AIR CANADA

2008
Management's Discussion and Analysis of Results of Operations and Financial Condition

FEBRUARY 13, 2009

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1. Highlights

The following table provides the reader with financial and operating highlights for the Corporation for the periods indicated:

(Canadian dollars in millions except per share figures)	Fourth Quarter 2008	Fourth Quarter 2007	Fourth Quarter Change $	Full Year 2008	Full Year 2007 [1]	Full Year Change $
Financial						
Operating revenues	2,498	2,513	(15)	11,082	10,646	436
Operating income (loss) before a special provision [2]	(146)	72	(218)	(39)	433	(472)
Operating income (loss)	(146)	72	(218)	(164)	433	(597)
Non-operating expense	(44)	(52)	8	(170)	(122)	(48)
Income (loss) before non-controlling interest, foreign exchange and income taxes	(190)	20	(210)	(334)	311	(645)
Income (loss) for the period	(727)	35	(762)	(1,025)	429	(1,454)
Operating margin before a special provision % [2]	-5.8%	2.9%	(8.7) pp	-0.4%	4.1%	(4.5) pp
Operating margin %	-5.8%	2.9%	(8.7) pp	-1.5%	4.1%	(5.6) pp
EBITDAR before a special provision [2][3]	108	274	(166)	934	1,263	(329)
EBITDAR [2]	108	274	(166)	809	1,263	(454)
EBITDAR margin before a special provision % [2][3]	4.3%	10.9%	(6.6) pp	8.4%	11.9%	(3.5) pp
EBITDAR margin % [3]	4.3%	10.9%	(6.6) pp	7.3%	11.9%	(4.6) pp
Cash, cash equivalents and short-term investments	1,005	1,239	(234)	1,005	1,239	(234)
Free cash flow	(428)	(892)	464	(985)	(2,233)	1,248
Adjusted debt/equity ratio	89.6%	67.0%	22.6 pp	89.6%	67.0%	22.6 pp
Earnings (loss) per share - basic	($7.27)	$0.35	($7.62)	($10.25)	$4.29	($14.54)
Earnings (loss) per share - diluted	($7.27)	$0.35	($7.62)	($10.25)	$4.27	($14.52)
Operating Statistics			**Change %**			**Change %**
Revenue passenger miles (millions) (RPM)	10,845	11,446	(5.3)	50,519	50,629	(0.2)
Available seat miles (millions) (ASM)	13,571	14,715	(7.8)	62,074	62,814	(1.2)
Passenger load factor	79.9%	77.8%	2.1 pp	81.4%	80.6%	0.8 pp
Passenger revenue per RPM (cents) [4]	20.1	18.9	6.2	19.2	18.4	4.3
Passenger revenue per ASM (cents) [4]	16.0	14.7	9.1	15.6	14.8	5.3
Operating revenue per ASM (cents) [4]	18.4	16.9	8.9	17.9	16.9	5.3
Operating expense per ASM ("CASM") (cents)	19.5	16.6	17.4	17.9	16.3	10.2
CASM, excluding fuel expense (cents)	13.6	12.4	9.9	12.4	12.2	1.7
Average number of full-time equivalent (FTE) employees (thousands) [5]	23.6	23.9	(1.3)	24.2	23.9	1.1
Aircraft in operating fleet at period end [6]	333	340	(2.1)	333	340	(2.1)
Average fleet utilization (hours per day) [7]	8.8	9.3	(5.4)	9.6	9.8	(2.0)
Average aircraft flight length (miles) [7]	827	851	(2.8)	863	874	(1.3)
Fuel price per litre (cents) [8]	95.8	67.5	41.9	90.4	65.6	37.8
Fuel litres (millions)	822	905	(9.2)	3,763	3,873	(2.8)

(1) Reflects the financial and operating highlights for Air Canada for 2008 and the financial and operating highlights for the Air Canada Services segment, which excluded the consolidation of Jazz, for 2007.
(2) A provision for cargo investigations of $125 million was recorded in the first quarter of 2008.
(3) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before the provision for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).
(4) A favourable revenue adjustment of $26 million relating to a change in accounting estimates was recorded in the fourth quarter of 2007. For comparative purposes, yield and RASM percentage changes were adjusted to include the impact of removing $26 million from the fourth quarter of 2007.
(5) Reflects FTE employees at Air Canada. Excludes FTE employees at Jazz.
(6) Excludes chartered freighters in 2008 and 2007. Includes Jazz aircraft covered under the Jazz CPA.
(7) Excludes third party carriers operating under capacity purchase arrangements. Includes Jazz aircraft covered under the Jazz CPA.
(8) Includes fuel handling and is net of fuel hedging results.

2. Introduction

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers to, as the context may require, Air Canada and/or one or more of Air Canada's subsidiaries.

This 2008 MD&A provides the reader with a view of Air Canada from the perspective of management and includes an overview of Air Canada's business strategy, an analysis of Air Canada's financial results for the fourth quarter of 2008 and for the full year 2008, the risks and uncertainties associated with its business and a discussion on its controls and procedures. This MD&A should be read in conjunction with Air Canada's 2008 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 2008.

Prior to May 24, 2007, Air Canada's consolidated financial statements included the financial position, results of operations and cash flows of Jazz Air LP ("Jazz") as Air Canada was deemed to be the primary beneficiary of Jazz under Accounting Guideline 15 "Consolidation of Variable Interest Entities" ("AcG-15"). The distribution by ACE Aviation Holdings Inc. ("ACE") 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. 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 service business operated by Air Canada and related ancillary services, and Jazz, Air Canada's regional capacity provider. Segment information provided useful information to shareholders as it enabled them to distinguish between the results of operations, cash and other assets and liabilities of the two segments.

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

Except as otherwise noted, all monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 21 "Glossary". Except as otherwise noted, this MD&A is current as of February 12, 2009.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of the risks relating to the Corporation, see section 18 "Risk Factors" of this MD&A.

The Corporation issued a news release dated February 13, 2009 reporting on its results for the fourth quarter of 2008. This news release is available on www.sedar.com and on www.aircanada.com.

For further information on Air Canada's public disclosure file, including Air Canada's Annual Information Form, 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. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, industry, market, credit and economic conditions, the ability to reduce operating costs and secure financing, pension issues, energy prices, currency exchange and interest rates, employee and labour relations, competition, war, terrorist acts, epidemic diseases, insurance issues and costs, changes in demand due to the seasonal nature of the business, supply issues, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties as well as the factors identified throughout this MD&A and, in particular, those identified in section 18 "Risk Factors" of this MD&A. The forward-looking statements contained in this MD&A represent 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. Air Canada assumes that the North American economy will continue to contract in the first quarter of 2009 and will remain weak for the remainder of 2009. Air Canada also assumes that Canadian real GDP will be approximately negative 1% and US real GDP will be approximately negative 2%. In addition, Air Canada expects that the Canadian dollar will trade, on average, at Cdn $1.18 per US dollar in the first quarter of 2009 and Cdn $1.16 per US dollar for the full year 2009 and that the price of fuel will average 68 cents per litre in the first quarter of 2009 and will average 69 cents per litre for the full year 2009 (both net of fuel hedging positions).

3. About Air Canada

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 and in the international market to and from Canada.

In 2008, Air Canada, together with Jazz, operated an average of approximately 1,374 scheduled flights daily and carried approximately 33 million passengers and provided direct passenger service to 160 destinations and, through commercial agreements with other unaffiliated regional airlines, to an additional 11 destinations, for a total of 171 direct destinations on five continents.

Air Canada enhances its network through a capacity purchase agreement with Jazz (the "Jazz CPA") pursuant to which Air Canada purchases substantially all of Jazz's fleet capacity based on predetermined rates and Air Canada determines 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.

Air Canada is a founding member of the Star Alliance® network. The Star Alliance® network currently includes 21 member airlines and three regional member airlines. Through its membership in the Star Alliance® network, Air Canada is able to offer its customers access to approximately 912 destinations in 159 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges.

Through its long-term relationship with Aeroplan Limited Partnership ("Aeroplan"), Air Canada's frequent flyer program provider, Air Canada is able to build customer loyalty by offering those customers who are Aeroplan members the opportunity to earn Aeroplan miles when they fly with Air Canada. Aeroplan is also Air Canada's single largest customer. The relationship with Aeroplan is designed to provide 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 Services").

Air Canada Cargo provides air cargo services on domestic and US transborder flights using cargo capacity on aircraft operated by Air Canada and Jazz in these markets. Air Canada offers international cargo services on routes between Canada and major markets in Europe, Asia, South America and Australia using cargo capacity on Boeing 777 and other wide-body aircraft operated by Air Canada.

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 the US) by developing, marketing and distributing vacation travel packages and services through its website (www.aircanadavacations.com) and a network of independent travel agencies across Canada.

Air Canada Ground Handling Services provides passenger handling services to Air Canada, Jazz and other airlines in Canada. These services include passenger check-in, ramp services, cabin cleaning, deicing services, gate management and baggage and cargo handling.

4. Overview

Air Canada's results of operations for the fourth quarter of 2008 and the full year 2008 are discussed in sections 6 and 7, respectively, of this MD&A.

In summary, Air Canada's results of operations for 2008 compared to 2007 are as follows:

Air Canada recorded a net of loss of $1,025 million or $10.25 per diluted share in 2008 compared to net income of $429 million or $4.27 per diluted share in 2007. The net loss in 2008 included a provision for cargo investigations of $125 million and net losses on foreign exchange of $655 million.

Air Canada recorded an operating loss (before a provision for cargo investigations) of $39 million, a deterioration of $472 million from the operating income of $433 million recorded in 2007 and EBITDAR (before the provision for cargo investigations) of $934 million compared to EBITDAR of $1,263 million in the same period in 2007, a decrease of $329 million.

In response to historically high fuel prices, on June 17, 2008, Air Canada announced capacity and staff reductions for the fall and winter schedule. In the third quarter of 2008, Air Canada reduced its capacity by 3.5% from the third quarter of 2007 and further reduced its capacity by 7.8% in the fourth quarter of 2008 compared to the same period in 2007. ASM capacity for the full year 2008 decreased 1.2% from the full year 2007.

Operating revenues increased $436 million or 4% from 2007, mainly due to a passenger revenue increase of $384 million or 4% over the same period in 2007. The growth in passenger revenue was mainly due to increased fares and fuel surcharges to partially offset higher fuel prices. RASM growth of 5.3% over 2007 reflected a year-over-year yield increase of 4.3% and a passenger load factor improvement of 0.8 percentage points.

Operating expenses increased $908 million or 9% from 2007 which included an increase in fuel expense of $867 million or 34% compared to the same period in 2007. Ownership costs, comprised of aircraft rent and depreciation and amortization expense, increased $143 million or 17%, reflecting Air Canada's investment in new aircraft and its aircraft interior refurbishment program.

In 2008, CASM increased 10.2% from 2007 largely due to higher fuel expense. Excluding fuel expense, CASM increased 1.7% from 2007 on a capacity reduction of 1.2%. The key factor in the increase was the higher unit cost of ownership which reflected Air Canada's investment in new aircraft and the aircraft interior refurbishment program.

Along with many airline carriers globally, Air Canada faced a number of significant challenges in 2008, including as a result of volatile fuel prices, foreign exchange, liquidity requirements and the weakening demand for air travel. With the expectation of a continuing recession in 2009, the industry, including Air Canada, will continue to face significant challenges throughout 2009. The recession is expected to put significant pressures on passenger and cargo revenues for many airlines, including Air Canada. At the same time, it is expected that lower fuel prices in 2009 and capacity adjustments made in 2008 as a result of the high fuel prices will provide some relief. Air Canada continues to be significantly leveraged requiring continuing interest payments and debt payments, which are largely denominated in foreign currencies. Further, the funding of employee benefit plans for many companies, including Air Canada, will be impacted during 2009 by the declines in the value of plan assets. In 2009, a number of the Corporation's collective agreements expire and uncertainties exist with respect to the outcome of their negotiation. In addition, the credit markets continued to be constrained throughout the latter part of 2008 raising concerns about available funding for a number of companies, including Air Canada. These factors have had an impact on the liquidity risk of Air Canada during 2008 and are continuing challenges for Air Canada as well as other airline industry companies. Refer to section 9.3 of this MD&A for a further discussion on liquidity risks. These risks may have an impact on future operating results and liquidity.

While management believes it has developed planned courses of action and identified other opportunities to overcome these challenges and mitigate the operating and liquidity risks, there is no assurance that management will be able to successfully conclude these initiatives and maintain sufficient liquidity, including if events or conditions develop, that are not consistent with management's expectations and planned courses of actions.

5. Strategy

Our Business Strategy

Effectively managing Air Canada through an uncertain economic environment is the top priority in 2009. Managing Air Canada's liquidity was a key focus in 2008 and remains a key focus going forward. Refer to section 9.3 of this MD&A for a discussion on Air Canada's liquidity. In addition to improving its liquidity, Air Canada's plans for long-term viability and business profitability include:

- **Leveraging its innovative customer driven revenue model**

  Air Canada's 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. Also, it provides customers with the ability to purchase lower branded fares and then purchase selected attributes which typically are attached only to higher branded fares. Choices of branded fares are: Tourist, Leisure, Latitude Plus, Executive First Lowest and Executive First Flexible for customers traveling to international destinations, including the Caribbean and Mexico. Air Canada's revenue model has allowed it to match the lowest fare in the markets in which it operates and maintain revenue premiums from customers who are willingly purchasing higher fares with additional attributes. In 2008, 47% of Air Canada's domestic consumers chose a branded fare higher than Tango, Air Canada's lowest fare (46% in 2007).

