 a workforce reduction plan was announced to reduce non-unionized employee levels by 20 percent. A special charge of $20 was recorded in 2006 relating to this program.

(e) Other includes asset retirement obligations of the Corporation. Under the terms of their respective land leases each Fuel Facility Corporation has an obligation to restore the land to vacant condition at the end of the lease and to rectify any environmental damage for which it is responsible. If it were found that the Fuel Facility Corporations had to contribute to any remediation costs, each contracting airline would share pro rata, based on system usage, in the costs. For all Fuel Facility Corporations in Canada in which the Corporation participates, the Corporation has recorded an obligation of $7 ($44 undiscounted) representing the present value of the estimated decommissioning and remediation obligations at the end of the lease using an 8% discount rate, with lease term expiry dates ranging from 2032 to 2039. This estimate is based on numerous assumptions including the overall cost of decommissioning and remediation and the selection of alternative decommissioning and remediation approaches. The estimated fair value of the obligation is nil.

## 12. STOCK-BASED COMPENSATION

**ACE Stock Option Plan**

Certain of the Corporation's employees participate in the ACE stock option plan. Plan participation is limited to employees holding positions that, in ACE Board's view (or a committee selected by the ACE Board), have a significant impact on ACE's long term results. The stock option plan provides that the options will have an exercise price of not less than 100% of the market price of the underlying shares at the time of grant. Under the terms of the stock option plan, fifty percent of all options vest over four years. The remaining options vest upon performance conditions that are based on net income targets established by the ACE Board over the same time period. All options expire after seven years. The terms of ACE's stock option plan specify that upon the retirement of the employee, options granted to that employee may be exercised as the options vest within three years of such retirement.

In compliance with the terms of the ACE stock option plan, in November 2007, the Board of ACE resolved to immediately vest all remaining unvested ACE stock options. This resulted in the immediate expense recognition of all deferred stock based compensation on outstanding ACE options granted to Air Canada employees, less amounts previously recognized as compensation expense. This expense of $6 is included in the amount below in 2007. As a result of this immediate vesting of all ACE options granted to Air Canada employees, no further stock based compensation expense is expected to be recorded related to the ACE stock option plan.

The number of ACE stock options granted to employees, the related compensation expense recorded and the assumptions used to determine stock-based compensation expense, using the Black-Scholes option valuation model were as follows:

| | 2007 | 2006 |
|---|---|---|
| Compensation expense ($millions) | $ 9 | $ 3 |
| Number of stock options granted to Air Canada employees | - | 186,006 |
| Weighted average fair value per option granted ($) | $ - | $ 10.39 |
| Aggregated fair value of options granted ($ millions) | $ - | $ 2 |
| Weighted average assumptions: | | |
| Risk-free interest rate | - | 4.02 % |
| Expected volatility | - | 35 % |
| Dividend yield | - | 0 % |
| Expected option life (years) | - | 4.50 |

A summary of the activity related to Air Canada employees participating in the ACE stock option plan is as follows:

| | 2007 | | 2006 | |
|---|---|---|---|---|
| | Options (000) | Weighted Average Exercise Price/Share | Options (000) | Weighted Average Exercise Price/Share |
| Beginning of year | 1,610 | $ 24.42 | 1,550 | $ 24.37 |
| Granted | - | - | 26 | 34.78 |
| Exercised | (20) | 18.70 | (80) | 20.00 |
| Forfeited | - | - | (30) | 20.00 |
| Outstanding options, prior to special distribution January 10, 2007 (March 3, 2006) | 1,590 | 24.49 | 1,466 | 24.88 |
| Adjustment - ACE special distribution (a) | 386 | - | 101 | |
| Outstanding options, after special distribution (a) | 1,976 | 19.71 | 1,567 | 23.26 |
| Granted | - | - | 160 | 32.08 |
| Exercised | (410) | 17.15 | (96) | 19.07 |
| Forfeited | (2) | 26.16 | (21) | 20.73 |
| Outstanding options, prior to special distribution March 14, 2007 | 1,564 | 20.37 | 1,610 | 24.42 |
| Adjustment - ACE special distribution (a) | 272 | - | - | - |
| Outstanding options, after special distribution (a) | 1,836 | 17.35 | 1,610 | 24.42 |
| Granted | - | - | - | - |
| Exercised | (10) | 18.53 | - | - |
| Forfeited | (123) | 26.00 | - | - |
| Outstanding options, prior to special distribution May 24, 2007 | 1,703 | 16.73 | 1,610 | 24.42 |
| Adjustment - ACE special distribution (a) | 270 | - | - | - |
| Outstanding options, after special distribution (a) | 1,973 | 14.43 | 1,610 | 24.42 |
| Granted | - | - | - | - |
| Exercised | (1,433) | 13.12 | - | - |
| Forfeited | (216) | 20.95 | - | - |
| **Outstanding options, end of year** | **324** | **$ 15.90** | **1,610** | **$ 24.42** |
| **Options exercisable, end of year** | **324** | **$ 15.90** | **291** | **$ 24.27** |

(a) In accordance with the terms of the ACE stock option plan, each distribution of Aeroplan and Jazz units by ACE during 2007 and 2006 triggered an adjustment to the weighted average exercise price and the number of options outstanding. Effective on the applicable dates of the distributions, the adjustments were applied to all unexercised ACE stock options held by Air Canada employees, whether vested or not.

| Range of Exercise Prices | Expiry Dates | 2007 Outstanding Options | | | 2007 Exercisable Options | |
|---|---|---|---|---|---|---|
| | | Number of Options Outstanding | Weighted Average Remaining Life (Years) | Weighted Average Exercise Price/Share | Number of Exercisable Options | Weighted Average Exercise Price/Share |
| $ 11.05 | 2011 | 129,077 | 4 | $ 11.05 | 129,077 | $ 11.05 |
| $ 19.10 - $ 20.04 | 2013 | 194,677 | 6 | 19.12 | 194,677 | 19.12 |
| | | **323,754** | | **$ 15.90** | **323,754** | **$ 15.90** |

| Range of Exercise Prices | Expiry Dates | 2006 Outstanding Options | | | 2006 Exercisable Options | |
|---|---|---|---|---|---|---|
| | | Number of Options Outstanding | Weighted Average Remaining Life (Years) | Weighted Average Exercise Price/Share | Number of Exercisable Options | Weighted Average Exercise Price/Share |
| $ 18.70 | 2011 | 1,085,803 | 5 | $ 18.70 | 210,742 | $ 18.70 |
| $ 31.89 - $ 38.91 | 2012 | 339,604 | 6 | 38.52 | 80,220 | 38.91 |
| $ 30.61 - $ 33.89 | 2013 | 184,734 | 7 | 32.14 | - | - |
| | | **1,610,141** | | **$ 24.42** | **290,962** | **$ 24.27** |

**Air Canada Long-Term Incentive Plan**

As approved by the Board of Directors, concurrent with the Air Canada IPO described in Note 3, certain of the Corporation's employees participate in the Air Canada Long-term Incentive Plan (the "Long-term Incentive Plan") administered by the Board of Directors of Air Canada. The Long-term Incentive Plan provides for the grant of options and performance share units to senior management and officers of Air Canada.

The options to purchase shares granted under the Long-term Incentive Plan have a maximum term of 10 years and an exercise price based on the fair market value of the shares at the time of the grant of the options. Options granted under the Long-term Incentive Plan will vest over four years and will incorporate performance vesting features. The performance vesting conditions are based on operating margin (operating income over operating revenues) and net income targets established by the Air Canada Board over the same time period. The terms of the Long-term Incentive Plan specify that upon the retirement of the employee, options granted may be exercised as the rights to exercise accrue within three years from the retirement date.

The number of Air Canada stock options granted to employees, the related compensation expense recorded and the assumptions used to determine stock-based compensation expense, using the Black-Scholes option valuation model were as follows:

| | 2007 | 2006 |
|---|---|---|
| Compensation expense ($millions) | $ 4 | $ 3 |
| Number of stock options granted | 482,870 | 1,699,678 |
| Weighted average fair value per option granted ($) | $ 4.32 | $ 5.40 |
| Aggregated fair value of options granted ($ millions) | $ 2 | $ 9 |
| Weighted average assumptions: | | |
| Risk-free interest rate | 3.94 % - 4.43 % | 4.07 % |
| Expected volatility | 34 % - 35 % | 35 % |
| Dividend yield | 0 % | 0 % |
| Expected option life (years) | 4.50 | 4.50 |

A summary of the activity related to Corporation employees participating in the Air Canada Long-term Incentive Plan is as follows:

| | 2007 | | 2006 | |
|---|---|---|---|---|
| | Options (000) | Weighted Average Exercise Price/Share (b) | Options (000) | Weighted Average Exercise Price/Share |
| Beginning of year | 1,700 | $ 21.00 | - | $ - |
| Granted | 483 | 14.74 | 1,700 | 21.00 |
| Exercised | - | - | - | - |
| Forfeited | (463) | 21.00 | - | - |
| **Outstanding options, end of year** | **1,720** | **$ 19.24** | **1,700** | **$ 21.00** |
| **Options exercisable end of year** | **155** | **$ 21.00** | **-** | **$ -** |

| Range of Exercise Prices | Expiry Dates | 2007 Outstanding Options | | | 2007 Exercisable Options | |
|---|---|---|---|---|---|---|
| | | Number of Options Outstanding | Weighted Average Remaining Life (Years) | Weighted Average Exercise Price/Share | Number of Exercisable Options | Weighted Average Exercise Price/Share |
| $ 21.00 | 2013 | 1,237,222 | 6 | $ 21.00 | 154,653 | $ 21.00 |
| $ 11.08 - $ 18.60 | 2014 | 482,870 | 7 | 14.74 | - | - |
| | | **1,720,092** | | **$ 19.24** | **154,653** | **$ 21.00** |

| Range of Exercise Prices | Expiry Dates | 2006 Outstanding Options | | | 2006 Exercisable Options | |
|---|---|---|---|---|---|---|
| | | Number of Options Outstanding | Weighted Average Remaining Life (Years) | Weighted Average Exercise Price/Share | Number of Exercisable Options | Weighted Average Exercise Price/Share |
| $ 21.00 | 2013 | 1,699,678 | 7 | $ 21.00 | - | $ - |

**Performance Share Units**

The Long-term Incentive Plan also includes Performance Share Units ("PSUs"). The value of the PSUs is based on the fair market value of the shares at the time of the grant. The vesting term of PSUs is three years, generally commencing on January 1 of the year following granting, and incorporate performance vesting features based upon achieving the average Earnings Per Share target established over the vesting period. Subject to vesting and other conditions, each PSU shall entitle the employee to receive a payment in the form of one common share, cash in the amount equal to market value of one common share, or a combination thereof, at the discretion of the Board of Directors. The terms of the plan specify that upon the retirement of an employee, the number of PSUs that vest will be prorated based on the total number of completed months of active service during the PSU vesting term.