- **Further developing its innovative revenue strategy to generate additional revenues**

  In order to provide its customers with more travel options, geographical reach and purchase flexibility, in early 2008, Air Canada began to offer its customers a new Flight Pass shopping environment on www.aircanada.com.

  In the drive to provide customers with new and unique products, Air Canada continued to further expand the offering of "Flight Passes" and "subscriptions" payment options for fixed credit flight passes and unlimited travel, respectively. 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.

  In 2008, Air Canada introduced Spring Getaway and New York Weekender passes, an Executive Class Pass and Ontario and Quebec passes for unlimited flying in the summer. Air Canada offers its customers a choice of different flight passes tailored for consumers, small to medium-sized businesses and large corporations. In 2008, revenues from Air Canada's Flight Pass products increased 52% over 2007, and represented 5.2% of North American revenues.

- **Continuing to focus on costs**

  Air Canada's business strategy is focused on continually evaluating and improving its cost structure to remain competitive and overcome the challenges facing the Corporation. Air Canada's plan includes the following initiatives:

  - The continued implementation of a cost reduction program which monitors key initiatives and projects that are focused on generating revenues and reducing costs. In 2008, through its company-wide initiatives, Air Canada achieved improvements in excess of $90 million under this program. Air Canada's cost savings target for 2009 is approximately $100 million.
  - The continued implementation of a company-wide fuel efficiency program. In 2008, this program provided Air Canada with savings of approximately $20 million. Air Canada's target for 2009 is an additional $15 million.
  - A supplier concession program with expected annual savings of $20 to $40 million.

  In 2008, including fuel expense, CASM increased 10.2% from 2007. Excluding fuel expense, CASM increased 1.7% from 2007. Starting in the third quarter of 2008, Air Canada began transitioning to a lower level of ASM capacity which negatively impacted its CASM. CASM, excluding fuel expense, in the first half of 2008 decreased 3.3% year-over-year while CASM, excluding fuel expense, in the last half of 2008 increased 6.8% year-over-year.

In the fourth quarter of 2008, CASM, excluding fuel expense, increased 9.9% versus the same period in 2007. The capacity reduction, which started in the second half of the year, was a factor in this year-over-year growth in CASM as Air Canada's cost structure is such that its fixed costs do not fluctuate proportionately with changes in capacity in the short term. In addition, certain variable costs, such as labour, are progressively being reduced, however, not at the same rate as the capacity reduction. The program to reduce the number of employees, which was announced in conjunction with the capacity reduction, only took effect in November 2008. Air Canada expects these reductions to be completed in early 2009. Further reductions in the number of employees have been planned for early 2009. A significantly weaker Canadian dollar versus the US dollar in the fourth quarter of 2008, a decrease of 5.4% in aircraft utilization and a reduction of 2.8% in average stage length were also contributing factors in the year-over-year increase in CASM, excluding fuel expense, in the fourth quarter of 2008.

- **Continuing to focus on sound capacity management**

  As previously discussed, on June 17, 2008, in response to historically high fuel prices, Air Canada announced capacity and staff reductions for the fall and winter schedule.

  In the second half of 2008, Air Canada reduced its capacity by 5.4% compared to the second half of 2007. The traffic decrease of 3.6% was less than the capacity reduction of 5.4%, resulting in a 1.6 percentage point improvement in passenger load factor compared to the second half of 2007. By focusing diligently on network management and as a result of capacity constraints in the airline industry in general, Air Canada was able to successfully shift its capacity to better match passenger demand.

  ASM capacity for the full year 2008 decreased 1.2% from the full year 2007. In 2008, the traffic decrease of 0.2% was less than the capacity reduction of 1.2%, resulting in a 0.8 percentage point improvement in passenger load factor compared to 2007.

  Capacity constraints generally improve passenger load factors and lead to a more favourable fare mix, thus resulting in increased yields. RASM growth is driven by a higher passenger load factor or a higher yield, or both.

  With the slowing economy continuing to impact both its leisure and business customers, one of Air Canada's challenges in 2009 will be to maintain high passenger load factors through continued aggressive capacity management.

- **Maintaining a high degree of web penetration and increasing direct distribution**

  Air Canada's transparent pricing strategy and its user friendly web platform have contributed to a high level of web penetration which, in turn, has allowed it to reduce its 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 most US and 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 Air Canada to generate cost savings while increasing its customer satisfaction. Web penetration for domestic Canada sales in 2008 was 66%, an increase of 3 percentage points from 2007 (63% in 2007). Web penetration for combined Canada and US transborder sales was 54%, an increase of 4 percentage points from 2007. In 2008, 74% of domestic Canada sales, or 64% when combined with US sales, were made directly with Air Canada, either online or through call centres (compared to 73% of domestic Canada sales, or 61% when combined with US sales, in 2007).

- **Further enhancing its product offering through a redesigned network and a renewed fleet**

  Within North America, Air Canada adopted a demand-based network strategy through the use of large regional jet aircraft which have lower trip costs than conventional narrow-body aircraft. Starting in 2005, Air Canada progressively introduced 15 Embraer E175 and 45 Embraer E190 aircraft into its fleet. This has allowed Air Canada to offer its customers improved frequencies on key routes, maintain competitive frequencies on other routes and introduce new non-stop routes thus serving customers to destinations where such demand was expected.

In order to support the expansion of its international operations and deliver a superior aircraft product in the international market to and from Canada, starting in 2007, Air Canada progressively introduced 16 Boeing 777 aircraft into its fleet. One of two additional Boeing 777 aircraft is expected to be delivered in the first quarter of 2009, with the last Boeing 777 aircraft expected to be delivered in the third quarter of 2009. The new Boeing 777 aircraft is allowing Air Canada to modernize and re-size its 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 Air Canada 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 and removing older and less efficient aircraft, Air Canada offers its customers a world class product. Starting in 2006, Air Canada began the interior refurbishment of its aircraft. To date, Air Canada has refurbished the interior of its entire operating fleet with the exception of seven Airbus A330 aircraft and one Boeing 767-300 aircraft. The new Embraer and Boeing 777 aircraft are being delivered with new seats and entertainment systems. Refurbished aircraft have new seats with personal in-flight entertainment systems and in-seat power outlets accessible at every seat in Economy Class, Executive Class and Executive First.

Refer to section 8 of this MD&A for additional information on Air Canada's fleet.

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

New reservation system
A new web-enabled reservation system continues to be 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 involved the roll-out of a web-based document management system for all policies and procedures has been substantially completed. The next two phases involve the completion of the development and cutover of the reservation system and an airport departure control system. Air Canada continues to evaluate the timeline for completion of POLARIS. Certain components of POLARIS are expected to move into production before the end of 2010.

Self-Service Products
In 2008, Air Canada 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 Air Canada to simplify its business processes and enhance the travel experience for its customers while generating cost savings. In 2008, 56% of Air Canada's customers used self-service products worldwide (55% in 2007). In Canada, self-service increased from 59% in 2007 to 61% in 2008. Mobile check-in and web check-in are available at all Canadian airports, as well as in 42 international stations and 38 US stations. In addition, customers now have the option of prepaying applicable excess baggage fees as part of the check-in process on the web or at kiosks.

In November 2008, Air Canada celebrated the 10-year anniversary of the launch of the self-service kiosk. The kiosk product is now available in 41 stations around the world. The Air Canada check-in application is installed on close to a thousand airport-managed, common-use kiosks. In December, Air Canada and Jazz launched a new streamlined version of the product called the A-Series Kiosk. It has been deployed at nine Jazz stations across Canada.

Kiosk self-tagging is now available for customers at Montreal Pierre Elliott Trudeau Airport, Vancouver International Airport, Toronto Pearson Airport, Paris Charles de Gaulle Airport and London Heathrow Airport. In 2008, self-tagging volumes increased by 413%, and self-tagging was used by approximately one million passengers. Air Canada's customers can also experience its new quick bag drop-off solutions in Montreal, Vancouver and London Airports.

Additionally, in 2008, Air Canada enhanced its flight notification product which enabled it to provide customers with more information with respect to changes to their travel plans.

In 2009, Air Canada is planning to continue to introduce new self-service products and enhance its applications to simplify the customer's experience before travel. Air Canada plans to introduce new languages to its kiosk application (Korean, German, Chinese Mandarin, Japanese, and Spanish). Additionally, mobile native applications will be available for customers using smartphones (iphone, BlackBerry, etc.) where a complete set of services will be offered to the customer, enhancing the user experience. Air Canada plans to introduce the electronic boarding pass to select stations in the US and in Europe. Finally, the new early check-in product will provide customers with the possibility of registering for check-in as soon as their reservation is complete and receive a boarding pass to their e-mail or mobile device 24 hours before departure.

NetLine

The legacy technology of Air Canada's current flight operations systems has been replaced by the NetLine system, an integrated software suite. The new system is designed to enable Air Canada to enhance operational efficiencies by providing better real time operational information. Furthermore, NetLine allows for an easier and more cost effective adaptation to changes in Air Canada's 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, Air Canada began the design phase of the project with subsequent releases of the functional phases expected throughout 2009 and 2010. In 2009, Air Canada plans to finalize the development of the solution and begin its deployment in the latter part of 2009. The deployment strategy is one of a phased implementation that is expected to be rolled out over throughout 2009 and 2010.

- **Maintaining positive employee and labour relations**

  In Canada, Air Canada has collective agreements with its pilots, flight attendants, maintenance personnel, certain clerical and finance personnel, customer service agents, ramp and cargo employees and dispatchers which were concluded in 2003 and 2004 and which expire in 2009. Collective agreements with two groups of crew schedulers also expire in 2009. No strikes or lock-outs may lawfully occur during the term of the collective agreements.

On December 19, 2008, Air Canada announced that its US-based customer service workforce, represented by the International Brotherhood of Teamsters (IBT), ratified its labour agreement. The IBT represents approximately 650 Air Canada airport, cargo and call centre employees based in the United States. The three year agreement takes effect on July 1, 2009.

On January 14, 2009, Air Canada announced that it had reached a tentative, three-year labour agreement with the Canadian Auto Workers (CAW) Local 2002. The agreement was subject to a ratification vote by union members. The CAW represents approximately 5,000 customer service and sales agents employed by Air Canada. The tentative agreement also provided for a detailed plan for Air Canada employees currently working in the Aeroplan call centres to transition to employment at Aeroplan or remain at Air Canada. Similarly, affected Air Canada employees would also have been able to request a transfer to Aeroplan. On January 28, 2009, Air Canada announced that it had been advised by the CAW Local 2002 that the tentative agreement reached by the parties on January 14, 2009 was not ratified by its membership.

In 2005, Air Canada 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 2008, a total of $33 million was paid in advance under the "Sharing Our Success" plan.

Air Canada is one of the few remaining North American carriers with defined benefit pension plans. Air Canada provides defined retirement benefits for all unionized and most management employees. In 2008, Air Canada made cash contributions of $456 million under these plans, of which $189 million represented past service costs in accordance with Air Canada's agreement with the Office of the Superintendent of Financial Institutions ("OSFI"). Refer to section 9.6 of this MD&A for additional information on Air Canada's pension funding obligations.

As part of Air Canada's ongoing objective to improve overall employee relations throughout the organization, in 2007, it 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. This program was provided to its frontline unionized employees in lead functions starting in the first quarter of 2008.

In the latter part of 2007, Air Canada 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. Substantially all executive, senior management and frontline managers have completed this training program.

In 2008, Air Canada also commenced an intensive course on all aspects of customer services. Called "Customer Service Managers Foundation", this program provides managers with the skills to coach and support employees to provide consistent exceptional customer service. It involves classroom time as well as job shadowing across the organization to help share tips and best practices.

6. Results of Operations – Fourth Quarter 2008 versus Fourth Quarter 2007

The following table and discussion compares the results of Air Canada for the fourth quarter of 2008 to its results for the fourth quarter of 2007.

	Fourth Quarter		Change	
(Canadian dollars in millions except per share figures)	**2008**	**2007**	**$**	**%**
Operating revenues				
Passenger	$ 2,182	$ 2,196	$ (14)	(1)
Cargo	113	142	(29)	(20)
Other	203	175	28	16
	2,498	**2,513**	**(15)**	**(1)**
Operating expenses				
Aircraft fuel	792	615	177	29
Wages, salaries, and benefits	444	468	(24)	(5)
Airport and navigation fees	230	238	(8)	(3)
Capacity purchase with Jazz	237	227	10	4
Depreciation and amortization	174	140	34	24
Aircraft maintenance	157	173	(16)	(9)
Food, beverages and supplies	70	67	3	4
Communications and information technology	72	67	5	7
Aircraft rent	80	62	18	29
Commissions	40	37	3	8
Other	348	347	1	-
	2,644	**2,441**	**203**	**8**
Operating income (loss)	**(146)**	**72**	**(218)**	
Non-operating income (expense)				
Interest income	11	22	(11)	
Interest expense	(88)	(89)	1	
Interest capitalized	6	20	(14)	
Loss on capital assets	(5)	-	(5)	
Gain (loss) on financial instruments recorded at fair value	32	(1)	33	
Other	-	(4)	4	
	(44)	(52)	8	
Income (loss) before the following items	**(190)**	**20**	**(210)**	
Non-controlling interest	(4)	(3)	(1)	
Foreign exchange gain (loss)	(527)	20	(547)	
Provision for income taxes	(6)	(2)	(4)	
Income (loss) for the period	**$ (727)**	**$ 35**	**$ (762)**	
EBITDAR [(1)]	**$ 108**	**$ 274**	**$ (166)**	
Earnings (loss) per share, basic and diluted	**$ (7.27)**	**$ 0.35**	**$ (7.62)**	

(1) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).