The number of PSUs granted to employees and the related compensation expense were as follows:

| | 2007 | 2006 |
|---|---|---|
| Compensation expense ($millions) | $ 2 | $ - |
| Number of PSUs granted | 232,760 | 345,805 |
| Weighted average fair value per PSU granted ($) | $ 16.46 | $ 19.40 |
| Aggregate fair value of PSUs granted | $ 4 | $ 7 |

During the year 27,314 PSUs were forfeited (2006 – nil).

**Jazz Long-Term Incentive Plan**

Jazz provides certain of its employees with unit based compensation plans. The Jazz segment recorded compensation expense of $1 for the period ended May 24, 2007 (2006 - $2) related to this plan. The units under this plan relate to units in Jazz Air Income Fund. Effective May 24, 2007, Jazz is no longer consolidated.

**Employee Ownership Plans**

Employee ownership plans have been established for shares of ACE and Air Canada under which eligible employees are allowed to invest up to 6% of their base salary for the purchase of shares on the secondary market. Air Canada will match 33.3% of the investments made by the employee. During 2007, the Corporation recorded compensation expense of $1 (2006 - $2).

## 13. SHAREHOLDERS' EQUITY

Share capital (net of issue costs) consists of the following:

| Share Capital | 2007 | 2006 |
|---|---|---|
| Common shares | $ 562 | $ 562 |
| Adjustment to shareholders' equity (a) | (288) | (288) |
| | **$ 274** | **$ 274** |

(a) As a result of the financial reorganization under CCAA, the assets and liabilities of the consolidated entity, excluding goodwill, were comprehensively valued to fair values and a revaluation adjustment of $4,234 was recorded as a credit to share capital. GAAP does not permit goodwill to be recorded even if the fair value of net assets is less than the fair value of the enterprise as a whole.

**Common Shares**

As at December 31, 2007, the common shares issuable by Air Canada consist of an unlimited number of Class A Variable Voting Shares ("Variable Voting Shares") and an unlimited number of Class B Voting Shares ("Voting Shares"). The two classes of common shares have equivalent rights as common shareholders except for voting rights. Holders of Variable Voting Shares are entitled to one vote per share unless the aggregate number of Variable Voting Shares outstanding, as a percentage of the total number of votes attaching to all issued and outstanding voting shares of Air Canada exceeds 25% or the total number of votes cast by or on behalf of holders of Variable Voting Shares at any meeting exceeds 25% of the total number of votes that may be cast at such meeting. If the 25% threshold would be surpassed, the votes attaching to the Variable Voting Shares would be proportionately reduced. Variable Voting Shares will be automatically converted to Voting Shares if the shares become held, beneficially owned and controlled, directly or indirectly, by a Canadian, as defined in the Canada Transportation Act. Voting Shares will be automatically converted to Variable Voting Shares if the shares become held, beneficially owned or controlled, directly or indirectly, by a party that is not a Canadian, as defined in the Canada Transportation Act.

The issued and outstanding common shares of Air Canada, along with the potential common shares, are as follows:

| Outstanding common shares | 2007 | 2006 |
|---|---|---|
| **Issued and outstanding** | | |
| Class A variable voting shares | 16,654,049 | 18,343,095 |
| Class B voting shares | 83,345,951 | 81,656,905 |
| **Total issued and outstanding** | 100,000,000 | 100,000,000 |
| **Potential common shares** | | |
| Stock options | 1,720,092 | 1,695,035 |
| Performance share units | 551,251 | 345,805 |

**Accumulated Other Comprehensive Income**

The following table outlines the components of Accumulated other comprehensive income:

| (in millions) | 2007 | 2006 |
|---|---|---|
| **Accumulated other comprehensive income** | | |
| Unrealized period change in fair value of derivatives (net of tax of $28) | $ 56 | $ - |
| | **$ 56** | **$ -** |

## 14. EARNINGS PER SHARE

The following table outlines the calculation of basic and diluted earnings per share:

| (in millions, except per share amounts) | 2007 | 2006 |
|---|---|---|
| **Numerator:** | | |
| **Numerator for basic and diluted earnings per share:** | | |
| Income (loss) for the year | $ 429 | $ (74) |
| **Adjusted numerator for diluted earnings per share** | **$ 429** | **$ (74)** |
| **Denominator:** | | |
| **Denominator for basic earnings per share:** | | |
| **Weighted-average shares** | 100 | 89 |
| Effect of potential dilutive securities: | | |
| Performance share units | 1 | - |
| **Adjusted denominator for diluted earnings per share** | 101 | 89 |
| | | |
| **Basic earnings (loss) per share** | **$ 4.29** | **$ (0.83)** |
| **Diluted earnings (loss) per share** | **$ 4.27** | **$ (0.83)** |

The calculation of earnings per share is based on whole dollars and not on rounded millions. As a result, the above amounts may not be recalculated to the per share amount disclosed above.

The dilutive effect of outstanding stock options on earnings per share is based on the application of the treasury stock method. Under this method, the proceeds from the exercise of such securities are assumed to be used to purchase Class B Voting Shares.

Excluded from the calculation of diluted earnings per share were 1,606,820 outstanding options where the options' exercise prices were greater than the average market price of the common shares for the year (2006 - 1,699,678).

## 15. SEGMENT INFORMATION

A reconciliation of the total amounts reported by each business segment and geographic region to the applicable amounts in the consolidated statements is as follows:

| | 2007 | | |
|---|---|---|---|
| | Air Canada Segment | Jazz | Elimination |
| Passenger revenue | $ 9,329 | $ - | $ - |
| Cargo revenue | 550 | - | - |
| Other revenue | 717 | 3 | - |
| External revenue | 10,596 | 3 | - |
| Inter-segment revenue | 50 | 610 | (660) |
| | **10,646** | **613** | **(660)** |
| Special charge for Aeroplan miles | - | - | - |
| **Total revenues** | **10,646** | **613** | **(660)** |
| Wages, salaries and benefits | 1,920 | 139 | - |
| Aircraft fuel | 2,552 | 125 | (124) |
| Aircraft rent | 282 | 57 | (16) |
| Airport and navigation fees | 1,022 | 80 | (81) |
| Aircraft maintenance, materials and supplies | 757 | 50 | (8) |
| Communications and information technology | 275 | 2 | - |
| Food, beverages and supplies | 313 | 6 | - |
| Depreciation, amortization and obsolescence | 548 | 9 | - |
| Commissions | 201 | - | - |
| Capacity purchase with Jazz | 923 | - | (386) |
| Special charge for labour restructuring | | | |
| Other operating expenses | 1,420 | 83 | (45) |
| **Total operating expenses** | **10,213** | **551** | **(660)** |
| **Operating income** | **433** | **62** | **-** |
| Interest income | 92 | 2 | - |
| Interest expense | (348) | (3) | - |
| Interest capitalized | 108 | - | - |
| Gain (loss) on sale of assets | 19 | - | - |
| Gain (loss) on financial instruments recorded at fair value | 26 | - | - |
| Other non-operating income (expense) | (19) | 1 | - |
| Non-controlling interest | (9) | - | (62) |
| Foreign exchange gain | 317 | - | - |
| Recovery of (provision) for income taxes | (190) | - | - |
| | (4) | - | (62) |
| **Segment income (loss)** | **$ 429** | **$ 62** | **$ (62)** |

| | 2006 | | | |
|---|---|---|---|---|
| **Consolidated Total** | **Air Canada Segment** | **Jazz** | **Elimination** | **Consolidated Total** |
| $ 9,329 | $ 8,887 | $ - | $ - | $ 8,887 |
| 550 | 629 | - | - | 629 |
| 720 | 644 | 7 | - | 651 |
| 10,599 | 10,160 | 7 | - | 10,167 |
| - | 106 | 1,374 | (1,480) | - |
| **10,599** | **10,266** | **1,381** | **(1,480)** | **10,167** |
| - | (102) | - | - | (102) |
| **10,599** | **10,164** | **1,381** | **(1,480)** | **10,065** |
| 2,059 | 1,816 | 311 | - | 2,127 |
| 2,553 | 2,544 | 285 | (284) | 2,545 |
| 323 | 341 | 134 | (34) | 441 |
| 1,021 | 982 | 178 | (178) | 982 |
| 799 | 768 | 98 | (11) | 855 |
| 277 | 273 | 8 | (3) | 278 |
| 319 | 322 | 15 | (2) | 335 |
| 557 | 493 | 21 | - | 514 |
| 201 | 237 | - | - | 237 |
| 537 | 871 | - | (871) | - |
| | 20 | - | - | 20 |
| 1,458 | 1,383 | 187 | (98) | 1,472 |
| **10,104** | **10,050** | **1,237** | **(1,481)** | **9,806** |
| **495** | **114** | **144** | **1** | **259** |
| 94 | 82 | 6 | (1) | 87 |
| (351) | (313) | (8) | - | (321) |
| 108 | 62 | (1) | - | 61 |
| 19 | (6) | - | - | (6) |
| 26 | (18) | - | - | (18) |
| (18) | 2 | (1) | - | 1 |
| (71) | (12) | - | (140) | (152) |
| 317 | 12 | - | - | 12 |
| (190) | 3 | - | - | 3 |
| (66) | (188) | (4) | (141) | (333) |
| **$ 429** | **$ (74)** | **$ 140** | **$ (140)** | **$ (74)** |

Included within Depreciation, amortization and obsolescence is depreciation of property and equipment for 2007 of $514 (2006 - $458). This is broken down by segment as follows: Air Canada $505 (2006 - $437) and Jazz $9 ($21).

| Passenger revenues | 2007 | 2006 |
|---|---|---|
| Canada | $ 3,970 | $ 3,680 |
| US Transborder | 1,884 | 1,825 |
| Atlantic | 1,806 | 1,795 |
| Pacific | 967 | 946 |
| Other | 702 | 641 |
| | **$ 9,329** | **$ 8,887** |

| Cargo revenues | 2007 | 2006 |
|---|---|---|
| Canada | $ 108 | $ 119 |
| US Transborder | 25 | 28 |
| Atlantic | 219 | 222 |
| Pacific | 159 | 218 |
| Other | 39 | 42 |
| | **$ 550** | **$ 629** |

Passenger and cargo revenues are based on the actual flown revenue for flights with an origin and destination in a specific country or region. Atlantic refers to flights that cross the Atlantic Ocean with origin and destinations principally in Europe. Pacific refers to flights that cross the Pacific Ocean with origin and destinations principally in Asia. Other revenues are principally derived from customers located in Canada.

**Segment Asset Information**

As at December 31, 2007, the Corporation has one reportable segment. The following is the segment asset information for the Corporation's two reportable segments as at December 31, 2006.

| | 2006 | | | |
|---|---|---|---|---|
| | Air Canada Segment | Jazz | Elimination | Consolidated Total |
| Cash and cash equivalents | $ 1,312 | $ 135 | $ - | $ 1,447 |
| Short-term investments | 798 | - | - | 798 |
| | **$ 2,110** | **$ 135** | **$ -** | **$ 2,245** |
| Additions to capital assets | $ 863 | $ 25 | $ - | $ 888 |
| **Total assets** | **$ 11,388** | **$ 483** | **$ (122)** | **$ 11,749** |

The Corporation is a domestic and international carrier and for the purposes of segment reporting, flight equipment is attributed to Canada. As a result, substantially all of the Corporation's property and equipment are related to operations in Canada.

The Air Canada segment is comprised of the passenger and cargo transportation services business operated by the Corporation and related ancillary services.

The Jazz segment, included up to May 24, 2007, is operating under the Jazz CPA with the Corporation. Effective May 24, 2007, the results of Jazz are not consolidated within Air Canada. Refer to note 1. Pass-through costs, which are non-marked-up costs charged to the Corporation from Jazz, include fuel, airport and user fees and other; these expenses are recorded in the applicable category within the operating expenses in the 2007 results of Air Canada.

Also refer to Note 19 *Related Party Transactions*.

## 16. COMMITMENTS

In 2004, the Corporation signed definitive purchase agreements with Embraer for the acquisition of regional jet aircraft. In November 2005, the Corporation also concluded agreements with The Boeing Company ("Boeing") for the acquisition of Boeing 777 and Boeing 787 aircraft.

**Boeing**

In November 2005, the Corporation concluded agreements with Boeing for the acquisition of up to 36 Boeing 777 aircraft and up to 60 Boeing 787 Dreamliners. The initial order for the 36 Boeing 777 aircraft was comprised of firm orders for 18 aircraft plus purchase rights for 18 more. The initial order for the Boeing 787 aircraft was comprised of firm orders for 14 aircraft plus purchase rights, options and rolling options for 46 aircraft. In conjunction with the initial agreements, the Corporation received financing commitments from Boeing and the engine manufacturer for all firm aircraft orders covering up to 90% of the capital expenditure. This available financing is based on a floating or fixed rate equivalent and was at 8.70% at December 31, 2007. The term to maturity is 15 years with principal payments made on a mortgage style basis resulting in equal instalment payments of principal and interest over the term to maturity.

During 2007, the Corporation amended agreements with Boeing to cancel orders for two Boeing 777 aircraft scheduled for delivery in 2009. In addition, the Corporation increased its order for Boeing 787 aircraft by 23, bringing its total firm orders to 37 Boeing 787 aircraft. The first delivery of the Boeing 787 firm aircraft is scheduled for 2010 and deliveries of all 37 firm aircraft are scheduled to be completed by 2014. As at December 31, 2007, 18 purchase rights for Boeing 777 aircraft and 23 options for Boeing 787 aircraft remained exercisable. In January, 2008, Boeing announced a delay in the production of its first Boeing 787 aircraft from the end of the first quarter of 2008 to the end of the second quarter of 2008 due to production delays. The Corporation has not been notified that its Boeing 787 deliveries have been affected, however, the Corporation expects to receive an update towards the end of the first quarter of 2008.

In conjunction with the amended agreements, the Corporation received additional financing commitments from Boeing for seven of the additional Boeing 787 aircraft (21 Boeing 787 aircraft in total) on the same terms and conditions as described above. Should the Corporation not utilize any of the financing commitments on the Boeing 777 aircraft, the financing commitments for the Boeing 787 aircraft will be increased to 31 aircraft of which the terms for 28 aircraft would be revised to cover 80% of the aircraft delivery price and the term to maturity would be reduced to 12 years with straight-line principal repayments over the term to maturity.

As at December 31, 2007, seven of the Boeing 777 firm aircraft have been delivered with the remaining nine firm deliveries expected to be delivered by end of year 2008. The first seven aircraft were financed under loan guarantee support from EXIM. All of the nine Boeing 777 firm aircraft deliveries expected in 2008 have commitments for loan guarantee support to be provided by EXIM which was signed in January, 2008. The loan guarantee, subject to certain conditions, covers a 12-year loan term for 85 percent of the capital expenditure at an interest rate based on a floating rate. This loan guarantee from EXIM is expected to be used instead of the financing commitments provided by Boeing and the engine manufacturer described above. As a result, it is not expected that any of Boeing's and the engine manufacturer's financing commitments for the Boeing 777 aircraft will be utilized. The firm commitment financing on capital purchase commitments disclosed below reflects this guarantee support for only five aircraft in 2008, given that the Corporation expects to sell and lease back the other four aircraft (see below).

In January 2008, the Corporation signed letters of intent for the sale and lease back of four of the nine Boeing 777 deliveries scheduled for delivery in 2008. The lease term for two of the Boeing 777 aircraft is 12 years. The other two Boeing 777 aircraft each have 10.5 year lease terms and the Corporation has options to extend each for an additional 18 months. All four leases are at market lease rates. This replaces an equivalent number of aircraft loan guarantee support commitments provided by EXIM. As a result, the capital expenditure forecast in the table below does not include expenditures relating to these aircraft. These four aircraft deliveries are included in the operating lease commitments table below. The impact of these leases results in a significant reduction in capital expenditures from what was previously disclosed. Operating lease commitments have increased as a result of this change.

**Embraer**

The agreement with Embraer covers firm orders for 45 Embraer 190 series aircraft. The purchase agreement also contains rights to exercise options for up to 60 additional Embraer 190 series aircraft as well as providing for conversion rights to other Embraer models. As of December 31, 2007, 31 options remain exercisable.

The Embraer 190 series deliveries commenced in December 2005. As at December 31, 2007, 42 of the Embraer 190 series firm aircraft orders have been completed and an additional aircraft was delivered in January 2008. The final two Embraer 190 series firm aircraft are scheduled for delivery in the first quarter of 2008.

The Corporation has received loan commitments from third parties for the remaining three firm aircraft covering approximately 80% of the capital expenditure to be repaid in quarterly instalments for a 12-year term. Two of these aircraft will be based on floating rates at the 90-day US LIBOR plus 1.90% and one will be based at the fixed rate equivalent of the 90-day US LIBOR plus 1.70%.

**Aircraft Interior Refurbishment Program**

In addition to acquiring new aircraft, the Corporation commenced a major refurbishment of the interior of its existing aircraft in April 2006. The Corporation has completed the refurbishment of 26 Airbus A319 aircraft, 30 Airbus A320 aircraft, 10 Airbus A321 aircraft and 15 Boeing 767-300 aircraft to date, for a total of 81 aircraft. The Embraer and Boeing 777 aircraft are being delivered with the new seats and entertainment systems already installed. The capital expenditures associated with this program, which are committed, are amortized over a five-year period. A significant portion of the remaining capital expenditures relating to this program are included in the capital commitments table below.

**Capital Commitments**

The estimated aggregate cost of the future firm deliveries, and other capital purchase commitments as at December 31, 2007 including the impact of the sale and lease back transaction described above and the loan guarantee support signed in January 2008, approximates $4,739 (of which $2,698 is subject to committed financing, subject to the fulfillment of certain terms and conditions). US dollar amounts are converted using the December 31, 2007 noon day rate of CDN$0.9881. 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 US LIBOR rate at December 31, 2007.

| | |
|---|---|
| Year ending December 31, 2008 | $ 555 |
| Year ending December 31, 2009 | 102 |
| Year ending December 31, 2010 | 760 |
| Year ending December 31, 2011 | 891 |
| Year ending December 31, 2012 | 692 |
| Thereafter | 1,739 |
| | **$ 4,739** |

**Operating Lease Commitments**

As at December 31, 2007 the future minimum lease payments under existing operating leases of aircraft and other property amount to $2,108 (December 31, 2006 - $2,957) using year end exchange rates. This also includes payments for aircraft contemplated by letters of intent signed in January 2008 for the sale and lease back of four Boeing 777 aircraft as described above.

| Operating lease commitments | Aircraft | Other Property | Total |
|---|---|---|---|
| Year ending December 31, 2008 | $ 280 | $ 59 | $ 339 |
| Year ending December 31, 2009 | 271 | 42 | 313 |
| Year ending December 31, 2010 | 255 | 36 | 291 |
| Year ending December 31, 2011 | 197 | 33 | 230 |
| Year ending December 31, 2012 | 180 | 32 | 212 |
| Thereafter | 602 | 121 | 723 |
| | **$ 1,785** | **$ 323** | **$ 2,108** |

As described in Note 19, the Corporation subleases certain aircraft to Jazz on a flow through basis, which are reported net on the statement of operations. These subleases relate to 33 Bombardier CRJ-200 aircraft and 15 Bombardier CRJ-705 aircraft. The operating lease commitments under these aircraft, which are recovered from Jazz, are not included in the aircraft operating lease commitments table above but are summarized as follows:

| | |
|---|---|
| Year ending December 31, 2008 | $ 84 |
| Year ending December 31, 2009 | 84 |
| Year ending December 31, 2010 | 76 |
| Year ending December 31, 2011 | 75 |
| Year ending December 31, 2012 | 75 |
| Thereafter | 673 |
| | **$ 1,067** |

The subleases with Jazz have the same terms and maturity as the Corporation's corresponding lease commitments to the lessors.

Lease payments for aircraft classified as capital leases and variable interest entities for accounting purposes are disclosed in Note 8.

As at December 31, 2007, the future minimum non-cancellable commitments for the next 12 months under the capacity purchase agreements with Jazz is approximately $650 and with unaffiliated regional carriers is $20. As described in Note 19, the initial term of the Jazz CPA expires December 31, 2015 with two automatic renewal periods of five years each, subject to either party's right not to renew by notice at least one year prior to the expiration of the then applicable term. As the rates under the Jazz CPA are subject to adjustments beginning in 2009, it is not possible to determine the minimum non-cancellable commitments beyond 2008; however they are not expected to change significantly from the 2008 amount.

## 17. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Under its risk management policy, the Corporation manages its currency risk, interest rate risk, and market risk through the use of various foreign exchange, interest rate, and fuel derivative financial instruments. The Corporation uses derivative financial instruments only for risk management purposes, not for generating trading profit.