In the fourth quarter of 2008, Air Canada reported an operating loss of $146 million compared to operating income of $72 million in the fourth quarter of 2007, a deterioration of $218 million. In the fourth quarter of 2008, EBITDAR amounted to $108 million compared to EBITDAR of $274 million in the same period in 2007, a decrease of $166 million.

System passenger revenues decreased 0.6% from the fourth quarter of 2007

In response to historically high fuel prices, on June 17, 2008, Air Canada announced capacity reductions for the fall and winter schedule. In the fourth quarter of 2008, Air Canada reduced its capacity by 7.8% from the fourth quarter of 2007.

Compared to the fourth quarter of 2007, passenger revenues decreased $14 million or 0.6% to $2,182 million in the fourth quarter of 2008 due to a decline in traffic. In the fourth quarter of 2008, passenger revenues in North America decreased $47 million or 3.3% while passenger revenues in the international market increased $33 million or 4.3% compared to the fourth quarter of 2007. The decrease in passenger revenue due to lower traffic was partly offset by additional revenue from increased fares and fuel surcharges. The capacity reduction on many routes also led to an improvement in the mix of economy fares which contributed to a higher average system yield. Factors contributing to the year-over-year change in fourth quarter system passenger revenues included:

- In the fourth quarter of 2008, adjusted system yield improved 6.2% (excludes a favourable adjustment of $26 million in the fourth quarter of 2007) from the fourth quarter of 2007, reflecting yield growth in all markets. The yield improvement was mainly due to higher fares and increased fuel surcharges and a favourable foreign exchange impact from foreign denominated revenues. A more favourable fare mix in the economy cabin was also a factor in the yield improvement from the fourth quarter of 2007. Yield in the premium cabin declined 1.1%, reflecting decreases in all markets with the exception of the domestic and other markets, which is comprised of services to the South Pacific, Caribbean, Mexico and South American markets ("other markets").
- A weaker Canadian dollar in the fourth quarter of 2008, which increases the Canadian dollar value of sales in foreign countries, had a positive impact on foreign currency denominated revenues, accounting for an increase of $35 million to fourth quarter 2008 passenger revenues compared to the fourth quarter of 2007. Approximately 1.6 percentage points of the year-over-year yield improvement in the fourth quarter of 2008 was due to the favourable impact of foreign exchange.
- In the fourth quarter of 2008, Air Canada reduced overall capacity by 7.8% from the fourth quarter of 2007. Capacity decreases were recorded in all markets with the exception of other markets. Approximately half of the capacity reduction was achieved through the reduction of frequencies on existing routes and cancellation of service on a small number of unprofitable routes, with the remainder through the increased use of smaller aircraft in the fleet.
- In the fourth quarter of 2008, a traffic decline of 5.3% was less than the capacity decrease of 7.8% resulting in a 2.1 percentage point improvement in passenger load factor from the fourth quarter of 2007. Passenger load factor improvements were recorded in all markets with the exception of other markets where capacity increases were not fully met by traffic improvements.
- In the fourth quarter of 2008, adjusted RASM increased 9.1% from the fourth quarter of 2007 due primarily to the growth in yield but also to the passenger load factor improvement. RASM improvements were reflected in all markets.

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

Fourth Quarter 2008 Versus Fourth Quarter 2007	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	(1.2)	(4.3)	(3.3)	0.9	2.2	3.2
US transborder	(7.7)	(15.0)	(12.8)	2.0	5.9	8.6
Atlantic	5.3	(7.2)	(3.7)	2.9	9.5	13.5
Pacific	5.2	(17.7)	(10.4)	7.1	17.4	27.9
Other	1.0	10.2	7.3	(2.0)	(5.9)	(8.4)
Other (1)	17.4	10.2	7.3	(2.0)	9.3	6.5
System	(0.6)	(7.8)	(5.3)	2.1	4.9	7.8
System (1)	**0.5**	**(7.8)**	**(5.3)**	**2.1**	**6.2**	**9.1**

(1) System and Other passenger revenue, yield and RASM percentage changes include the impact of removing $26 million from the fourth quarter of 2007. This adjustment was related to a change in accounting estimates.

The system ASM capacity decrease of 7.8% in the fourth quarter of 2008 compared to the fourth quarter of 2007 was in line with the 7.0% to 8.0% ASM capacity reduction projected in the Corporation's news release dated November 7, 2008.

Domestic passenger revenues decreased 1.2% from the fourth quarter of 2007

Domestic passenger revenues of $960 million in the fourth quarter of 2008 decreased $12 million or 1.2% from the fourth quarter of 2007 due to a decline in demand. A higher yield in the fourth quarter of 2008 was more than offset by a decrease in traffic. Factors contributing to the year-over-year change in fourth quarter domestic passenger revenues included:

- In the fourth quarter of 2008, yield increased 2.2% from the fourth quarter of 2007 largely due to increased fares.
- A weaker Canadian dollar in the fourth quarter of 2008, which increases the Canadian dollar value of sales in foreign countries, had a positive impact on foreign currency denominated revenues, accounting for an increase of $6 million to fourth quarter 2008 domestic passenger revenues compared to the fourth quarter of 2007.
- In the fourth quarter of 2008, traffic decreased 3.3% on a capacity reduction of 4.3% resulting in a passenger load factor improvement of 0.9 percentage points from the fourth quarter of 2007. Capacity decreases were reflected on all services and were achieved mostly through the reduction of frequencies on existing routes.
- In the fourth quarter of 2008, RASM increased 3.2% from the fourth quarter of 2007 due to the yield improvement and, to a lesser extent, the passenger load factor improvement.

US transborder passenger revenues decreased 7.7% from the fourth quarter of 2007

US transborder passenger revenues of $421 million in the fourth quarter of 2008 decreased $35 million or 7.7% from the fourth quarter of 2007 due to a decline in traffic. A higher yield in the fourth quarter of 2008 compared to the fourth quarter of 2007 was more than offset by a decrease in traffic. Factors contributing to the year-over-year change in fourth quarter US transborder passenger revenues included:

- In the fourth quarter of 2008, yield improved 5.9% from the fourth quarter of 2007 largely due to a favourable foreign exchange impact but also due to increased fares. Capacity reductions, which mostly impacted longer-haul and more leisure-oriented lower-yielding routes, also resulted in an overall higher average yield in the US market compared to the fourth quarter of 2007.
- A weaker Canadian dollar in the fourth quarter of 2008, which increases the Canadian dollar value of sales in foreign countries, had a positive impact on foreign currency denominated revenues, accounting for an increase of $11 million to fourth quarter 2008 US transborder passenger revenues compared to the fourth quarter of 2007.
- In the fourth quarter of 2008, capacity was reduced by 15.0% from the fourth quarter of 2007. Capacity decreases were achieved mainly through the increased use of smaller aircraft in the fleet. In anticipation of the leisure discretionary traffic being impacted by the softening economy and increased fares, Air Canada reduced capacity on routes to California, Las Vegas and Florida. In addition, there was a capacity reduction on the Hawaii service as a result of the introduction of a non-stop service from Vancouver to Sydney which was previously operated as a one-stop via Hawaii. The Vancouver – Sydney route is recorded in other passenger revenues.
- In the fourth quarter of 2008, traffic decreased 12.8% on a capacity reduction of 15.0% resulting in a passenger load factor improvement of 2.0 percentage points from the fourth quarter of 2007. Premium cabin traffic decreased which the Corporation attributes, in large part, to the softening economy and a reduction in business travel expenses.
- In the fourth quarter of 2008, RASM increased 8.6% from the fourth quarter of 2007 due to the yield improvement and the passenger load factor improvement.

Atlantic passenger revenues increased 5.3% from the fourth quarter of 2007

Atlantic passenger revenues of $394 million in the fourth quarter of 2008 increased $20 million or 5.3% from the fourth quarter of 2007 due to significant yield growth which more than offset a decrease in traffic. Factors contributing to the year-over-year change in fourth quarter Atlantic passenger revenues included:

- In the fourth quarter of 2008, yield improved 9.5% from the fourth quarter of 2007, reflecting yield improvements on all Atlantic services. The overall Atlantic yield improvement over the fourth quarter of 2007 was due to a combination of increased fares and fuel surcharges and an improvement in fare mix in the economy cabin. Several initiatives were put in place to retain traffic in the premium cabin which had a negative impact on the premium cabin yield.
- A weaker Canadian dollar in the fourth quarter of 2008, which increases the Canadian dollar value of sales in foreign countries, had a positive impact on foreign currency denominated revenues, accounting for an increase of $7 million to fourth quarter 2008 Atlantic passenger revenues compared to the fourth quarter of 2007.
- In the fourth quarter of 2008, capacity was reduced by 7.2% from the fourth quarter of 2007. Capacity reductions were largely reflected on United Kingdom routes and were mainly achieved through discrete frequency adjustments and the use of smaller aircraft on existing routes. In addition, service from Toronto – Rome was suspended at the end of October for the winter season. In the fourth quarter of 2008, capacity on the Canada – Germany service was increased by 4.8% which reflected Air Canada's new Ottawa – Frankfurt service and increased frequency on Toronto – Frankfurt, but this increase was partly offset by reductions on its Calgary – Frankfurt service.
- In the fourth quarter of 2008, traffic decreased 3.7% on a capacity reduction of 7.2% resulting in a passenger load factor improvement of 2.9 percentage points from the fourth quarter of 2007. Traffic on the United Kingdom service decreased 3.7% on a capacity reduction of 10.8%, resulting in a passenger load factor improvement of 5.9 percentage points.
- In the fourth quarter of 2008, RASM increased 13.5% from the fourth quarter of 2007 due to both the growth in yield and the passenger load factor improvement.

Pacific passenger revenues increased 5.2% from the fourth quarter of 2007

Pacific passenger revenues of $220 million in the fourth quarter of 2008 increased $11 million or 5.2% from the fourth quarter of 2007 due to significant yield growth which more than offset a decrease in traffic. Factors contributing to the year-over-year change in fourth quarter Pacific passenger revenues included:

- In the fourth quarter of 2008, yield improved 17.4% from the fourth quarter of 2007, reflecting yield growth on all Pacific services. A higher average fare in the economy cabin, as a result of an improvement in fare mix, combined with increased fuel surcharges, were also factors in the Pacific yield growth over the fourth quarter of 2007. A variety of initiatives were put in place to retain traffic in the premium cabin which had a negative impact on the premium cabin yield.
- A weaker Canadian dollar in the fourth quarter of 2008, which increases the Canadian dollar value of sales in foreign countries, had a positive impact on foreign currency denominated revenues, accounting for an increase of $7 million to fourth quarter 2008 Pacific passenger revenues compared to the fourth quarter of 2007.
- In the fourth quarter of 2008, capacity was reduced by 17.7% from the fourth quarter of 2007. Capacity decreases were reflected on all Pacific services and were mainly achieved through the reduction of frequencies on existing routes. This reduction was led by the cancellation of the Vancouver – Osaka service, the suspension of Toronto-Tokyo service for the winter season, and by reducing the Vancouver – China routes from daily to three times a week on Beijing and four times a week on Shanghai. The use of larger aircraft from Vancouver to both Hong Kong and Tokyo offset some of the capacity reductions.
- In the fourth quarter of 2008, traffic decreased 10.4% on a capacity reduction of 17.7% resulting in passenger load factor improvement of 7.1 percentage points from the fourth quarter of 2007.
- In the fourth quarter of 2008, RASM increased 27.9% from the fourth quarter of 2007 due to both the growth in yield and the passenger load factor improvement.

Other passenger revenues increased 1.0% from the fourth quarter of 2007

Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) of $187 million in the fourth quarter of 2008 increased $2 million or 1% from the fourth quarter of 2007 due to traffic and yield growth. Factors contributing to the year-over-year change in fourth quarter other passenger revenues included:

- In the fourth quarter of 2008, traffic increased 7.3% on a capacity growth of 10.2%, resulting in a decrease of 2.0 percentage points in passenger load factor compared to the fourth quarter of 2007. Traffic growth in these markets mainly reflected the addition of a new non-stop service from Vancouver to Sydney, Australia which is now being operated with a Boeing 777-200 aircraft. For the majority of the fourth quarter of 2007, this one-stop service via Hawaii was operated through the use of a Boeing 767-300 aircraft and the Vancouver-Hawaii segment was recorded in US transborder passenger revenues. Higher capacity to traditional leisure destinations and to South America was also a factor in the traffic growth versus the same period in 2007. Additionally, effective December 1, 2008, the service to Sao Paolo was upgauged to a Boeing 777 aircraft from a Boeing 767-300 aircraft, and non-stop service to Buenos Aires was introduced. In 2007, this service was a one-stop via Santiago.
- In the fourth quarter of 2008, adjusted yield improved 9.3% (excludes a favourable adjustment of $26 million in the fourth quarter of 2007) from the fourth quarter of 2007 largely due to increased fares and fuel surcharges. The higher yield was achieved in spite of a 7.1% increase in average stage length compared to the same period in 2007.
- A weaker Canadian dollar in the fourth quarter of 2008, which increases the Canadian dollar value of sales in foreign countries, had a positive impact on foreign currency denominated revenues, accounting for an increase of $4 million to fourth quarter 2008 other passenger revenues compared to the fourth quarter of 2007.
- In the fourth quarter of 2008, adjusted RASM increased 6.5% from the fourth quarter of 2007 due to the growth in yield.