**Interest Rate Risk Management**

The Corporation enters into forward interest rate agreements to manage the risks associated with interest rate movement on US dollar and Canadian dollar floating rate debt and investments. During 2006 the Corporation entered into 19 interest rate swaps with a notional value of US$414 to receive floating rates and pay a weighted average fixed rate of 5.81% for the debt to be arranged in relation to the financing of Embraer 190 aircraft between June 2006 and February 2008. The swaps have 15 year terms from the expected delivery date of the aircraft and their maturities range from June 2021 to December 2022. The Corporation has been settling the interest rate swaps upon delivery of the related aircraft. The Corporation did not apply hedge accounting to these derivative instruments. As at December 31, 2007, one contract remains outstanding with a fair value of $2 in favour of the counterparty. (December 31, 2006 - $13 in favour of the counterparty for 12 contracts outstanding) During 2007, 11 contracts settled at a net loss of $10.

The Corporation has entered into interest rate swap agreements with a term to January 2024 which convert lease payments related to two B767 aircraft leases consolidated under AcG-15 from fixed to floating rates. These have not been designated as hedges for accounting purposes. As at December 31, 2007 these two swaps have a fair value of $7 in favour of the Corporation ($4 in favour of the Corporation as at December 31, 2006). The notional amount under these two swaps is $103 (US$104) as at December 31, 2007 (December 31, 2006 - $131 (US$112)).

**Foreign Exchange Risk Management**

The Corporation enters into certain foreign exchange forward contracts or currency swaps to manage the risks associated with foreign currency exchange rates. As at December 31, 2007, the Corporation had entered into foreign currency forward contracts and option agreements on $2,132 (US$2,158) and $26 (EUR$18) of future purchases in 2008 and 2009. The fair value of these foreign currency contracts as at December 31, 2007 is $124 in favour of third parties (December 31, 2006 - $25 in favour of the Corporation on $586 (US$503) of future purchases in 2007). These derivative instruments have not been designated as hedges for accounting purposes.

The Corporation has entered into currency swap agreements for 16 CRJ aircraft operating leases until lease terminations between 2007 and 2011. During 2007 five currency swaps were settled with a fair value of $10 (which was equal to carrying value) (December 31, 2006 - $10 in favour of the counterparties). The Corporation has 11 currency swap agreements remaining. These currency swaps with third parties have a nominal fair value in favour of the Corporation as at December 31, 2007 (December 31, 2006 - $3 in favour of the Corporation). The notional amount under these swaps is $78 (US$79) as at December 31, 2007 (December 31, 2006 - $103 (US$88)). These have not been designated as hedges for hedge accounting purposes.

**Fuel Price Risk Management**

The financial results of the Corporation are impacted by changes in jet fuel prices as a result of the Corporation's inherent dependence on energy for its operations. To manage its exposure to jet fuel prices, the Corporation enters into derivative contracts with financial intermediaries for the purpose of managing volatility in operating cash flows. The Corporation uses derivative contracts on jet fuel and also on other crude oil based commodities, such as heating oil and crude oil, due to the relative limited liquidity of jet fuel derivative instruments on a medium to longer term horizon, since jet fuel is not traded on an organized futures exchange. The Corporation does not purchase or hold any derivative financial instruments for trading purposes.

As of December 31, 2007, approximately 20% of the Corporation's anticipated purchases of jet fuel for 2008 are hedged. The Corporation's contracts to hedge anticipated jet fuel purchases over the 2008 period comprised of jet fuel, heating oil and crude-oil based contract. The Corporation also hedged approximately 3% of its 2009 anticipated jet fuel purchase in heating oil based contracts and 2% of its 2010 anticipated jet fuel purchase in crude oil based contracts.

The following table outlines the notional volumes per barrel along with the weighted average floor and ceiling price for each year currently hedged. These average contract prices represent the equivalent price in West Texas Intermediate ("WTI") using the forward prices for WTI, heating oil, and jet oil as at December 31, 2007:

| Notional Volumes (bbl) | Term | WTI-equivalent Average Floor Price (USD$/bbl) | WTI-equivalent Average Ceiling Price (USD$/bbl) |
|---|---|---|---|
| 4,890,000 | 2008 | $ 77.97 | $ 81.58 |
| 840,000 | 2009 | $ 76.03 | $ 80.92 |
| 480,000 | 2010 | $ 84.20 | $ 88.00 |

The Corporation designates certain of its fuel derivatives as cash flow hedges and applies hedge accounting as prescribed under CICA section 3865, Hedges. Designated hedging items under cash flow hedges result in all period changes in the fair value of the hedging item that are considered effective being recorded in AOCI until the underlying jet fuel is consumed. Upon maturity of the hedging item, the effective gains and losses are recorded in fuel expense. The ineffective component of the change in fair value is recorded in Non-operating income (expense) when it occurs.

Effectiveness is defined as the extent to which changes in the fair value of a hedged item relating to a risk being hedged is offset by changes in the fair value of the corresponding hedging item. The Corporation's accounting policy measures effectiveness based on the change in the intrinsic value of fuel derivatives compared to the change in the intrinsic value of the anticipated jet fuel purchase (based on the Corporation's weighted average price). As the Corporation's current policy does not take into account variables affecting fair value such as volatility and time value of money, a significant component of the change in fair value of outstanding fuel derivatives may be recorded as ineffective under the current policy.

Ineffectiveness is inherent in hedging diversified jet fuel purchases with derivative positions in crude oil and related commodities and in the differences between intrinsic values and fair market values of the derivative instruments, especially given the magnitude of volatility observed in oil market prices. As a result the Corporation is unable to predict the amount of ineffectiveness for each period. This may result, and has resulted, in increased volatility in the accounting results of the Corporation, but has no impact on the underlying cash flows.

If the hedge ceases to qualify for hedge accounting, any period change in fair value of the fuel derivative instrument is recorded in Non-operating income (expense). For those fuel derivatives that do not qualify for hedge accounting, the period changes in fair value of the fuel derivative is recorded in Non-operating income (expense).

During 2007 hedge accounting was discontinued for certain fuel hedge contracts where the hedging relationship ceased to satisfy the conditions for hedge accounting. The value of the AOCI balance recognized in connection with these derivatives will be taken into fuel expense upon the maturity of the contracts. The Corporation still continues to hold these derivatives as it believes they continue to be good economic hedges in managing its exposure to jet fuel prices.

The following information summarizes the financial statement impact of derivatives designated under fuel hedge accounting, before the impact of tax:

- The fair value of outstanding fuel derivatives under hedge accounting at December 31, 2007 is $67 in favour of the Corporation.
- The 2007 benefit to Fuel expense for the year ended December 31, 2007 is $31.
- The Non-operating income (loss) for the year ended December 31, 2007 is $12. The amount in Non-operating income (loss) represents the ineffective portion of the fair value change in items under hedge accounting.
- The effective change in the fair value of derivatives recorded in OCI for the period is $110 before tax expense of $28. OCI amounts for the year ended December 31, 2007 are presented net of this tax expense in the Consolidated statement of comprehensive income.

The estimated net amount of existing gains and losses reported in AOCI that is expected to be reclassified to net income during 2008 is $68.

The following information summarizes the financial statement impact of derivatives not designated under fuel hedge accounting, but held as economic hedges, before the impact of tax:

- The fair value of outstanding fuel derivatives not under hedge accounting at December 31, 2007 is $10 in favour of the Corporation.
- The Non-operating gain for the year ended December 31, 2007 is $26. The amount in Non-operating income (loss) represents the change in fair value of these contracts (realized and unrealized) for the current year.

**Concentration of Credit Risk**

The Corporation does not believe it is subject to any significant concentration of credit risk. Cash and short-term investments are in place with major financial institutions, Canadian governments and major corporations. Accounts receivable are generally the result of sales of tickets to individuals, often through the use of major credit cards, through geographically dispersed travel agents, corporate outlets, or other airlines, often through the use of major credit cards. Refer to Note 7 for a description of ABCP held by the Corporation.

**Financial Instrument Fair Values in the Statement of Consolidated Financial Position**

The carrying amounts reported in the Consolidated statement of financial position for short term financial assets and liabilities, which includes cash and short-term investments, accounts receivable and accounts payable approximate fair values due to the immediate or short-term maturities of these financial instruments. Cash equivalents and short-term investments are classified as held for trading and therefore are recorded at fair value.

The carrying amounts of foreign currency and interest rate swaps and fuel derivatives is equal to the fair value, which is based on the amount at which they could be settled based on estimated current market rates.

The following is a comparison of fair value versus carrying value of the Corporation's long-term debt and capital lease obligations, as at December 31, 2007, which was estimated using valuation techniques based on current market rates of interest for similar financial liabilities:

| | Carrying Value | Estimated Fair Value |
|---|---|---|
| Direct Corporation debt | $ 2,551 | $ 2,611 |
| Debt consolidated under AcG-15 | 896 | 933 |
| Capital lease obligations | 972 | 1,127 |
| | **$ 4,419** | **$ 4,671** |

## 18. CONTINGENCIES, GUARANTEES AND INDEMNITIES

**Contingencies**

Investigation by Competition Authorities Relating to Cargo

The European Commission, the United States Department of Justice and the Competition Bureau in Canada, among other competition authorities, are investigating alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including the Corporation, a number of whom, including the Corporation, have received a statement of objections from the European Commission that sets out the European Commission's preliminary assessment in relation to such matter. Competition authorities have sought or requested information from the Corporation as part of their investigations. The Corporation is cooperating with these investigations which are likely to lead to proceedings against the Corporation and a number of airlines and other cargo operators in certain jurisdictions. The Corporation is also named as a defendant in a number of class action lawsuits that have been filed before the United States District Court and in Canada in connection with these allegations. Management has determined it is not possible at this time to predict with any degree of certainty the outcome of these proceedings, but these proceedings may result in a material liability to the Corporation.

Porter Airlines Inc.

In February 2006, Jazz commenced proceedings before the Ontario Superior Court of Justice against Porter Airlines Inc. ("Porter") and other defendants (collectively the "Porter Defendants") after Jazz became aware that it would be excluded from operating flights from Toronto City Centre (Island) Airport (the "TCCA"). On October 26, 2007, the Porter Defendants counter-claimed against Jazz and Air Canada alleging various violations of competition law, including that Jazz and Air Canada's commercial relationship contravenes Canadian competition laws, and claiming $850 in damages. Concurrently with the Ontario Superior Court of Justice proceedings, Jazz commenced judicial review proceedings against the Toronto Port Authority ("TPA") before the Federal Court of Canada relating to Jazz' access to the TCCA. The Porter Defendants were granted intervener and party status in these proceedings. In January of 2008, Porter filed a defence and counterclaim against Jazz and Air Canada making allegations and seeking conclusions similar to those in the Ontario Superior Court counterclaim. Management views Porter's counterclaims in both jurisdictions as being without merit.