Cargo revenues decreased 20% from the fourth quarter of 2007

Fourth quarter 2008 cargo revenues amounted to $113 million and were $29 million or 20% below the fourth quarter of 2007. Reduced freighter revenues accounted for almost two thirds of the revenue decrease due to cancellation of freighter flying in 2008. Non-freighter revenues decreased $10 million or 8%, mainly reflecting lower revenues in the domestic, US transborder and Pacific markets. Freighter revenues declined $19 million as no MD-11 freighter aircraft were operated in the fourth quarter of 2008 versus one MD-11 freighter operated in the same period in 2007. System cargo yield per revenue ton mile improved 7%, mainly reflecting a positive currency impact and, to a lesser extent, increased fuel surcharges. Factors contributing to the year-over-year change in fourth quarter cargo passenger revenues included:

- In the fourth quarter of 2008, system traffic declined 25% from the fourth quarter of 2007, mostly as a result of the termination of MD-11 freighter operations. Traffic on non-freighter aircraft decreased by 14% due to reduced cargo volumes in the domestic market with the termination of the Canada Post contract in mid-September 2008, and in the Pacific and US transborder markets mainly due to reduced capacity. Weakening demand for air cargo was also a factor in the decrease in cargo traffic.
- In the fourth quarter of 2008, a weaker Canadian dollar (with corresponding stronger foreign currencies) had a positive impact of approximately $9 million on the value of foreign currency denominated revenues.

Other revenues increased 16% from the fourth quarter of 2007

Other revenues of $203 million in the fourth quarter of 2008 increased $28 million or 16% from the fourth quarter of 2007, largely due to an increase of $21 million in aircraft sublease revenues, of which $5 million was due to the favourable impact of foreign exchange on US denominated sublease revenues. Other factors amounted to a net increase of $7 million.

Excluding fuel expense, CASM increased 9.9% from the fourth quarter of 2007

Operating expenses were $2,644 million in the fourth quarter of 2008, an increase of $203 million or 8% from the fourth quarter of 2007. As Air Canada incurs significant expenses in US dollars such as fuel, aircraft maintenance and airport user fees, the significantly weaker Canadian dollar versus the US dollar was a major contributing factor to the increase in operating expenses in the fourth quarter of 2008, accounting for approximately $180 million in additional expense.

Including fuel expense, CASM increased 17.4% over the fourth quarter of 2007. Excluding fuel expense, CASM increased 9.9% over the fourth quarter of 2007. Factors contributing to the year-over-year change in fourth quarter CASM included:

- A significantly weaker Canadian dollar versus the US dollar compared to the fourth quarter of 2007 accounted for over 40% of the CASM increase (including fuel expense) in the fourth quarter of 2008.
- Higher ownership costs reflecting Air Canada's investment in new aircraft and the aircraft interior refurbishment program in the fourth quarter of 2008.
- The capacity reduction was a factor in the year-over-year growth in CASM as Air Canada's cost structure is such that its fixed costs do not fluctuate proportionately with changes in capacity in the short term. In addition, certain variable costs, such as labour, are progressively being reduced, however, not at the same rate as the capacity reduction.
- A decrease of 5.4% in aircraft utilization and a reduction of 2.8% in average stage length were also contributing factors in the year-over-year increase in CASM compared to the fourth quarter of 2007.

The 9.9% increase in CASM, excluding fuel expense, was in line with the projected CASM, excluding fuel expense, provided in the Corporation's news release dated November 7, 2008 in which CASM, excluding fuel expense, was projected to increase between 9 to 10% compared to the same period in 2007.

The following table compares Air Canada's operating expenses per ASM for the fourth quarter of 2008 to Air Canada's operating expenses per ASM for the corresponding period in 2007.

	Fourth Quarter		Change	
(cents per ASM)	**2008**	**2007**	**cents**	**%**
Wages and salaries	2.71	2.56	0.15	5.9
Benefits	0.56	0.62	(0.06)	(9.7)
Ownership (DAR) (1)	1.87	1.38	0.49	35.5
Airport user fees	1.70	1.61	0.09	5.6
Capacity purchase with Jazz	1.74	1.54	0.20	13.0
Aircraft maintenance	1.16	1.20	(0.04)	(3.3)
Food, beverages and supplies	0.52	0.45	0.07	15.6
Communications and information technology	0.53	0.46	0.07	15.2
Commissions	0.29	0.25	0.04	16.0
Other	2.56	2.34	0.22	9.4
Operating expense, excluding fuel expense (2)	**13.64**	**12.41**	**1.23**	**9.9**
Aircraft fuel	5.84	4.18	1.66	39.7
Total operating expense	**19.48**	**16.59**	**2.89**	**17.4**

(1) DAR refers to the combination of Aircraft rent and Depreciation and amortization.
(2) Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for additional information.

Fuel expense increased 29% from the fourth quarter of 2007

Fuel expense amounted to $792 million in the fourth quarter of 2008, an increase of $177 million or 29% from the fourth quarter of 2007. Factors contributing to the year-over-year change in fourth quarter fuel expense included:

- Fuel hedging losses of $111 million in the fourth quarter of 2008 versus fuel hedging gains of $31 million in the fourth quarter of 2007, an unfavourable variance of $142 million compared to the fourth quarter of 2007.
- The unfavourable impact of a weaker Canadian dollar versus the US dollar which accounted for an increase of $110 million to fuel expense in the fourth quarter of 2008.

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

- A volume-related decrease of $60 million, including termination of freighter flying.
- A lower base fuel price which accounted for a decrease of $15 million.

Wages, salaries and benefits expense amounted to $444 million in the fourth quarter of 2008, a decrease of $24 million or 5% from the fourth quarter of 2007.

Wages and salaries expense totaled $369 million in the fourth quarter of 2008, a decrease of $8 million or 2% from the fourth quarter of 2007. Factors contributing to the year-over-year change in fourth quarter wages and salaries expense included:

- A year-over-year fourth quarter decrease of 1.3% or an average of 319 full-time equivalent ("FTE") employees on a capacity decrease of 7.8%. Given the required notice periods required under the Canada Labour Code, the reductions in unionized ranks announced in June only took effect in November 2008. The insourcing of supply chain management in the aircraft maintenance division accounted for an increase of approximately 200 FTE employees compared to the same period in 2007.
- Provisions relating to stock-based compensation expense amounted to $7 million in the fourth quarter of 2007 versus nil in the fourth quarter of 2008. In the fourth quarter of 2008, provisions relating to stock-based compensation were reversed as management had determined that certain performance vesting criteria would not be met.
- Provisions relating to employee profit sharing programs amounted to $11 million in the fourth quarter of 2007 versus provisions of $3 million in the fourth quarter of 2008.

The above-noted increases were largely offset by an increase in average wages of approximately 2.5% over the fourth quarter of 2007.

Employee benefits expense amounted to $75 million in the fourth quarter of 2008, a decrease of $16 million or 18**%** from the fourth quarter of 2007, mainly due to reduced pension expense as a result of revised pension actuarial estimates made as of January 1, 2008. Refer to section 9.6 of this MD&A for information on Air Canada's pension funding obligations.

Airport and navigation fees decreased 3% from the fourth quarter of 2007

Airport and navigation fees of $230 million decreased $8 million or 3% from the fourth quarter of 2007, largely due to reduced frequencies. Factors contributing to the year-over-year change in fourth quarter airport and navigation fees included:

- An overall frequency reduction of 4% from the fourth quarter of 2008, combined with changes in schedule and aircraft types being operated to certain destinations, resulted in a net decrease to airport user fees.
- Lower rates for landing and general terminal fees. Landing fees at Pearson Airport were reduced by 3.1% and terminal charges were reduced by 4.7% effective January 1, 2008.
- The impact of a weaker Canadian dollar versus the US dollar compared to the fourth quarter of 2007 partly offset these reductions, accounting for an increase of $3 million to airport user fees.

Capacity purchase costs with Jazz increased 4% from the fourth quarter of 2007

Capacity purchase costs with Jazz, pursuant to Jazz CPA, amounted to $237 million in the fourth quarter of 2008 compared to $227 million in the fourth quarter of 2007, an increase of $10 million or 4%. This year-over-year increase in capacity purchase costs in the fourth quarter of 2008 was mainly due to the unfavourable impact of foreign exchange on US denominated Jazz CPA expenses which accounted for an increase of $11 million compared to the same period in 2007. A predetermined contractual increase in Jazz CPA rates of $3 million and other costs amounting to $2 million were partially offset by the impact of reduced flying. Jazz ASM capacity was reduced by 3.4% in the fourth quarter of 2008 compared to the fourth quarter of 2007.

Ownership costs increased 26% from the fourth quarter of 2007

Ownership costs, comprised of aircraft rent, depreciation and amortization expenses, of $254 million in the fourth quarter of 2008 increased $52 million or 26% from the fourth quarter of 2007. Factors contributing to the year-over-year change in fourth quarter ownership costs included:

- The addition of new Boeing 777 and Embraer aircraft to Air Canada's operating fleet which accounted for an increase of $23 million.
- An increase in depreciation expense for engines and rotable spare parts of $11 million over the fourth quarter of 2007. A favourable adjustment of $9 million relating to rotable spare parts was recorded in the fourth quarter of 2007 versus a favourable adjustment of $2 million in the fourth quarter of 2008.
- The impact of a weaker Canadian dollar versus the US dollar which accounted for an increase of $12 million to aircraft rent expense.
- An increase in depreciation expenses of $11 million related to Air Canada's aircraft interior refurbishment program.
- Other factors accounting for a net increase of $7 million.

The above-noted favourable items were partially offset by the following:

- The removal of aircraft from Air Canada's fleet which accounted for a decrease of $6 million in aircraft rent and depreciation and amortization expenses.
- A decrease of $6 million to aircraft rent expense as a result of reduced MD-11 freighter flying.

Aircraft maintenance expense decreased 9% from the fourth quarter of 2007

In the fourth quarter of 2008, aircraft maintenance expense of $157 million decreased $16 million or 9% from the fourth quarter of 2007. Factors contributing to the year-over-year change in fourth quarter aircraft maintenance expense included:

- A decrease of $10 million due to timing of engine maintenance activities relating to the Airbus A320 aircraft compared to the fourth quarter of 2007.
- A decrease of $7 million in component maintenance expenses due to an overall reduction in maintenance events in part due to reduced flying.
- In the fourth quarter of 2007, Air Canada recorded expenses related to the preparation for sale and subleasing of aircraft of $6 million. There were no expenses of this nature in the fourth quarter of 2008.
- In the fourth quarter of 2007, Air Canada recorded provisions relating to short-term leases which were extended in 2008. As a result of these lease extensions, certain provisions, amounting to $4 million, were reversed in the fourth quarter of 2008.
- A decrease of $8 million relating to a reduction in third party supply chain management fees as a result of the insourcing of these activities. This decrease was partly offset by growth in FTE employees, resulting in an increase to wages and salaries.
- Other factors accounting for a net decrease of $18 million, largely the result of revised estimates relating to prior periods for airframe and engine maintenance events.

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

- The impact of a weaker Canadian dollar versus the US dollar which accounted for an increase of $20 million to aircraft maintenance expense compared to the fourth quarter of 2007.

- An increase of $9 million in maintenance expenses relating to Boeing 777 aircraft, Embraer ERJ-190 aircraft and Embraer ERJ-175 aircraft compared to the fourth quarter of 2007. Air Canada had 16 Boeing 777 aircraft in its operating fleet as at December 31, 2008 versus only eight Boeing 777 aircraft as at December 31, 2007. In addition, Embraer aircraft are entering a cycle where additional maintenance is required.
- An increase of $8 million in airframe maintenance expenses for the Airbus A320 and A321 aircraft due to timing of maintenance activities versus the fourth quarter of 2007.

Other operating expenses increased $1 million from the fourth quarter of 2007

Other operating expenses amounted to $348 million in the fourth quarter of 2008, an increase of $1 million from the fourth quarter of 2007. Factors contributing to the year-over-year change in fourth quarter other expenses included:

- The increase in expenses for ground packages at Air Canada Vacations was mainly due higher passenger volumes compared to the the fourth quarter of 2007 and the impact of a weakening Canadian dollar versus the US dollar which accounted for an increase of $6 million to Air Canada's land costs compared to the same period in 2007.
- The increase in terminal handling costs was in large part due to newly-imposed airport charges and rate increases at various Air Canada international stations. These increases were partly offset by the impact of reduced flying compared to the fourth quarter of 2007.
- The decreases in other expenses included employee injury compensation, aircraft engine rental, advertising and promotion, and cargo trucking expenses.

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

	Fourth Quarter		Change	
(Canadian dollars in millions)	**2008**	**2007**	**$**	**%**
Other expenses				
Air Canada Vacations' land costs	$ 49	$ 34	$ 15	44
Terminal handling	45	37	8	22
Credit card fees	44	45	(1)	(2)
Building rent and maintenance	35	33	2	6
Crew expenses (meals, transportation and hotels)	30	27	3	11
Miscellaneous fees and services	30	30	-	-
Remaining other expenses	115	141	(26)	(18)
	$ 348	**$ 347**	**$ 1**	**-**

Non-operating expense amounted to $44 million in the fourth quarter of 2008

Non-operating expense amounted to $44 million in the fourth quarter of 2008 compared to non-operating expense of $52 million in the fourth quarter of 2007. Factors contributing to the year-over-year change in fourth quarter non-operating expense included:

- Gains relating to fair value adjustments on derivatives instruments amounted to $32 million in the fourth quarter of 2008 versus a loss of $1 million in the same quarter of 2007. The non-cash mark-to-market gain on financial instruments of $32 million recorded in the fourth quarter of 2008 represented a gain of $19 million related to the fair value of fuel derivatives as well as other gains on interest rate swaps. Refer to section 12 of this MD&A for additional information on Air Canada's derivative instruments.