Pay Equity

The Canadian Union of Public Employees ("CUPE"), which represents the Corporation's flight attendant, has a complaint before the Canadian Human Rights Commission where it alleges gender-based wage discrimination. CUPE claims the predominantly female flight attendant group should be paid the same as the predominantly male pilot and mechanics groups because their work is of equal value. The complaint dates from 1991 but has not been investigated on the merits because of a legal dispute over whether the three groups work in the same "establishment" within the meaning of the Canadian Human Rights Act. On January 26, 2006, the Supreme Court of Canada ruled that they do work in the same "establishment" and sent the case back to the Canadian Human Rights Commission, which may now proceed to assess the merits of CUPE's complaint. On March 16, 2007, the Canadian Human Rights Commission referred the complaint against the Corporation for investigation. The Corporation considers that any investigation will show that it is complying with the equal pay provisions of the Canadian Human Rights Act; however, management has determined it is not possible at this time to predict with any degree of certainty the final outcome of the Commission's investigation.

Claim by the Air Canada Pilots Association

In October 2006, ACPA commenced proceedings before the Ontario Superior Court of Justice against Air Canada, ACE and certain members of the board of directors of Air Canada alleging that certain past and future actions are oppressive to it. A variety of remedies were sought against the parties including an injunction to impose, among other things, limits on corporate distributions including those contemplated under the ACE plan of arrangement which became effective on October 10, 2006. Following a hearing in December, 2006, Mr. Justice Cumming of the Ontario Superior Court of Justice dismissed ACPA's application for an injunction and granted respondents' cross-motion to dismiss ACPA's claim. ACPA has not appealed the dismissal of the injunction application but has appealed the order dismissing its claim and the appeal is scheduled to be heard by the Ontario Court of Appeal in March 2008. Management is of the view that the ACPA claim is without merit.

<u>Other Contingencies</u>
Various other lawsuits and claims, including claims filed by various labour groups of Air Canada are pending by and against the Corporation and provisions have been recorded where appropriate. It is the opinion of management that final determination of these claims will not have a significant material adverse effect on the financial position or the results of the Corporation.

With respect to 45 aircraft leases, the difference between the amended rents as a result of the implementation of the Plan of Reorganization, Compromise and Arrangement (the "Plan") under the Companies' *Creditors Arrangement Act* ("CCAA") on September 30, 2004 and amounts due under the original lease contracts will be forgiven at the expiry date of the leases if no material defaults have occurred. If a material default occurs, this difference plus interest will become due and payable and all future rent will be based on the original contracted rates. Rent expense is being recorded on the renegotiated lease agreements and any liability would be recorded only at the time management believes the amount is likely to occur.

**Guarantees**

<u>Guarantees in Fuel Facilities Arrangements</u>
The Corporation participates in fuel facility arrangements operated through fuel facility corporations ("Fuel Facility Corporations"), along with other airlines that contract for fuel services at various major airports in Canada. The Fuel Facility Corporations operate on a cost recovery basis. The purpose of the Fuel Facility Corporations is to own and finance the system that distributes the fuel to the contracting airlines, including leasing the Land Rights under the land lease. The aggregate debt of the five Fuel Facility Corporations in Canada that have not been consolidated by the Corporation under AcG-15 is approximately $119 as at December 31, 2007 (2006 - $108), which is the Corporation's maximum exposure to loss without taking into consideration any cost sharing that would occur amongst the other contracting airlines. The Corporation views this loss potential as remote. Each contracting airline participating in a Fuel Facility Corporation shares pro rata, based on system usage, in the guarantee of this debt.

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

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

When the Corporation, as a customer, enters into technical service agreements with service providers, primarily service providers who operate an airline as their main business, the Corporation has from time to time agreed to indemnify the service provider against liabilities that arise from third party claims, whether or not these liabilities arise out of or relate to the negligence of the service provider, but excluding liabilities that arise from the service provider's gross negligence or willful misconduct.

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

The maximum amount payable under the foregoing indemnities cannot be reasonably estimated. The Corporation expects that it would be covered by insurance for most tort liabilities and certain related contractual indemnities described above.

## 19. RELATED PARTY TRANSACTIONS

At December 31, 2007, ACE has a 75% ownership interest in Air Canada. Air Canada has various related party transactions with ACE and other ACE-related entities, including Aeroplan, Jazz and ACTS Aero. ACTS Aero conducts the business operated by ACTS LP prior to the sale of ACTS LP announced by ACE and completed on October 16, 2007 (refer to Note 20). Also refer to Note 3 for certain related party transactions completed during the Air Canada IPO.

Related party trade balances, as outlined below, mainly arise from the provision of services, including the allocation of employee related costs, as further described in Note 10, the allocation of corporate expenses, as described in Note 3, and centralized cash management activities as described below. Trade balances between the related parties have trade terms which generally require payment 30 days after receipt of invoice.

The related party balances resulting from the application of the related party agreements were as follows:

| | 2007* | 2006 |
|---|---|---|
| **Accounts receivable** | | |
| ACE | $ 9 | $ - |
| Aeroplan | 20 | 6 |
| ACTS / ACTS Aero | 75 | 97 |
| Jazz | 85 | - |
| | **$ 189** | **$ 103** |
| **Prepaid Maintenance** | | |
| ACTS Aero | $ 24 | $ - |
| | **$ 24** | **$ -** |
| **Accounts payable and accrued liabilities** | | |
| ACE | $ - | $ 12 |
| ACTS / ACTS Aero | 88 | 111 |
| Jazz | 71 | - |
| | **$ 159** | **$ 123** |

* Effective May 24, 2007, the results and financial position of Jazz are not consolidated within Air Canada (Note 1).

Revenues and expenses with related parties are summarized as follows:

| | 2007* | | 2006 | |
|---|---|---|---|---|
| **Revenues** | | | | |
| Passenger revenues from Aeroplan related to Aeroplan rewards, net of purchase of Aeroplan miles | $ | 154 | $ | 115 |
| Property rental revenues from related parties | | 46 | | 46 |
| Revenues from information technology services to related parties | | 28 | | 27 |
| Revenues from corporate services and other | | 25 | | 14 |
| Aircraft sublease revenues from Jazz | | 14 | | - |
| Air Canada Ground Handling revenues from related parties | | 33 | | - |
| Cargo revenues from related parties | | 3 | | 4 |
| | **$** | **303** | **$** | **206** |
| **Expenses** | | | | |
| Maintenance expense for services from ACTS / ACTS Aero | $ | 631 | $ | 614 |
| Expense from CPA with Jazz | | 537 | | - |
| Pass through fuel expense from Jazz | | 197 | | - |
| Pass through airport expense from Jazz | | 120 | | - |
| Pass through other expense from Jazz | | 17 | | - |
| Other expenses | | 12 | | 49 |
| Recovery of wages, salary and benefit expense for employees assigned to related parties | | (412) | | (413) |
| | **$** | **1,102** | **$** | **250** |
| **Net interest expense (income) from related parties** | **$** | **(1)** | **$** | **6** |

* Effective May 24, 2007, the results and financial position of Jazz are not consolidated within Air Canada (Note 1).

In addition to the above revenues and expenses with Jazz, the Corporation transfers fuel inventory and sub leases certain aircraft to Jazz on a flow through basis, which are reported net on the statement of operations.

The Corporation held certain investments in Aeroplan, Jazz and ACTS. As described in Note 3, certain cash payments and notes received from ACE on transfer of these investments to ACE have been included in these consolidated financial statements as a contribution from ACE to Shareholders' Equity.

**Summary of significant related party agreements**

***The Relationship between the Corporation and Aeroplan***

ACE has reported holding a 20.1% ownership interest in Aeroplan Income Fund at December 31, 2007. Aeroplan operates a loyalty program which provides loyalty marketing services to its customers. The transactions between the Corporation and Aeroplan described below are recorded at the exchange amount and are settled by netting amounts payable against amounts receivable in accordance with the inter-company agreements with any outstanding balance paid in the subsequent period. Accordingly, at December 31, 2007 and December 31, 2006, the amounts have been presented on a net basis as the parties intend to settle on a net basis.

Aeroplan Commercial Participation and Services Agreement (Aeroplan CPSA)
Air Canada and Aeroplan are parties to the Aeroplan CPSA dated June 9, 2004. Pursuant to the Aeroplan CPSA, the Corporation allocates 8% of the seat capacity to Aeroplan on the flights operated by Air Canada and Jazz and certain other air carriers under the Air Canada code (collectively, the "AC Flights") at a fixed redemption cost. In 2007, the rates charged for such seat capacity were renegotiated in accordance with the Aeroplan CPSA for the period January 1, 2008 through to December 31, 2010. Aeroplan may also purchase an unlimited number of available seats based on published fares with a variable discount depending on the fare product. Any adjustment to this variable discount is based on an identified set of parameters. The Aeroplan CPSA also provides that Aeroplan will be charged the lowest fares charged to any other loyalty program taking into account Aeroplan's volume purchase of the Corporation's seat inventory. The Aeroplan CPSA expires June 29, 2020 with four automatic renewals of five year each, unless either party provides notice of its intention not to renew at least twelve months prior to the expiry of the applicable term.

Air Canada is one of Aeroplan's leading partners and it pays a fee to participate in the Aeroplan program, which fee is based on the Aeroplan miles awarded to Aeroplan members who are Air Canada customers traveling on AC Flights. Aeroplan is required to purchase a minimum number of reward travel seats on AC Flights annually, 2007 - $171 (2006 - $170), which number is a function of Aeroplan's consumption of seats in the three preceding calendar years. Moreover, the Corporation is required to purchase a minimum number of Aeroplan miles annually.

The Aeroplan CPSA also provides that Aeroplan shall, in return for a service fee, manage the Corporation's frequent flyer tier membership program for Air Canada Super Elite™, Elite™ and Prestige™ customers, as well as perform certain marketing and promotion services for the Corporation, including call centre services for the frequent flyer tier membership program.

Aeroplan Master Services Agreement (Aeroplan MSA)

Air Canada and Aeroplan are parties to the Aeroplan MSA effective January 1, 2005 pursuant to which, the Corporation provides certain services to Aeroplan in return for a fee based on the Corporation's fully allocated cost of providing such services to Aeroplan plus a mark-up to reflect overhead and administrative costs. Pursuant to the Aeroplan MSA, the Corporation provides Aeroplan with infrastructure support which is mostly administrative in nature, including information technology, human resources, finance and accounting, and legal services. Amounts related to the MSA are included in the table summarizing related party revenues and expenses under Revenues from corporate services and other.