- An increase in net interest expense of $24 million, the result of a lower amount of capitalized interest related to new aircraft and a decrease in interest income due to both lower cash balances and lower rates of return. A decrease in interest expense, largely driven by lower financing costs on the Boeing 777 aircraft commitments due to the favourable impact of the pre-delivery financing arranged in the fourth quarter of 2007, lower interest rates on floating rate debt compared to the fourth quarter of 2007 was offset by the financing of additional aircraft year-over-year and the unfavourable impact of a weaker Canadian dollar versus the US dollar in the fourth quarter of 2008.

Net losses on foreign exchange amounted to $527 million in the fourth quarter of 2008

Net losses on foreign exchange amounted to $527 million in the fourth quarter of 2008 compared to gains of $20 million in the fourth quarter of 2007. The losses in the fourth quarter of 2008 were attributable to a weaker Canadian dollar at December 31, 2008 compared to September 30, 2008, partially offset by gains of $174 million related to foreign currency derivatives. The December 31, 2008 noon day exchange rate was $1US = Cdn $1.2246 while the September 30, 2008 noon day exchange rate was $1US = Cdn $1.0599.

Provision of income taxes of $6 million in the fourth quarter of 2008

Air Canada recorded a provision for income taxes of $6 million in the fourth quarter of 2008. The tax provision reflected future income tax that has been reclassified from other comprehensive income to income for realized gains on fuel derivatives. The recovery of future income taxes on the 2008 loss has been offset by a valuation allowance. The provision for income taxes 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 a valuation allowance.

7. Results of Operations – 2008 versus 2007

Air Canada recorded an operating loss of $39 million, before a provision for cargo investigations of $125 million, and a net loss of $1,025 million in 2008. In the same period of 2007, Air Canada, including the consolidation of Jazz's operations up to May 24, 2007, reported consolidated operating income of $495 million and net income of $429 million. **The following table and discussion compares the results of Air Canada for 2008, which no longer includes the consolidation of Jazz, and the results of the Air Canada Services segment, which excluded the consolidation of Jazz, for 2007.**

(Canadian dollars in millions except per share figures)	2008	2007 (1)	Change $	Change %
Operating revenues				
Passenger	$ 9,713	$ 9,329	$ 384	4
Cargo	515	550	(35)	(6)
Other	854	767	87	11
	11,082	**10,646**	**436**	**4**
Operating expenses				
Aircraft fuel	3,419	2,552	867	34
Wages, salaries, and benefits	1,877	1,920	(43)	(2)
Airport and navigation fees	1,001	1,022	(21)	(2)
Capacity purchase with Jazz	948	923	25	3
Depreciation and amortization	694	548	146	27
Aircraft maintenance	659	757	(98)	(13)
Food, beverages and supplies	314	313	1	-
Communications and information technology	286	275	11	4
Aircraft rent	279	282	(3)	(1)
Commissions	194	201	(7)	(3)
Other	1,450	1,420	30	2
	11,121	**10,213**	**908**	**9**
Operating income (loss) before the undernoted item	**(39)**	**433**	**(472)**	
Provision for cargo investigations	(125)	-	(125)	
Operating income (loss)	**(164)**	**433**	**(597)**	
Non-operating income (expense)				
Interest income	57	92	(35)	
Interest expense	(319)	(348)	29	
Interest capitalized	37	108	(71)	
Gain (loss) on capital assets	(34)	19	(53)	
Gain on financial instruments recorded at fair value	92	26	66	
Other	(3)	(19)	16	
	(170)	(122)	(48)	
Income (loss) before the following items	**(334)**	**311**	**(645)**	
Non-controlling interest	(12)	(9)	(3)	
Foreign exchange gain (loss)	(655)	317	(972)	
Provision for income taxes	(24)	(190)	166	
Income (loss) for the year	**$ (1,025)**	**$ 429**	**$ (1,454)**	
EBITDAR before the provision for cargo investigations (2)	**$ 934**	**$ 1,263**	**$ (329)**	
EBITDAR (2)	**$ 809**	**$ 1,263**	**$ (454)**	
Earnings (loss) per share – Basic	**$ (10.25)**	**$ 4.29**	**$ (14.54)**	
Earnings (loss) per share – Diluted	**$ (10.25)**	**$ 4.27**	**$ (14.52)**	

(1) Reflects the results of the Air Canada Services segment, which excluded the consolidation of Jazz, for 2007. Refer to section 2 of this MD&A for additional information on Air Canada's reportable segments prior to May 24, 2007.

(2) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before the provision for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).

In 2008, Air Canada reported an operating loss, before a provision for cargo investigations, of $39 million compared to operating income of $433 million in 2007, a deterioration of $472 million. An increase in operating revenues of $436 million or 4% was more than offset by a fuel expense increase of $867 million or 34%.

In 2008, EBITDAR, before a provision for cargo investigations, amounted to $934 million compared to EBITDAR of $1,263 million in the same period in 2007, a decrease of $329 million.

System passenger revenues increased 4.1% over 2007

In response to historically high fuel prices, on June 17, 2008, Air Canada announced capacity reductions for the fall and winter schedule. In the first half of 2008, Air Canada increased its capacity by 3.4% from the first half of 2007. In the second half of 2008, Air Canada reduced its capacity by 5.4% compared to the same period in 2007. Total system ASM capacity for the full year 2008 decreased 1.2% from the full year 2007.

Compared to 2007, passenger revenues increased $384 million or 4.1% to $9,713 million in 2008 mainly due to increased fares and fuel surcharges to partially offset higher fuel prices. Passenger revenue growth was reflected in all markets with the exception of the US transborder market which showed a relatively small reduction in passenger revenues. Factors contributing to the year-over-year change in system passenger revenues included:

- In 2008, system yield improved 4.3% from 2007, reflecting yield growth in all markets. The yield improvement was mainly due to higher fares and increased fuel surcharges to partially offset higher fuel prices. A more favourable fare mix in both the economy and premium cabins was also a factor in the yield improvement from 2007.
- A stronger Canadian dollar in 2008, which lowers the Canadian dollar value of sales in foreign countries, had a negative impact on foreign currency denominated revenues, accounting for a decrease of $111 million to 2008 passenger revenues compared to 2007.
- In the first half of 2008, capacity increased 3.4% compared to the first half of 2007. Starting in the third quarter of 2008, Air Canada began reducing its capacity through fewer frequencies on existing routes and through the increased use of smaller aircraft in the fleet. In the last half of 2008, capacity was reduced by 5.4% compared to the last half of 2007. Overall, in 2008, system capacity was reduced by 1.2%, reflecting capacity decreases in all markets with the exception of other markets.
- In 2008, a traffic decline of 0.2% was less than the capacity decrease of 1.2% resulting in a 0.8 percentage point improvement in passenger load factor from 2007. Passenger load factor improvements were recorded in the international markets while decreases in passenger load factor were recorded in the domestic and US transborder markets. However, in the fourth quarter of 2008, Air Canada further reduced capacity to better match passenger demand which resulted in year-over-year improvements in passenger load factors in these markets.
- In 2008, RASM increased 5.3% from 2007 due to the growth in yield and, to a lesser extent, the passenger load factor improvement. RASM improvements were reflected in all markets.

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

2008 Versus 2007	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	3.5	(0.2)	(0.4)	(0.2)	3.8	3.6
US transborder	(0.5)	(7.4)	(7.5)	(0.1)	7.5	7.4
Atlantic	4.3	(2.5)	(0.4)	1.8	4.6	6.9
Pacific	3.0	(4.4)	(2.1)	2.0	5.1	7.7
Other	21.2	16.4	18.2	1.2	2.5	4.1
System	**4.1**	**(1.2)**	**(0.2)**	**0.8**	**4.3**	**5.3**

The system ASM capacity decrease of 1.2% in 2008 compared to 2007 was in line with the 1.0% to 1.5% ASM reduction projected in the Corporation's news release dated November 7, 2008. The domestic ASM capacity decrease of 0.2% was also in line with the 0.0% to 0.5% ASM capacity reduction projected in the Corporation's news release dated November 7, 2008.

Domestic passenger revenues increased 3.5% from 2007

Domestic passenger revenues of $4,108 million in 2008 increased $138 million or 3.5% from 2007 due to yield growth. The positive impact of the higher yield was offset by a slight decrease in traffic. Factors contributing to the year-over-year change in domestic passenger revenues included:

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- In 2008, yield increased 3.8% from 2007 mainly due to fare increases and fuel surcharges to partially offset higher fuel prices.
- A stronger Canadian dollar in 2008, which lowers the Canadian dollar value of sales in foreign countries, had a negative impact on foreign currency denominated revenues, accounting for a decrease of $22 million in 2008 domestic passenger revenues compared to 2007.
- In 2008, traffic declined 0.4% on a capacity reduction of 0.2% resulting in a passenger load factor decrease of 0.2 percentage points from 2007.
- In the premium cabin, premium traffic declined slightly, but under the capacity reductions, which resulted in a passenger load improvement of 2.4 percentage points. Premium cabin yield also increased mostly due to fare increases.

US transborder passenger revenues decreased 0.5% from 2007

US transborder passenger revenues of $1,876 million in 2008 decreased $8 million or 0.5% from 2007. The impact of a 7.5% traffic decline was largely offset by an increase in yield of 7.5%. Factors contributing to the year-over-year change in US transborder passenger revenues included:

- In 2008, capacity was reduced by 7.4% from 2007. Capacity decreases were achieved mainly through the reduction of frequencies on existing routes as well as the increased use of smaller aircraft in the fleet. In anticipation of the leisure discretionary traffic being impacted by the softening economy and increased fares and fuel surcharges, Air Canada reduced capacity on routes to California, Nevada and Florida. In addition, there was a capacity reduction on the Hawaiian service as a result of the introduction of a Vancouver – Sydney non-stop route which was previously operated as a one-stop via Hawaii. The Vancouver – Sydney route is recorded in other passenger revenues.
- In 2008, traffic declined 7.5% on a capacity reduction of 7.4% resulting in a decrease of 0.1 percentage points in passenger load factor from 2007. Passenger demand on Air Canada's short-haul routes was particularly impacted by the softening economy.
- In 2008, yield improved 7.5% from 2007 largely due to increased fares and fuel surcharges to partially offset higher fuel prices. In addition, the capacity reductions, mostly impacting longer-haul and more leisure-oriented lower-yielding routes, resulted in a higher overall average yield in the US market compared to 2007.
- In the premium cabin, premium traffic declined in line with the capacity reduction. Premium cabin yield improved 7.2% in line with the economy yield increases due to fare increases.
- The stronger Canadian dollar had a negative impact on foreign currency denominated revenues. The impact accounted for a decrease of $38 million to 2008 US transborder passenger revenues compared to 2007.
- In 2008, RASM increased 7.4% from 2007 due to the yield improvement.

Atlantic passenger revenues increased 4.3% from 2007

Atlantic passenger revenues of $1,883 million in 2008 increased $77 million or 4.3% from 2007 due to yield growth. The positive impact of the higher yield was offset by a slight decrease in traffic. Factors contributing to the year-over-year change in Atlantic passenger revenues included:

- In 2008, capacity was reduced by 2.5% from 2007. Capacity reductions were largely reflected on United Kingdom routes and were mainly achieved through the reduction of frequencies on existing routes.
- In 2008, traffic decreased 0.4% on the capacity reduction of 2.5% resulting in a passenger load factor improvement of 1.8 percentage points from 2007. Traffic on the United Kingdom service decreased 4.4% on a capacity reduction of 8.0%, resulting in a passenger load factor improvement of 3.2 percentage points.
- In 2008, yield improved 4.6% from 2007, reflecting yield improvements on all Atlantic services. The overall Atlantic yield improvement was largely due to increased fares and fuel surcharges to partially offset higher fuel prices. In addition, the tight capacity environment led to a more favourable fare mix in the economy cabin and therefore to a higher yield. Air Canada was able to maintain traffic in its

premium cabin however, due to pricing pressures to maintain this premium traffic, the premium cabin yield was negatively impacted.

- The stronger Canadian dollar had a negative impact on foreign currency denominated revenues. The impact accounted for a decrease of $28 million to 2008 Atlantic passenger revenues compared to 2007.
- In 2008, RASM increased 6.9% from 2007 due mostly to the growth in yield but also to the passenger load factor improvement.

Pacific passenger revenues increased 3.0% from 2007

Pacific passenger revenues of $995 million in 2008 increased $28 million or 3.0% from 2007 due entirely to yield growth. The positive impact of the higher yield was partially offset by a decrease in traffic. Factors contributing to the year-over-year change in Pacific passenger revenues included:

- In 2008, capacity was reduced by 4.4% from 2007, reflecting capacity reductions in all markets with the exception of China.
- In 2008, traffic decreased 2.1% on a capacity reduction of 4.4% resulting in passenger load factor improvement of 2.0 percentage points from 2007.
- In 2008, yield increased 5.1% from 2007 largely due to increased fares and fuel surcharges to partially offset higher fuel prices. Yield improvements were recorded in the Chinese, Japanese and Hong Kong markets while the Korean market reflected a yield decline. The Korean market was negatively impacted by local currency devaluation. Yield in the Chinese market was positively impacted by the Olympic Games where Air Canada was able to favourably price fares as a result of strong market demand. The higher yield on Pacific routes was achieved in spite of a 6.0% increase in average stage length compared to the same period in 2007.
- The stronger Canadian dollar had a negative impact on foreign currency denominated revenues. The impact accounted for a decrease of $12 million to 2008 Pacific passenger revenues compared to 2007.
- In 2008, RASM increased 7.7% from 2007 primarily due to the growth in yield but also due to the passenger load factor improvement.

Other passenger revenues increased 21.2% from 2007

Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) of $851 million in 2008 increased $149 million or 21.2% from 2007 primarily due to traffic growth. Factors contributing to the year-over-year change in other passenger revenues included:

- In 2008, traffic increased 18.2% on a capacity growth of 16.4% resulting in a 1.2 percentage point improvement in passenger load factor from 2007. Traffic growth in these markets mainly reflected the addition of a new non-stop service from Vancouver to Sydney, Australia which is served by a Boeing 777-200 aircraft. In 2007, this one-stop service via Hawaii was previously served by a Boeing 767-300 aircraft and the Vancouver-Hawaii segment was recorded in US transborder passenger revenues. Higher capacity mainly reflected increased flying on Air Canada Vacations routes, and to South America. Air Canada's one-stop service to Chile and Argentina was increased to a daily service this past summer versus five times per week in 2007. In addition, overall capacity to South America was substantially increased on December 1, 2008 compared to the same period in 2007.
- In 2008, yield improved 2.5% from 2007 largely due to fare increases to partially offset higher fuel prices. An increase in the proportion of higher-yielding business travelers was also a factor in the yield growth reflecting in part a greater demand for Air Canada's new Executive First product.
- The stronger Canadian dollar had a negative impact on foreign currency denominated revenues. The impact accounted for a decrease of $11 million to 2008 other passenger revenues compared to 2007.
- In 2008, RASM increased 4.1% from 2007 due to both the yield growth and the passenger load factor improvement.

Cargo revenues decreased 6% from 2007

2008 cargo revenues amounted to $515 million, $35 million or 6% below 2007. Freighter revenues decreased $58 million as Air Canada operated one MD-11 freighter aircraft to Europe in the first half of 2008 versus one MD-11 freighter to Europe for the full year 2007 and one freighter to Asia in the first half of 2007. Non-freighter revenues increased $23 million or 5%, reflecting higher revenues in international markets. System cargo yield per revenue ton mile improved 12%, mainly reflecting increased fuel surcharges in 2008. The following contributed to the year-over-year change in cargo revenues:

- In 2008, system traffic declined 16% from 2007 largely as a result of the termination of MD-11 freighter operations. Traffic on non-freighter aircraft decreased by 5% due to reduced cargo volumes in the domestic and US transborder markets. The termination of the Canada Post contract in mid-September 2008, reduced capacity in the US transborder market and weakening demand for air cargo, especially in the fourth quarter of 2008, contributed to the traffic decrease.

Other revenues were up 11% from 2007

Other revenues of $854 million in 2008 increased $87 million or 11% from 2007. Factors contributing to the year-over-year change in other revenues included:

- Higher aircraft sublease revenues of $61 million versus 2007.
- An increase of $18 million in revenues at Air Canada Vacations, mainly as a result of higher passenger volumes compared to 2007.
- Other factors amounting to a net increase of $8 million.

Excluding fuel expense, CASM increased 1.7% from 2007

Operating expenses were $11,121 million in 2008, an increase of $908 million or 9% from 2007, reflecting a significant fuel expense increase of $867 million and higher ownership costs of $143 million compared to the same period in 2007. These increases were partly offset by a reduction in aircraft maintenance expense of $98 million versus 2007.

Including fuel expense, CASM increased 10.2% over 2007. Excluding fuel expense, CASM increased 1.7% over 2007. Higher unit cost of ownership, reflecting Air Canada's investment in new aircraft and the aircraft interior refurbishment program, and the capacity reduction in the last half of 2008 were factors in the year-over-year increase in CASM, excluding fuel expense. A significant reduction in aircraft maintenance expense, the stronger Canadian dollar versus the US dollar for most of 2008 and unit cost savings related to the Boeing 777 aircraft partially offset the overall unit cost increase, excluding fuel expense.

The 1.7% increase in CASM, excluding fuel expense, was in line with the projected CASM, excluding fuel expense, provided in the Corporation's news release dated November 7, 2008 in which CASM, excluding fuel expense, was projected to increase between 1 to 2%, compared to the same period in 2007.

The following table compares Air Canada's operating expenses per ASM for 2008 to Air Canada's operating expenses per ASM for the corresponding period in 2007.

(cents per ASM)	2008	2007	Change cents	Change %
Wages and salaries	2.46	2.43	0.03	1.2
Benefits	0.56	0.63	(0.07)	(11.1)
Ownership (DAR) (1)	1.57	1.32	0.25	18.9
Airport user fees	1.61	1.63	(0.02)	(1.2)
Capacity purchase with Jazz	1.53	1.47	0.06	4.1
Aircraft maintenance	1.06	1.21	(0.15)	(12.4)
Food, beverages and supplies	0.51	0.50	0.01	2.0
Communications and information technology	0.46	0.44	0.02	4.5
Commissions	0.31	0.32	(0.01)	(3.1)
Other	2.34	2.25	0.09	4.0
Operating expense, excluding fuel expense (2)	**12.41**	**12.20**	**0.21**	**1.7**
Aircraft fuel	5.51	4.06	1.45	35.7
Total operating expense	**17.92**	**16.26**	**1.66**	**10.2**

(1) DAR refers to the combination of Aircraft rent and Depreciation and amortization.
(2) Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for additional information.

Fuel expense increased 34% from 2007

Fuel expense amounted to $3,419 million in 2008, an increase of $867 million or 34% from 2007. Factors contributing to the year-over-year change in fuel expense included:

- A higher base fuel price accounted for an increase of $1,131 million over 2007.

The above-noted increase was partially offset by the following:

- Fuel hedging gains of $79 million in 2008 versus fuel hedging gains of $31 million in 2007, an increase of $48 million over 2007.
- A volume-related decrease of $78 million, including the reduction MD-11 freighter flying. Air Canada operated one MD-11 freighter aircraft to Europe in the first half of 2008 versus one MD-11 freighter to Europe for the full year 2007 and one freighter to Asia in the first half of 2007.
- The favourable impact of a stronger Canadian dollar versus the US dollar which accounted for a decrease of $138 million to fuel expense compared to 2007.

The following table provides Air Canada's quarterly fuel price per litre and fuel consumption information for 2008.

2008	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
Fuel volume (millions of litres)	947	946	1,048	822	3,763
Fuel price per litre (cents)	75.2	89.2	101.0	95.8	90.4

Wages, salaries and benefits expense amounted to $1,877 million in 2008, a decrease of $43 million or 2% from 2007.

Wages and salaries expense totaled $1,528 million in 2008, an increase of $3 million from 2007. Factors contributing to the year-over-year change in wages and salaries expense included:

- A year-over-year increase of 1.1% or an average of 274 full-time equivalent ("FTE") employees on a capacity decrease of 1.2%. The insourcing of supply chain management in the aircraft maintenance division accounted for an increase of approximately 200 FTE employees compared to the same period in 2007.
- The reductions in unionized ranks announced in June only took effect in November 2008. Additional FTE employee reductions are anticipated in early 2009.
- Average wages increased 1.0% over 2007.
- In 2008, Air Canada recorded a provision of $8 million related to the reduction of employees under the staff reduction plan announced on June 17, 2008.

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

- Provisions relating to stock-based compensation expense amounted to $15 million in 2007. In 2008, provisions relating to stock-based compensation of $5 million were reversed as management had determined that certain performance vesting criteria would not be met.
- Provisions relating to employee profit sharing programs amounted to $43 million in 2007 versus provisions of $29 million in 2008.
- Overtime expenses were reduced by $8 million compared to 2007.

Employee benefits expense amounted to $349 million in 2008, a decrease of $46 million or 12% from 2007, mainly due to a reduction in pension expense as a result of revised pension actuarial estimates made as of January 1, 2008. Refer to section 9.6 of this MD&A for information on Air Canada's pension obligations.

Airport and navigation fees decreased 2% from 2007

Airport and navigation fees of $1,001 million decreased $21 million or 2% from 2007. Factors contributing to the year-over-year change in airport and navigation fees included:

- Lower rates for landing and general terminal fees. Landing fees at Toronto Pearson Airport were reduced by 3.1% and terminal charges were reduced by 4.7% effective January 1, 2008.
- Navigation fees in Canada were reduced by 4% effective August 2007.

Capacity purchase costs with Jazz increased 3% from 2007

Capacity purchase costs with Jazz, pursuant to the Jazz CPA, amounted to $948 million in 2008 compared to $923 million in 2007, an increase of $25 million or 3%, mainly due to a predetermined contractual increase in Jazz CPA rates of $20 million and other costs amounting to $12 million. Partly offsetting these increases was the favourable impact of foreign exchange on US denominated Jazz CPA expenses, accounting for a decrease of $7 million compared to 2007. Jazz ASM capacity was reduced by 1.6% in 2008 compared to 2007.

Ownership costs increased 17% from 2007

Ownership costs, comprised of aircraft rent, depreciation and amortization expenses, of $973 million in 2008 increased $143 million or 17% from 2007. Factors contributing to the year-over-year change in ownership costs included:

- The addition of new aircraft to Air Canada's operating fleet which accounted for an increase of $97 million.
- An increase in depreciation expenses of $68 million related to Air Canada's aircraft interior refurbishment program.
- An increase in depreciation expense for engines and rotable spare parts of $20 million over 2007. A favourable adjustment of $9 million relating to rotable spare parts was recorded in 2007 versus a favourable adjustment of $2 million in 2008.

- An increase of $6 million in software amortization costs compared to 2007.
- An increase of $6 million as a result of aircraft lease rate changes compared to 2007.
- Other factors accounting for a net increase of $8 million.

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

- The removal of aircraft from Air Canada's fleet which accounted for a decrease of $36 million in aircraft rent and depreciation and amortization expenses.
- A decrease of $23 million to aircraft rent expense as a result of reduced MD-11 freighter flying.
- The impact of a stronger Canadian dollar versus the US dollar which accounted for a decrease of $3 million to aircraft rent expense compared to 2007.

Aircraft maintenance expense decreased 13% from 2007

In 2008, aircraft maintenance expense of $659 million decreased $98 million or 13% from 2007. The decrease was partly due to timing of maintenance activities in engine and component maintenance as well as an overall reduction in maintenance expenses due to the sale, sublease to third parties or lease returns of certain aircraft previously in Air Canada's fleet. In addition, the insourcing of supply chain management had a positive impact on aircraft maintenance expense, accounting for a decrease of $26 million to aircraft maintenance expense. This decrease was partly offset by growth in FTE employees, resulting in an increase to wages and salaries. The impact of a stronger Canadian dollar versus the US dollar was also a factor in the decline versus the same period in 2007, accounting for a decrease of $13 million to aircraft maintenance expense. Partly offsetting these decreases were expenses of $32 million relating to Boeing 777, Embraer ERJ-190 and Embraer ERJ-175 aircraft in 2008 as well as an increase in airframe maintenance activities largely due to timing of maintenance events for narrow-body Airbus aircraft.

Other operating expenses increased 2% from 2007

Other operating expenses amounted to $1,450 million in 2008, an increase of $30 million or 2% from 2007. Factors contributing to the year-over-year change in other expenses included:

- Increased expenses for ground packages at Air Canada Vacations, which was largely the result of higher passenger volumes versus 2007.
- Higher credit card fees, which was largely driven by higher passenger sales and card usage.
- The decreases in other expenses included taxes, employee injury compensation, aircraft engine rental, training, insurance, joint venture and cargo trucking expenses.

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

(Canadian dollars in millions)	2008	2007	Change $	Change %
Other expenses				
Air Canada Vacations' land costs	$ 223	$ 195	$ 28	14
Credit card fees	197	184	13	7
Terminal handling	180	176	4	2
Building rent and maintenance	137	129	8	6
Crew expenses (meals, transportation and hotels)	117	117	-	-
Miscellaneous fees and services	112	103	9	9
Remaining other expenses	484	516	(32)	(6)
	$ 1,450	**$ 1,420**	**$ 30**	**2%**

Non-operating expense amounted to $170 million in 2008

Non-operating expense amounted to $170 million in 2008 compared to non-operating expense of $122 million in 2007. Factors contributing to the year-over-year change in non-operating expense included:

- Gains relating to fair value adjustments on derivatives instruments amounted to $92 million in 2008 versus gains of $26 million in 2007. The non-cash mark-to-market gain on financial instruments of $92 million recorded for the year ended December 31, 2008 represented a gain of $74 million related to the fair value of fuel derivatives as well as other gains on interest rate swaps. Refer to section 12 of this MD&A for additional information on Air Canada's derivative instruments.
- An increase in net interest expense of $77 million. A lower amount of capitalized interest related to new aircraft and a decrease in interest income due to both lower cash balances and lower rates of return more than offset a $29 million decrease in interest expense. The decrease in interest expense was driven by lower financing costs on the Boeing 777 aircraft commitments due to the favourable impact of the pre-delivery financing arranged in 2007, lower interest rates on floating rate debt, and the favourable impact of a stronger Canadian dollar versus the US dollar in 2008 compared to 2007, partially offset by the financing of additional aircraft year-over-year.
- In 2008, Air Canada recorded an impairment charge of $38 million related to the retirement of its fleet of Boeing 767-200 aircraft.
- In 2007, Air Canada recorded a gain on disposal of $14 million from insurance proceeds related to a CRJ-100 aircraft owned by Air Canada and leased to Jazz which was damaged beyond repair and gains of $5 million mainly pertaining to the sale of one real estate property.