Aeroplan General Services Agreement (Aeroplan GSA)

Air Canada and Aeroplan are parties to the Aeroplan GSA effective January 1, 2005 pursuant to which the Corporation provides Aeroplan with the services of a group of call centre employees of the Corporation. Aeroplan must reimburse Air Canada for all costs, including salary and benefits, related to the call centre employees on a fully allocated basis. With regard to the shortfall in the pension plan maintained by the Corporation, which covers, among others, these call centre employees, Aeroplan has agreed to pay an amount not to exceed $11 over a six year period ending in 2013 to compensate the Corporation for call centre employees' share of the unfunded Air Canada pension liability. Either party may, subject to collective agreements of the employees assigned to Aeroplan, terminate the GSA upon six months notice.

Trademark License Agreement

Pursuant to a Trademark License Agreement effective May 13, 2005, Air Canada and Aeroplan have granted each other reciprocal royalty-free, non-exclusive, non-sublicensable, non-assignable rights to use certain of each other's trademarks around the world which incorporate their names or logos, solely in association with the Aeroplan Program. No fees were charged or earned under this agreement for 2007 and 2006.

***The Relationship between the Corporation and Jazz***

ACE reported a 20.1% ownership interest in Jazz Air Income Fund at December 31, 2007. On January 24, 2008, ACE's ownership interest in Jazz Air Income Fund was reported to have been reduced to 9.5%. Air Canada has no ownership interest in Jazz. Jazz is consolidated in these consolidated financial statements under AcG-15 up to May 24, 2007. Jazz is still considered to be a variable interest entity to the Corporation, however, is no longer the primary beneficiary under AcG-15 (refer to Note 1). The deconsolidation of Jazz does not impact any of the contractual arrangements between Air Canada and Jazz.

In addition to the agreements summarized below, Air Canada and Jazz are also parties to a number of lease agreements pursuant to which Jazz leases or subleases, from the Corporation, certain premises at airports across Canada. Refer to Note 16, Commitments for further details.

Jazz Capacity Purchase Agreement (Jazz CPA)

Air Canada and Jazz are parties to the Jazz CPA, effective January 1, 2006, pursuant to which the Corporation purchases substantially all of Jazz's fleet capacity based on predetermined rates, in addition to reimbursing Jazz, without mark-up, for certain pass-through costs as defined in the Jazz CPA which include fuel, airport and navigation fees. The fees include both a variable component that is dependent on Jazz aircraft utilization and a fixed component. The initial term of the Jazz CPA expires December 31, 2015. There are two automatic renewal periods of five years each, subject to either party's right not to renew by notice at least one year prior to the expiration of the then applicable term. The rates under the Jazz CPA are subject to periodic adjustment with the next adjustment scheduled for the start of 2009. Amounts related to the CPA are included on the Expense from CPA with Jazz line in the table above.

Jazz Master Services Agreement (Jazz MSA)

Air Canada and Jazz are parties to the Jazz MSA pursuant to which the Corporation provides certain services to Jazz in return for a fee based on the fair market value of the services provided by the Corporation to Jazz. Pursuant to the Jazz MSA, the Corporation provides Jazz with infrastructure support consisting principally of administrative services in relation with information technology, corporate real estate, environmental affairs and legal services. Jazz benefits from certain information technology services available to the Corporation from third parties and from the Corporation's internal information technology resources.

Either Air Canada or Jazz may elect to terminate any services under the Jazz MSA (without terminating the whole Jazz MSA) or the entire Jazz MSA upon one year's prior written notice. The Jazz MSA terminates upon the termination of the Jazz CPA.

Jazz Trademark License Agreements

Air Canada and Jazz are parties to the Jazz Trademark License Agreement pursuant to which the Corporation has granted Jazz a royalty-free, non-exclusive, non-sublicensable, non-assignable right to use certain trademarks owned or registered by the Corporation around the world including "Jazz" and certain trademarks which incorporate the Air Canada name, and/or Air Canada's roundel design, solely in association with the Jazz business. The Jazz Trademark License Agreement can be terminated in the event that the Jazz CPA is terminated. However, Air Canada and Jazz have also entered into a Jazz Special Trademark Agreement which would grant all of the Corporation's rights to the Jazz trademark to Jazz (and preclude the Corporation from using the Jazz trademark or licensing the Jazz trademark to third parties) upon the occurrence of certain events involving (i) the expiration or termination of the Jazz CPA if, at such time, Jazz is no longer an affiliate of the Corporation; (ii) the occurrence of a change of control pursuant to which Jazz ceases to be an affiliate of the Corporation if, at or prior to such time, the Jazz CPA has expired or has been terminated; or (iii) the sale or transfer of all or substantially all of the assets or business of Jazz to a third party that is not an affiliate of the Corporation if, at or prior to such time, the Jazz CPA has expired or has been terminated.

***The Relationship between the Corporation and ACTS***

As described in Note 20, on October 16, 2007, ACE announced the completion of the sale of ACTS LP pursuant to which ACTS LP sold substantially all of its assets, liabilities and business to ACTS Aero. ACTS Aero conducts the business previously operated by ACTS LP.

The ACTS Maintenance Agreements, the ACTS Master Services Agreement, the ACTS Trademark License Agreement, the Repair Schemes and Non-Compete Agreement and the ACTS General Services Agreements, all between Air Canada and ACTS LP and described below and in Note 20 were assigned from ACTS LP to ACTS Aero upon closing of the monetization of ACTS. On closing of the ACTS sale, Air Canada recorded proceeds of \$28 for the sale of a building to ACTS Aero, \$17 for the settlement of a intercompany note with ACTS LP, \$20 pursuant to the transfer of repair schemes and the funding of a letter of credit in the amount of \$101 related to a "*Pension and Benefits Agreement*" as described in Note 20. ACTS Aero is a related party to Air Canada due to ACE's investment in both entities.

ACTS Maintenance Agreements

ACTS Aero and Air Canada are parties to a general terms and related services agreements effective October 1, 2006, pursuant to which ACTS Aero provides technical services to the Corporation including engine and auxiliary power unit maintenance services, aircraft heavy maintenance services (excluding line and cabin maintenance services which are provided by the Corporation), component maintenance services, paint services, training services and ancillary services. ACTS Aero serves as the Corporation's exclusive repair agency in respect of aircraft heavy maintenance, engine maintenance, auxiliary power unit maintenance services as well as for maintenance services relating to certain components. ACTS Aero serves as the Corporation's non-exclusive repair agency in respect of other services provided. Except for the services agreement relating to aircraft heavy maintenance services, which expires in October 2011, and the services agreement relating to paint services, which expires in October 2009, each of the agreements referred to above expires in October 2013.

ACTS Aero and Jazz are parties to a component maintenance agreement (the "ACTS-Jazz Agreement") dated August 1, 2005, pursuant to which ACTS Aero provides selected maintenance, repair, overhaul and related services with respect to Jazz's CRJ aircraft. Pursuant to the ACTS-Jazz Agreement, ACTS Aero serves as Jazz's exclusive repair agency to provide component repair and overhaul work on parts which can be removed from the aircraft in respect of CRJ-100/200 and common CRJ-705 parts not performed internally by Jazz employees. The initial term of the ACTS-Jazz Agreement expires in August 2015 and it is renewable for three successive two-year periods. The amounts related to the ACTS Maintenance Agreements and other maintenance agreements with Jazz are recorded in the above table summarizing related party revenues and expenses under Maintenance expense from ACTS. Jazz amounts with ACTS are not reported for the period after deconsolidation on May 24, 2007.

ACTS Master Services Agreement (ACTS MSA)

ACTS Aero and Air Canada are parties to an amended and restated master services agreement (the "ACTS MSA"), effective January 1, 2007, pursuant to which the Corporation provides ACTS Aero with services including infrastructure support and services which are mostly administrative in nature, including information technology, human resources, finance and accounting, and claims services in return for fees paid by ACTS Aero to the Corporation. ACTS Aero may elect to terminate any services under the ACTS MSA or the entire ACTS MSA upon six months' prior written notice, with the exception of services relating to information technology which ACTS Aero cannot terminate prior to the expiry of the ACTS MSA. Air Canada may elect to terminate any services under the ACTS MSA or the entire ACTS MSA upon 18 months' prior written notice. These amounts are recorded in the above table summarizing related party revenues and expenses under Revenues from corporate services and other.

ACTS Trademark License Agreement

ACTS Aero and Air Canada are parties to a trademark license agreement (the "ACTS Trademark License Agreement"), effective September 30, 2004, pursuant to which the Corporation has granted ACTS Aero a royalty-free, non-exclusive, non-assignable right to use certain Air Canada trademarks which incorporate the Air Canada name, and Air Canada's roundel design, solely in association with the provision of heavy maintenance, component maintenance and supply chain business services in Canada and the United States. The ACTS Trademark License Agreement was amended on closing of the sale of ACTS LP to provide for the termination of the agreement on October 16, 2008.

ACTS General Services Agreements

ACTS Aero and Air Canada are parties to an amended and restated general services agreement (the "ACTS GSA"), effective as of June 22, 2007, pursuant to which the Corporation provides ACTS Aero with the services of a group of unionized employees for which the Corporation is reimbursed by ACTS Aero for all costs, including salary and benefits, on a fully allocated basis. The ACTS GSA may be terminated by either party at any time upon 30 days' prior written notice.

Real Estate Agreements

As part of the closing of the monetization of ACTS LP, Air Canada sold a building to ACTS Aero for proceeds of $28 effective as of October 16, 2007. In connection with the sale, Air Canada and ACTS Aero entered into a land sublease for certain land contiguous with the building and a service contract whereby the Corporation provides ACTS Aero certain services related to the operation of the building.

Loan and Prepayment Agreements between ACTS and Air Canada

Pursuant to a Prepayment Agreement dated October 26, 2006, Air Canada prepaid an amount of approximately $595 to ACTS LP (the predecessor to ACTS LP and ACTS Aero) under the ACTS Maintenance Agreements for the estimated equivalent of 12 months of service to be rendered by ACTS to Air Canada under the ACTS Maintenance Agreements starting on November 1, 2006. The amount of such prepayment was immediately loaned back by ACTS LP to Air Canada pursuant to a loan agreement dated October 26, 2006. Such loan was non-interest bearing and repayable in instalments starting on November 1, 2006. The amount of the instalments was equal to the amount that would otherwise have been payable by Air Canada under the ACTS Maintenance Agreements and became due and payable on the day on which the amount became payable under the ACTS Maintenance Agreements. Repayment of the entire amount of the loan was completed in 2007.