Net losses on foreign exchange amounted to $655 million in 2008

Net losses on foreign exchange amounted to $655 million in 2008 compared to gains of $317 million in 2007. The losses in 2008 were attributable to a weaker Canadian dollar at December 31, 2008 compared to December 31, 2007, partially offset by gains of $327 million related to foreign currency derivatives. The December 31, 2008 noon day exchange rate was $1US = Cdn $1.2246 while the December 31, 2007 noon day exchange rate was $1US = Cdn $0.9881.

Provision of income taxes of $24 million in 2008

Air Canada recorded a provision for income taxes of $24 million in 2008. The tax provision reflected future income tax that has been reclassified from other comprehensive income to income for realized gains on fuel derivatives. A potential recovery of future income taxes of $148 million on the current year loss has been offset by a valuation allowance. This compared to a provision for income taxes of $190 million, at an effective income tax rate of 31%, for the same period in 2007. The effective income tax rate for 2007 was favourably impacted by the capital portion of certain foreign exchange gains reported in the year, which were tax-affected at 50% of the income tax rate. In addition, the favourable impact of a reduction in the federal corporate income tax rate was recognized in 2007. In 2007, Air Canada also recorded a current tax expense of $10 million related to the harmonization of Ontario and federal income taxes. This change in tax law resulted in a tax liability of $10 million payable over a period of five years, beginning in 2010.

8. Fleet

Air Canada's operating fleet at December 31, 2008 (excluding aircraft operated by Jazz under the Jazz CPA) was as follows:

	Total seats	Number of operating aircraft (1)	Average age	Owned (2)	Capital Lease (2)	Consolidated under AcG-15 (2)	Operating Lease
Air Canada							
Wide-body Aircraft							
Boeing 777-300	349	10	1.1	6	-	-	4
Boeing 777-200	270	6	1.1	4	-	-	2
Boeing 767-300	191-213	30	15.3	1	8	6	15
Airbus A330-300	265-274	8	8.2	-	8	-	-
Narrow-body Aircraft							
Airbus A321	174	10	6.8	-	-	5	5
Airbus A320	140-146	41	15.7	-	-	-	41
Airbus A319	120	35	11.0	-	17	15	3
Embraer E190	93	45	1.8	45	-	-	-
Embraer E175	73	15	3.3	15	-	-	-
Total		**200**	**8.8**	**71**	**33**	**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.

In 2008, Air Canada took delivery of the last three Embraer 190 aircraft on order bringing the total of Embraer 190 aircraft in its fleet to 45.

In 2008, Air Canada introduced five Boeing 777-300ER aircraft and three 777-200LR aircraft into its fleet. As at December 31, 2008, 15 of the 16 Boeing 777 firm aircraft under the purchase agreement with The Boeing Company ("Boeing") had been delivered, with the remaining aircraft firm delivery expected in the first quarter of 2009. In the third quarter of 2009, Air Canada expects to take delivery of one Boeing 777-300ER on a 10-year operating lease with International Lease Finance Corporation ("ILFC").

In 2008, Air Canada retired its fleet of Boeing 767-200 aircraft, consisting of 10 aircraft. These older aircraft are high unit cost aircraft from both a fuel consumption and maintenance perspective.

Pursuant to the Jazz CPA, Jazz operates an operating fleet of 133 aircraft with an average age of 13.4 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.

In response to record high fuel prices, on June 17, 2008, Air Canada announced a reduction in capacity. This capacity reduction, particularly the parking of the Boeing 767-200 aircraft, has impacted its fleet. The Corporation is continually evaluating its fleet requirements and planned aircraft events may be subject to further review and change.

The following table provides the existing and planned fleet changes to Air Canada's operating fleet (excluding aircraft operated by Jazz):

	Actual						Planned						
Fleet Plan	**December 31, 2007**	**New Deliveries**	**Sublease to Third Party**	**Lease returns**	**Parked**	**December 31, 2008**	**New Deliveries**	**Sublease toThird Party**	**Lease returns**	**Parked**	**December 31, 2009**	**2010 fleet changes**	**December 31, 2010**
B777-300	**5**	5	-	-	-	**10**	2	-	-	-	**12**	-	**12**
B777-200	**3**	3	-	-	-	**6**	-	-	-	-	**6**	**-**	**6**
B767-300	**31**	-	-	(1)	-	**30**	-	(2)	-	-	**28**	-	**28**
B767-200	**10**	-	-	-	(10)	**-**	-	-	-		**-**	-	**-**
A340-300 [(1)]	**5**	-	(3)	-	(2)	**-**	-	-	-	-	**-**	-	**-**
A330-300	**8**	-	-	-	-	**8**	-	-	-	-	**8**	**-**	**8**
A321	**10**	-	-	-	-	**10**	-	-	-	-	**10**	**-**	**10**
A320	**41**	-	-	-	-	**41**	-	-	-	-	**41**	**-**	**41**
A319	**37**	-	-	(2)	-	**35**	-	-	-	-	**35**	**-**	**35**
Embraer E190	**42**	3	-	-	-	**45**	-	-	-	-	**45**	**-**	**45**
Embraer E175	**15**	-	-	-	-	**15**	-	-	-	-	**15**	**-**	**15**
Total	**207**	11	(3)	(3)	(12)	**200**	2	(2)	-	-	**200**	-	**200**
Average age (years)	**9.0**					**8.8**					**9.5**		**10.5**

(1) Two Airbus A340-300 aircraft were parked in the fourth quarter of 2008 pending their sublease to third parties.

Aircraft Interior Refurbishment Program

Air Canada commenced a refurbishment program of the interiors of its existing aircraft (Boeing 767-300, Airbus A330-300, A321, A320 and A319 aircraft) in 2006 in order to offer its customers a world class product. Air Canada has completed the refurbishment of all its operating aircraft with the exception of seven Airbus A330 aircraft and one Boeing 767-300 aircraft. These aircraft are scheduled to be refurbished by mid-2009. The Embraer and Boeing 777 aircraft are delivered with the new seats and entertainment systems already installed.

9. Financial and Capital Management

9.1 Financial Position

The following table provides the financial position of Air Canada as at December 31, 2008 and as at December 31, 2007.

Condensed Statement of Financial Position (Canadian dollars in millions)	December 31, 2008	December 31, 2007
Assets		
Cash, cash equivalents and short-term investments	$ 1,005	$ 1,239
Other current assets	1,398	1,222
Current assets	2,403	2,461
Property and equipment	7,469	7,919
Intangible assets	997	952
Deposits and other assets	495	488
	$ 11,364	**$ 11,820**
Liabilities		
Current liabilities	$ 3,856	$ 2,939
Long-term debt and capital leases	4,691	4,006
Pension and other benefits liabilities	1,407	1,824
Other long-term liabilities	458	424
	10,412	**9,193**
Non-controlling interest	**190**	**184**
Shareholders' equity	**762**	**2,443**
	$ 11,364	**$ 11,820**

Net assets of the Corporation declined $1,681 million during the year reflecting the loss for the year of $1,025 million and the loss in the fair value of the Corporation's fuel derivatives recorded in other comprehensive income. The loss for the year was significantly impacted by losses on the Corporation's US denominated debt and the provision for cargo investigations of $125 million. Movements in current assets and liabilities are described below under "Working Capital".

Property and equipment amounted to $7,469 million at December 31, 2008, a reduction of $450 million from December 31, 2007, mainly due to the impact of depreciation expense of $646 million recorded during the year. In 2008, the impact of additions to capital assets of $883 million was largely offset by the disposal of assets related to the sale and leaseback of five Boeing 777 aircraft.

Long-term debt and capital leases, including the current portion, amounted to $5,354 million at December 31, 2008, an increase of $935 million from December 31, 2007. The increase was mainly due to a substantial depreciation of the Canadian dollar and the resulting impact on Air Canada's US denominated debt, which amounted to approximately $985 million. In 2008, the impact of additional borrowings of $871 million, which included new financings raised during the fourth quarter of 2008 amounting to $434 million, was more than offset by long-term debt and capital lease repayments of $992 million.

The decline in pension and other benefits liabilities of $417 million from December 31, 2007 was due to pension funding of $316 million in excess of pension expense and the reclassification of $132 million from pension and other benefits liabilities to current liabilities. Refer to section 9.6 of this MD&A for a discussion of Air Canada's pension funding obligations.

9.2 Adjusted Net Debt

The table reflects Air Canada's adjusted net debt balances and net debt to net debt plus equity ratio as at December 31, 2008 and as at December 31, 2007.

(Canadian dollars in millions)	December 31, 2008	December 31, 2007	Change
Total long-term debt and capital leases	$ 4,691	$ 4,006	$ 685
Current portion of long-debt and capital leases	663	413	250
	5,354	4,419	935
Non-controlling interest	190	184	6
Less cash, cash equivalents and short-term investments	(1,005)	(1,239)	234
Net debt and non-controlling interest	**4,539**	**3,364**	**1,175**
Capitalized operating leases (1)	2,093	2,115	(22)
Adjusted net debt and non-controlling interest	**6,632**	**5,479**	**1,153**
Less pre-delivery (PDP) financing included in long-term debt	(81)	(521)	440
Adjusted net debt and non-controlling interest, excluding PDP financing	**6,551**	**4,958**	**1,593**
Shareholders' equity	**$ 762**	**$ 2,443**	**$ (1,681)**
Adjusted net debt to net debt plus equity ratio, excluding PDP financing	**89.6%**	**67.0%**	**22.6 PP**

(1) *Adjusted net debt is a non-GAAP measure used by the Corporation and is not likely to be comparable to measures presented by other public companies. The Corporation includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7.5. This definition of capital is used by the Corporation and may not be comparable to similar measures presented by other public companies. Aircraft rent was $279 million for the twelve months ended December 31, 2008 and $282 million for the twelve months ended December 31, 2007. Aircraft rent expense 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 consolidated statement of operations.*

At December 31, 2008, adjusted net debt and non-controlling interest, including capitalized operating leases, and excluding the pre-delivery payment ("PDP") financing, increased $1,593 million from December 31, 2007. Net debt was adversely impacted by the substantial depreciation of the Canadian dollar and the resulting impact on US denominated debt. Net debt was also adversely impacted by the decrease in cash in 2008 which was driven by many factors including high fuel prices during most of 2008, the requirement to fund $322 million under fuel collateral deposits, higher past service pension funding payments and deteriorating economic conditions impacting travel demand. To offset these factors, Air Canada has been actively pursuing cost cutting and other measures and alternative financing arrangements as described in section 9.3 of this MD&A.

The adjusted net debt to net debt plus equity ratio for Air Canada increased to 89.6% at December 31, 2008 from 67.0% at December 31, 2007. The 22.6 percentage point deterioration from December 31, 2007 was impacted by both an increase in net debt and a decrease in shareholders' equity in the twelve months ended December 31, 2008.

9.3 Liquidity

Managing Air Canada's liquidity position was a key focus in 2008 and remains a key focus going forward. The Corporation's strategy for managing liquidity over the last few years was based on achieving positive cash from operations together with committed financing on new aircraft deliveries. Based on Air Canada's innovative revenue model, its renewed fleet combined and with its various cost containment programs, Air Canada had anticipated that cash from operations would provide adequate liquidity to service its pension funding obligations as well as its various contractual obligations, including debt repayments. Refer to sections 9.5 and 9.6 of this MD&A for additional information on the Corporation's contractual and pension funding obligations, respectively.

While the Corporation believes that it will benefit from its revenue model and achieve positive returns from its investment in its renewed fleet, as evidenced by yield improvements and positive load factors, the current economic environment, the volatility in the price of fuel combined with the collateral deposits under fuel derivatives and the increased pension funding obligations have caused the Corporation to revise its current strategy for managing liquidity, as described further below.

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 the Corporation's ability to continuously improve its controllable costs. Cash from operations can also be significantly affected by the fluctuations in the Corporation's pension deficit which requires funding over time and grows in circumstances where investment returns on pension assets are declining. Pension liabilities increase as a result of the lowering of interest rates.

Given the significant volatility in fuel prices and the current recessionary pressures, the Corporation is highly focused on preserving cash and identifying sources of cash inflows. As part of its efforts to preserve cash, the Corporation has reduced capacity and the associated expenses where appropriate.

Along with many airline carriers globally, Air Canada faced a number of significant challenges in 2008, including as a result of volatile fuel prices, foreign exchange, liquidity requirements and the weakening demand for air travel. With the expectation of a continuing recession in 2009, the industry, including Air Canada, will continue to face significant challenges throughout 2009. The recession is expected to put significant pressures on passenger and cargo revenues for many airlines, including Air Canada. At the same time, it is expected that lower fuel prices in 2009 and capacity adjustments made in 2008 as a result of the high fuel prices will provide some relief. Air Canada continues to be significantly leveraged requiring continuing interest payments and debt payments, which are largely denominated in foreign currencies. Further, the funding of employee benefit plans for many companies, including Air Canada, will be impacted during 2009 by the declines in the value of plan assets. In 2009, a number of the Corporation's collective agreements expire and uncertainties exist with respect to the outcome of their negotiation. In addition, the credit markets continued to be constrained throughout the latter part of 2008 raising concerns about available funding for a number of companies, including Air Canada. These factors have had an impact on the liquidity risk of Air Canada during 2008 and are continuing challenges for Air Canada as well as other airline industry companies.