ACTS Aero and Air Canada are parties to a master lease agreement, effective as of October 1, 2006, pursuant to which ACTS Aero leases space from the Corporation at the Vancouver, Winnipeg, Toronto and Montreal airports.

As described in Note 20, the non unionized employees were transferred to ACTS on October 16, 2007. Post October 16, 2007, the non-unionized employees of ACTS are not covered under the GSA.

Cash Management System

Air Canada manages the cash for ACTS up to October 2007. All cash collected from billings and sources other than Air Canada is recorded by Air Canada on a daily basis. Any payments to pay obligations related to operating and financing costs and capital expenditures other than obligations to the Corporation and other ACE affiliates were made through the Air Canada cash management system. Inter-company accounts receivable and payable include any excess cash (cash proceeds greater than cash expenditures), cash deficiencies (cash expenditures greater than proceeds) or deferrals of receipts of payments. The Consolidated statement of cash flows reflects the receipt and repayment of excess cash as a financing activity and the disbursement and repayment of cash deficiencies as investing activities.

**The Relationship between the Corporation and ACE**

Master Services Agreement

Air Canada provides certain administrative services to ACE in return for a fee. Such services relate to finance and accounting, information technology, human resources and other administrative services.

Share Purchase Rights Sold by Air Canada to ACE

During 2007, Air Canada entered into an aircraft transaction with an unrelated third party whereby partial consideration was paid to the Corporation in the form of the right to acquire shares of the unrelated third party. The Corporation recorded the value of the share purchase rights at fair value of $1. The transaction related to the sale by the Corporation of two Airbus A319 aircraft and the sublease by the Corporation of an additional two Airbus A319 aircraft, all of which was completed in 2007 with the exception of one of the owned Airbus A319 aircraft, which was completed in 2008. The Corporation sold the right to acquire the shares received from the unrelated third party to ACE, for proceeds of $1.

Warrants purchased from ACE

On November 26, 2007, Air Canada purchased certain share warrants held by ACE for consideration of $4, which was paid during the year and recorded as a decrease to contributed surplus. These warrants are for the purchase of shares of an unrelated third party from which the Corporation purchases services. The equity of the unrelated third party is not quoted in an active market and therefore fair value is not reliably measurable. As such, the financial instrument is recorded at cost, being the carrying amount in ACE of nil.

Purchase of Air Canada Vacations

During 2007, Air Canada purchased from ACE its 49% interest in Air Canada Vacations causing Air Canada Vacations to be wholly owned by the Corporation. Consideration for the interest was $10. The consideration is accounted for on the Consolidated statement of financial position in contributed surplus. Air Canada Vacations remains consolidated within the results of the Corporation.

## 20. SALE OF ACTS

On October 16, 2007, ACE announced the completion of the sale of ACTS LP, its wholly owned maintenance, repair and overhaul subsidiary, pursuant to which ACTS LP sold substantially all its assets, liabilities and business to ACTS Aero, a new entity established to purchase the assets of ACTS LP, with ACE retaining a 23% interest in ACTS Aero.

On closing of the ACTS Sale, the following transactions were recorded by Air Canada:

- Proceeds of $28 for the sale of a building to ACTS Aero (refer to Note 4).
- Proceeds of $17 for the settlement of a related party receivable with ACTS.
- Proceeds of $20 pursuant to the Repair Schemes and Non-Compete Agreement described below
- The funding of a letter of credit in the amount of $101 related to the "Pension and Benefits Agreement" as described below.

The ACTS Maintenance Agreements, the ACTS Master Services Agreement, the ACTS Trademark License Agreement, and the General Services Agreements, all between Air Canada and ACTS and as described in Note 19, and the Repair Schemes and Non-Compete Agreement described below were assigned from ACTS to ACTS Aero upon closing of the ACTS Sale.

**Pension and Benefits Agreement**

The Corporation, ACTS and ACTS Aero entered into a Pension and Benefits Agreement effective as of October 16, 2007 ("Pension and Benefits Agreement"), relating to pension and benefits arrangements pertaining to (i) the non-unionized employees of Air Canada who were previously assigned to the ACTS operation became employees of ACTS Aero on October 16, 2007 and (ii) unionized employees of Air Canada who were assigned to ACTS Aero operation pursuant to general services agreements between Air Canada and ACTS for the assignment of unionized employees from Air Canada to ACTS (these agreements were assigned to ACTS Aero upon closing of the ACTS Sale). New defined benefit and defined contribution pension plans as well as other employee and retiree benefit arrangements (including health, life and disability) are being established by ACTS Aero (the "ACTS Benefit Arrangements").

Upon receipt of regulatory approval where required and based upon valuations of the relevant pension and benefit arrangements of Air Canada (the "Air Canada Benefit Arrangements") as at October 16, 2007, the assets and obligations under the Air Canada Benefit Arrangements pertaining to the transferring non-unionized employees will be transferred to ACTS Aero or the ACTS Benefit Arrangements, as applicable. Amounts with a present value equal to the solvency deficiency in the defined benefit pension plans as at October 16, 2007 related to transferring non-unionized employees will be paid by Air Canada through quarterly payments to ACTS Aero until 2014. Amounts with a present value equal to the accounting liability as at October 16, 2007 in respect of retiree and disability benefits related to transferring non-unionized employees will be paid by Air Canada through quarterly payments to ACTS Aero until 2012. The present value of these quarterly payments is also referred to as the compensation amount. Until such future time as the assets and obligations under the Air Canada Benefit Arrangements pertaining to non-unionized employees may be transferred to ACTS Aero, the current service pension cost and the current service and interest costs for other employee benefits will be expensed by Air Canada with a full offset recorded as an amount charged to affiliates (ACTS Aero).

In addition, the Pension and Benefits Agreement contemplates similar asset and liability transfer and compensation arrangements in respect of unionized employees, which arrangements would take effect at such future time as those unionized employees may be transferred from Air Canada to ACTS Aero. However, the solvency deficiencies in respect of transferring unionized employees for which the future quarterly compensation payments would be made are determined as at October 16, 2007, subject to certain adjustments, and the discount rate used to compute the accounting liability for the unionized employees' retiree and disability benefits is fixed as at October 16, 2007. The compensation payments in respect of these solvency deficiencies and accounting liabilities would be made quarterly during the five years beginning after the unionized employees are transferred to ACTS Aero, but only if such a transfer occurs. Until such future time as the assets and obligations under the Air Canada Benefit Arrangement pertaining to unionized employees may be transferred to ACTS Aero, the current service pension cost and the current service and interest costs for other employee benefits in respect of Air Canada employees providing services to ACTS Aero are charged to ACTS Aero.

The Pension and Benefits Agreement also required that Air Canada provide letters of credit to ACTS Aero on October 16, 2007, to secure the above-described payment obligations in respect of the solvency deficiencies of the defined benefit pension plans and accounting liabilities for other retiree and disability benefit arrangements. The letters of credit total $101, subject to adjustment once the exact amounts of the relevant solvency deficiencies and accounting liabilities as at October 16, 2007 are determined by actuarial valuations. The face amount of the letter of credit in respect of the unionized solvency deficiency is also adjusted annually to recognize past service costs paid by Air Canada to the plan in respect of unionized employees assigned to ACTS Aero. The face amount of the letters of credit decreases as the related quarterly funding payments described above are made. ACTS Aero may call the letters of credit in whole or in part, in the event of a default as defined in the Pension and Benefits Agreement. Collateral equal to the amount of the letters of credit was paid in cash with the asset recorded in Deposits and other assets.

***Non-Compete and Repair Schemes Transfer Agreement***

ACTS Aero and Air Canada are parties to a non-compete and repair schemes transfer agreement, effective as of October 16, 2007 (the "Repair Schemes and Non-Compete Agreement"). Generally described, repair schemes are processes and methods which may be used in the maintenance and repair of aircraft and related equipment. The Repair Schemes and Non-Compete Agreement confirmed an arrangement and provides for the sale from Air Canada to ACTS Aero (as successor to ACTS LP) of an undivided joint ownership interest in repair schemes owned by Air Canada or approved under Air Canada's airworthiness engineering organization as well as the sale from ACTS Aero to Air Canada of an undivided joint ownership interest in the repair schemes owned or developed by ACTS Aero and applicable to airframe heavy maintenance services provided by ACTS to Air Canada under the parties' airframe heavy maintenance services agreement. However, in September 2004 as part of the implementation of the Corporation's plan of arrangement under the Companies' Creditors Arrangement Act, the Corporation had already granted ACTS full and exclusive right to these schemes on a royalty free basis.

The Repair Schemes and Non-Compete Agreement also restricts Air Canada's ability to own any equity interest in an entity (other than entities in which Air Canada previously held interests), or to carry on a business activity, related to the following commercial maintenance, repair and overhaul services in the airline industry, namely, airframe heavy maintenance and paint services, engine and auxiliary power unit ("APU") overhaul maintenance services, and component maintenance services. The applicable non-compete periods are as follows:

- With respect to airframe heavy maintenance services and paint services, the non-compete period ends one year after the current heavy maintenance services agreement is terminated or expires (the current term of the heavy maintenance services agreement expires October 1, 2011);
- With respect to engine and APU overhaul maintenance services, the non-compete period ends on October 1, 2015; and
- With respect to component maintenance services, the non-compete period ends on October 1, 2016;

The Repair Schemes and Non-compete Agreement does not restrict Air Canada from holding interests in any entities in which it held interests at the time of concluding the agreement nor does it limit Air Canada's line maintenance activities which it continues to operate.

In consideration for the transfer of the repair schemes, Air Canada received $20. These proceeds were recorded in financing activities on the Consolidated statement of cash flows and a credit of $20 was recorded in contributed surplus ($15 after future income tax) as the transaction was recorded at the Corporation's carrying amount of nil.

The Repair Schemes and Non-Compete Agreement was assigned to ACTS Aero upon closing of the ACTS Sale.

## 21. JAZZ IPO

On February 2, 2006, Jazz Air Income Fund completed an initial public offering of its fund units. The Jazz Fund is an unincorporated, open-ended trust. With the proceeds of the initial public offering, the Jazz Fund subscribed for 23.5 million units of Jazz at a price of $10.00 per unit for net proceeds of $218, net of offering costs of $17 that were paid during Quarter 1 2006. Concurrent with the closing of the initial public offering, Jazz received proceeds of $113, net of fees of $2, representing the drawing under a new term credit facility (refer to Note 8).

On February 27, 2006, following the exercise of the over-allotment option by the underwriters, the Jazz Air Income Fund issued an additional 1.5 million units at a price of $10.00 per unit for additional net proceeds of approximately $14. The proceeds of the over allotment were used to acquire 1,500,000 Jazz partnership units from ACE.

In connection with the initial public offering, Jazz Air Limited Partnership transferred substantially all of its assets and liabilities to the new Jazz Air LP that was wholly owned by ACE. In consideration ACE received 99,365,143 units of the Jazz Air LP partnership and an acquisition promissory note of $424. The acquisition promissory note was repaid by Jazz Air LP to ACE from proceeds it received from the offering, a drawdown under its new term credit facility (Note 8) and out of the working capital of Jazz Air LP.

## 22. SPECIAL CHARGE FOR AEROPLAN MILES

In 2001, Air Canada established Aeroplan Limited Partnership as a limited partnership wholly owned by Air Canada. The Aeroplan loyalty program was previously a division of Air Canada.

Under the Commercial Participation and Services Agreement (CPSA) between Air Canada and Aeroplan, Air Canada retained responsibility for the 103 billion Miles to be redeemed from accumulations up to December 31, 2001. Aeroplan assumed responsibility for all Miles issued beginning January 1, 2002. On December 31, 2001, there were 171 billion Miles outstanding of which, after considering breakage, management estimated that 103 billion Miles would be redeemed.

In 2006, management of Air Canada and Aeroplan re-estimated the number of Miles expected to be redeemed from accumulations up to December 31, 2001. As a result, management of Air Canada and Aeroplan concluded that they expected that 112 billion Miles would be redeemed compared to the original estimate of 103 billion. Pursuant to the terms of the CPSA, dated June 9, 2004, as amended, the management of Air Canada and Aeroplan agreed to further amend the terms of the CPSA. Effective October 13, 2006, by amendment, Air Canada assumed responsibility for the redemption of up to 112 billion Miles and, as a result, recorded a special charge of $102 for the incremental 9 billion Miles against Operating revenues in the year ended December 31, 2006 and increased Aeroplan deferred revenues. This amendment to the CPSA represented full and final settlement with Aeroplan of Air Canada's obligations for the redemption of pre-2002 Miles. Aeroplan is responsible for any redemption of Miles in excess of the re-estimated 112 billion Miles. The amount of the additional liability was determined by valuing the incremental Miles at fair value.

# OFFICERS

| | |
|---|---|
| **David I. Richardson** | Chairman of the Board |
| **Montie Brewer** | President and Chief Executive Officer |
| **Duncan Dee** | Executive Vice President, Customer Experience and Chief Administrative Officer |
| **Rob Reid** | Executive Vice President and Chief Operating Officer |
| **Michael Rousseau** | Executive Vice President and Chief Financial Officer |
| **Benjamin M. Smith** | Executive Vice President and Chief Commercial Officer |
| **Lise Fournel** | Senior Vice President, E-Commerce and Chief Information Officer |
| **Kevin Howlett** | Senior Vice President, Employee Relations |
| **Alan Butterfield** | Vice President, Air Canada Maintenance and Engineering |
| **Yves Dufresne** | Vice President, International and Regulatory Affairs |
| **Lucie Guillemette** | Vice President, Revenue Management |
| **Julie Laviolette** | Vice President, Procurement |
| **Priscille LeBlanc** | Vice President, Corporate Communications |
| **David Legge** | Vice President, Flight Operations |
| **Charlie D. McKee** | Vice President, Marketing |
| **Scott Morey** | Vice President, Labour Relations |
| **Marc Rosenberg** | Vice President, Sales and Product Distribution |
| **David J. Shapiro** | Vice President and General Counsel |
| **Daniel Shurz** | Vice President, Network Planning |
| **Susan Welscheid** | Vice President, Customer Service, In-Flight and Call Centres |
| **Carolyn M. Hadrovic** | Corporate Secretary |
| **Chris Isford** | Controller |
| **Chantal Baril** | President and Chief Executive Officer, ACGHS |
| **Claude Morin** | President and Chief Executive Officer, Air Canada Cargo |

# DIRECTORS

| | |
|---|---|
| **David I. Richardson** | Corporate Director and Chairman of the Board, Air Canada, Grafton, Ontario |
| **Bernard Attali** | Senior Advisor (France), TPG Capital, Paris, France |
| **Montie Brewer** | President and Chief Executive Officer, Air Canada, Hudson, Quebec |
| **Brian Dunne** | Executive Vice President and Chief Financial Officer, ACE Aviation Holdings Inc., Westmount, Quebec |
| **Pierre Marc Johnson** | Senior Counsel, Heenan Blaikie LLP, Montreal, Quebec |
| **Robert G. Long** | Corporate Director, Thornhill, Ontario |
| **Arthur T. Porter** | Director General and Chief Executive Officer, McGill University Health Centre, Montreal, Quebec |
| **Vagn Sørensen** | Corporate Director, Holte, Denmark |
| **Marvin Yontef** | Senior Partner, Stikeman Elliott LLP, Toronto, Ontario |

# Investor and Shareholder Information

Price Range and Trading Volume of Air Canada Variable Voting Shares (AC.A)

| 2007 | High | Low | Volume Traded |
|---|---|---|---|
| 1st Quarter | $ 20.39 | $ 16.13 | 15,727,182 |
| 2nd Quarter | $ 18.24 | $ 13.22 | 13,376,529 |
| 3rd Quarter | $ 14.74 | $ 10.00 | 13,682,103 |
| 4th Quarter | $ 17.47 | $ 11.46 | 20,831,220 |
| | | | 63,617,034 |

Price Range and Trading Volume of Air Canada Voting Shares (AC.B)

| 2007 | High | Low | Volume Traded |
|---|---|---|---|
| 1st Quarter | $ 20.25 | $ 16.13 | 7,650,137 |
| 2nd Quarter | $ 17.70 | $ 13.38 | 8,141,739 |
| 3rd Quarter | $ 14.59 | $ 10.10 | 5,327,295 |
| 4th Quarter | $ 17.40 | $ 11.45 | 4,577,285 |
| | | | 25,696,456 |

## Duplicate Communication

Shareholders receiving more than one copy are requested to call 1-800-387-0825 or write to the Transfer Agent and Registrar, CIBC Mellon Trust Company at the following address:
2001 University Street, Suite 1600, Montreal, Quebec H3A 2A6

Inquiries may be submitted by electronic mail to inquiries@cibcmellon.com

## Restrictions on Voting Securities

The Air Canada Public Participation Act and the articles of Air Canada limit ownership of the airline's voting interests by all non-residents of Canada to a maximum of 25%. The Canada Transportation Act (CTA) also requires that Canadians own and control at least 75% of the voting interests of licensed Canadian carriers. Since Air Canada is a licence holder, Air Canada's articles contain restrictions to ensure that it remains "Canadian" as defined under the CTA. The restrictions in Air Canada's articles provide that non-Canadians can only hold variable voting shares of Air Canada, that such variable voting shares will not carry more than 25% of the aggregate votes attached to all issued and outstanding voting shares and that the total number of votes cast by the holders of such variable voting shares at any meeting will not exceed 25% of the votes that may be cast at such meeting.

## For Further Information

**Shareholder Relations**
Assistant Secretary, Shareholder Relations
Telephone: (514) 205-7856
Facsimile: (514) 205-7859

**Investor Relations**
Director, Investor Relations
Telephone: (514) 422-7849
Facsimile: (514) 422-7877

**Head Office**
Air Canada Centre
7373 Côte-Vertu Blvd. West
Dorval, Quebec H4Y 1H4

**Internet**
www.aircanada.com

Air Canada complies with the guidelines adopted by the Toronto Stock Exchange.

**Transfer Agents and Registrar**
CIBC Mellon Trust Company
Telephone: 1-800-387-0825
Halifax, Montreal, Toronto,
Calgary and Vancouver.

Ce rapport annuel est publié dans les deux langues officielles du Canada. Pour en recevoir un exemplaire en français, veuillez écrire à la Secrétaire adjointe – Relations avec les actionnaires.

Designed and produced in-house by the Air Canada Multimedia Centre
Translated by:
Air Canada Linguistic Services
Printing: Integria Inc.

## ENGLISH OR FRENCH, IT'S THE CLIENT'S CHOICE.

**Official Languages at Air Canada**

For Air Canada, offering service in the language chosen by its customers is essential. Verbal exchanges with clients, public-address announcements at the airport and on board, briefing of passengers with special needs all constitute the very heart of customer service and call upon our employees linguistic skills at all times. Our consideration to bilingualism not only makes good sense customer-wise, but also supports our legal obligations to serve the public in the two official languages of Canada.

Air Canada puts great efforts to better serve clients in the language of their choice. It is through reach-out activities with the minority language communities as well as ongoing employee awareness and training that we can face the daily challenges, whether it is the growing difficulty to recruit bilingual candidates outside the province of Québec and the national capital region, or for our employees to maintain their language skills with very little opportunities to practice the acquired language in some regions of the country.

## Corporate Profile

Air Canada is Canada's largest domestic and international full-service airline and the largest provider of scheduled passenger services in the domestic market, the transborder market and each of the Canada-Europe, Canada-Pacific, Canada-Caribbean/Central America and Canada-South America markets. Passenger transportation is the principal business of the Corporation and, in 2007, represented 88% of its total operating revenues.

Air Canada and Jazz, the Corporation's regional carrier, operate an extensive domestic, transborder and international network. During 2007, Air Canada and Jazz operated, on average, approximately 1,370 scheduled flights each day and carried over 33 million passengers. In 2007, Air Canada and Jazz provided direct passenger air transportation to 158 destinations and, through commercial agreements with other unaffiliated regional airlines referred to as tier III carriers, to an additional 14 destinations, for a total of 172 direct destinations on five continents. The Corporation's primary hubs are located in Toronto, Montreal, Vancouver and Calgary.

Air Canada also operates an extensive global network in conjunction with its international partners. Air Canada is a founding member of the Star Alliance, the world's largest airline alliance group. The Star Alliance has grown, since its inception, to include 19 members and three regional members. Through its strategic and commercial arrangements with Star Alliance members and several other airlines, Air Canada offers service to 897 destinations in 160 countries, with reciprocal participation in frequent flyer programs and use of airport lounges.

The Corporation provides tour operator services and leisure vacation packages through Touram LP (Air Canada Vacations). The Corporation also provides Cargo Services through Air Canada and AC Cargo LP and Groundhandling Services through ACGHS LP.

**aircanada.com**

vancouver 2010

vancouver 2010
PARALYMPIC GAMES
JEUX PARALYMPIQUES

AIR CANADA
OFFICIAL SUPPORTER
*SUPPORTEUR OFFICIEL*