Liquidity risk is the risk that Air Canada will encounter difficulty in meeting obligations associated with its financial liabilities and other contractual obligations. Air Canada monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. A key component of managing liquidity risk is also ensuring that operating cash flows are optimized. Air Canada's principal objective in managing liquidity risk is to maintain a minimum cash, cash equivalents and short-term investments' ("unrestricted cash") balance in excess of a target liquidity level of 15% of operating revenues. However, management expects there may be challenges to achieving its target unrestricted cash to operating revenue ratio of 15% in 2009.

During 2008 and continuing in 2009, management undertook various initiatives and developed a plan to manage its operating and liquidity risks taking into account the prevailing economic conditions including:

- Adjusted capacity by reducing the number of flights to various locations as a result of the effects of the high fuel prices. This reduction positioned Air Canada's capacity, in part, to better respond to the effects of the recession. Air Canada continues to monitor the market and its capacity with the objective of matching its capacity to passenger demand.

- Implemented cost containment initiatives including staffing level reductions, a company-wide fuel efficiency program, a supplier concession program and other cost reduction initiatives. Management continues to monitor staffing levels and costs and will make adjustments to reflect the capacity reductions and achieve further efficiencies. During the first quarter of 2009, Air Canada announced further staff reductions to align its costs with the planned capacity.

- Entered into hedging programs to manage its exposure to jet fuel prices and help mitigate volatility in operating cash flows. With the drop in fuel prices in the latter half of the year, management undertook strategies to alleviate some of the effects of the hedges and related requirements to post collateral deposits as the fair values became unfavourable, including terminating certain hedging positions as disclosed in section 12 of this MD&A. These strategies have reduced some of the liquidity risk related to the derivatives however Air Canada is exposed to higher fuel costs as most of the current hedge positions are at much higher prices than today's WTI levels. Based on current fuel prices as at December 31, 2008, Air Canada has a liability of $420 million for hedging losses offset by a deposit of $328 million. Cash collateral deposits of $328 million at December 31, 2008 were extended to counterparties to cover the exposure on the fair value of fuel hedging contracts. The difference between the amount extended and the fair value of fuel hedging contracts of $420 million relates to credit extended by certain counterparties as well as foreign exchange contracts in favour of Air Canada.

- Continued its capital expenditure program to acquire more fuel efficient aircraft. Air Canada has also arranged to lease and sublease certain aircraft to third parties to further manage capacity. In response to current economic conditions, management has curtailed its capital expenditures program for 2009. Management continues to consider strategies to monetize its parked aircraft and aircraft leased to others.

- Entered into new financial arrangements which provided aggregate net proceeds of $641 million during 2008 and, subject to the fulfillment of certain conditions, additional available credit of $50 million as at December 31, 2008. The following summarizes the principal financing arrangements undertaken:

    - A series of agreements for secured financings with General Electric Capital Corporation ("GECC") and its affiliates providing up to US$195 million (approximately $238 million), of which $99 million was received in December and $92 million was received in January 2009. This financing bears interest at 6.97% and matures in 2014. The remaining financing agreement with GECC pertains to the sale and leaseback of a Boeing 777 aircraft, remains subject to certain conditions and is planned for completion in 2009.

    - A secured revolving credit facility of up to $100 million with the Canadian Imperial Bank of Commerce ("CIBC") with draw downs being subject to certain conditions, of which $50 million was drawn as at December 31, 2008 for net proceeds of $47 million. This facility, which has a one year term, contains a financial covenant requiring Air Canada to maintain, as of the last business day of each month, a minimum cash level of $900 million, which includes the unused and available commitment under the facility and an interest coverage ratio test determined as at the end of each fiscal quarter. As of February 12, 2009, no amounts were drawn under this facility.

    - A secured financing transaction with Calyon New York Branch and Norddeutsche Landesbank Girozentrale for a $143 million loan, of which $97 million was received in December 2008 and the remaining received in January 2009, maturing in December 2013 bearing interest at 5.13%.

    - An agreement with Aeroplan to accelerate payments for purchase of seats for the period from October 2008 to May 2009, in exchange for future credits to be settled in 2009. Payments by Air Canada to Aeroplan for Miles earned by passengers continue based on the original terms of settlement. Under this arrangement, cash flows from operations have been favourably impacted by $63 million as at December 31, 2008. This impact will reverse in 2009 upon expiry of this agreement.

    - Two secured financings amounting to proceeds of $92 million and $99 million, respectively, due in 2009 which bear interest at 6.45%.

    - Sale and leaseback arrangements for five Boeing 777 aircraft which generated net proceeds of $144 million. Future lease payments required under these operating leases are disclosed in section 9.5 of this MD&A. Management will continue to consider other opportunities to enter into sale and leaseback arrangements to provide funding if and when necessary.

At December 31, 2008, Air Canada had cash, cash equivalents and short-term investments of $1,005 million, which represented 9% of 2008 operating revenues. At January 31, 2009, Air Canada had cash, cash equivalents and short-term investments of approximately $985 million.

Management continues to closely monitor the cash flows to ensure Air Canada has adequate cash resources to meet its obligations and commitments when they become due.

Air Canada has equity in Boeing 777 aircraft and Embraer aircraft, based upon estimated fair value in excess of loan value which would be available to support additional financings going forward. Management has developed estimates of the current value of these assets and identified potential opportunities. However, given the current and continuing instability of credit markets and economic conditions, there can be no assurance that Air Canada will be able, if needed, to conclude further transactions, including on acceptable terms, or that Air Canada's assets will generate the expected proceeds.

Air Canada is faced with several risks that may have a material impact on future operating results and liquidity. While management believes it has developed planned courses of action and identified other opportunities to mitigate the operating and liquidity risks, there is no assurance that management will be able to, if needed, achieve any or all of the opportunities it has identified or obtain sufficient liquidity, including, if events or conditions develop that are not consistent with management's expectations and planned courses of actions.

In addition to the risks related to the economic conditions as described above, the following are the key risks that Air Canada is monitoring which may impact operating results and liquidity:

- Market risks
- Pension funding obligations
- Covenants in credit card agreements
- Cargo investigations

Market Risks

Market risk includes the risk that future cash flows will fluctuate because of changes in market prices, including foreign exchange rates, interest rates and commodity prices. During 2008, the Corporation's operating results and cash flows were significantly affected by historically high and volatile fuel prices during the first half of the year and the weakening of the Canadian dollar during the second half of the year. While management is able to mitigate certain of these risks through certain hedging activities, the volatility of the markets has created challenges to mitigating the full extent of some of these risks. The price of fuel, foreign exchange rates and interest rates are beyond the control of management and it is reasonably possible market volatility will continue in the future which may adversely impact operating results and cash flows.

Sustained lower fuel prices in 2009 would have a positive impact on the Corporation's cash flows. Based on 2008 levels of activity, each $1 change in the price per barrel of crude oil impacts the Corporation's operating cash flows by approximately $25 million on an annual basis, excluding the impact of fuel surcharges and fuel hedges. As at February 12, 2009, the 2009 average West Texas Intermediate ("WTI") crude oil price was approximately $50 per barrel versus an average of $104 per barrel in 2008.

Pension Funding Obligations

Air Canada maintains several defined benefit pension plans. As further explained in section 9.6 of this MD&A, Air Canada's pension funding obligations are likely to rise significantly starting in the second half of 2009. Based on preliminary estimates, the solvency deficit as at January 1, 2009 in the registered pension plans, which is used to determine funding requirements, is estimated to be approximately $3,200 million, a significant increase versus the $1,175 million determined as at January 1, 2008. Based on pension funding legislation and regulations as at December 31, 2008, this solvency deficit would be funded over five years which would require an approximate $410 million increase to cash funding obligations for 2009.

The Government of Canada has proposed certain amendments to the general pension funding requirements for federally registered pension plans to address concerns over the impact of the 2008 decline in value of pension assets. These proposals include increasing the limit for smoothing asset valuation fluctuations over five years and increasing the period for funding a solvency deficiency from five years to ten years, subject to certain conditions. In particular, both members and retirees would need to agree to the extended schedule, or the difference between the five and 10-year payment schedules would need to be secured by a letter of credit. One of these two conditions would need to be met by December 31, 2009. If agreement by plan members and retirees or a letter of credit were not secured by the end of 2009, the plan would be required to fund the deficiency over the following five years. If these provisions are finalized, and based on the above preliminary estimates, Air Canada estimates funding requirements for 2009 will increase by approximately $150 million versus 2008, resulting in estimated aggregate pension funding payments of approximately $605 million during 2009. The estimated funding payments of $605 million include the estimated impact of funding changes to current service costs as well as other pension arrangements which amount to a reduction of approximately $10 million. Air Canada is monitoring the government's actions and dialoguing with government officials on this matter. Until the government finalizes this proposal and the funding valuation is completed during the first half of 2009, uncertainty as to the amount and timing of additional pension funding continue to exist. There can be no assurance that the proposed funding relief will be implemented. Any increase in funding obligations for 2009 will be paid in the second half of the year as the funding in the first half of the year is based on the January 1, 2008 actuarial valuation reports.

Covenants in Credit Card Agreements

Air Canada has various agreements with companies that process customer credit card transactions. Approximately 80% of Air Canada's sales are processed using credit cards, with remaining sales processed through cash based transactions. Air Canada receives payment for a credit card sale generally in advance of when the passenger transportation is provided.

Under the terms of one credit card processing agreement, the credit card processing company may withhold payment of funds to Air Canada upon the occurrence of certain events ("triggering events"), which include cash, cash equivalents and short-term investments ("unrestricted cash") of less than $900 million as at the end of any month and operating losses in excess of certain amounts. The amount of funds withheld (the "deposit") is based upon a specified percentage of credit card sales processed through the credit card processing company for which transportation has not been provided to the passenger. The specified percentage increases based upon the level of unrestricted cash below $900 million or the level of operating losses. If a triggering event occurred, based upon advance sales as at December 31, 2008, the deposit could be from a minimum of $110 million up to a maximum of $425 million.

Under the terms of the above credit card processing agreement, beginning at the end of the second quarter of 2009, the triggering events for deposits will change and be based upon a matrix of unrestricted cash and a debt service coverage ratio. The ratio is based upon an EBITDAR (earnings before interest, income taxes, depreciation, amortization, aircraft rentals, certain non operating income (expense) and special items) to fixed charges (principal, interest and aircraft rentals) ratio for the preceding four quarters. Under these triggering events, beginning at the end of the second quarter of 2009, the unrestricted cash required in order to avoid a deposit could be as much as $1.3 billion. The basis for calculating the amount of the deposit, if required, remains consistent with the above description.

Cargo Investigations

Air Canada is exposed to potential liabilities related to the cargo matter, as described in section 18 of this MD&A. During 2008, Air Canada recorded a provision of $125 million as a preliminary estimate. This estimate is based upon the current status of the investigations and proceedings and Air Canada's assessment as to the potential outcome for certain of them. This provision does not address the proceedings in all jurisdictions, but only where there is sufficient information to do so. Management has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings. Additional material provisions may be required. Amounts could become payable within the year and may be materially different than management's preliminary estimate.

Working Capital

Actively managing working capital is a key element in ensuring cash is available to support liquidity growth objectives. The following table provides additional information on Air Canada's working capital balances at December 31, 2008 as compared to December 31, 2007.

(Canadian dollars in millions)	December 31, 2008	December 31, 2007	Change in working capital
Cash and short-term investments	$ 1,005	$ 1,239	$ (234)
Accounts receivable	702	750	(48)
Collateral deposits for fuel derivatives	328	-	328
Fuel derivatives in current assets	-	68	(68)
Other current assets	368	404	(36)
Accounts payable and accrued liabilities	(1,440)	(1,226)	(214)
Fuel derivatives in current liabilities	(420)	-	(420)
Advance tickets sales	(1,333)	(1,300)	(33)
Current portion of long-term debt and capital leases	(663)	(413)	(250)
	$ (1,453)	**$ (478)**	**$ (975)**

The working capital deficiency of $1,453 million has deteriorated by $975 million from December 31, 2007, reflecting, in part, the scheduled repayment of long-term debt, the impact of capital expenditures, net of the related aircraft financing, significant contributions to the Corporation's pension plans, and a decrease in the fair market value of outstanding derivatives. The accounts payable balance increase reflected an increase in the current portion of pension funding payments and the provision for cargo investigations. The increase in other current liabilities included the fair value of outstanding fuel derivative liabilities of $420 million and the impact of foreign exchange on the current portion of US denominated debt.

In 2008, cash was favourably impacted by net proceeds of $144 million, from the sale and leaseback of five Boeing 777 aircraft. This is derived from the proceeds from the sale and leaseback transactions of $708 million less the final delivery payments on the aircraft and the repayment of the related pre-delivery financing. In 2008, additions to capital assets, excluding the sale and leaseback transactions, amounted to $696 million and included three Embraer E190 aircraft, three Boeing 777 aircraft, expenditures related to the aircraft interior refurbishment program and inventory and spare engines and is net of the return of certain Boeing 787 pre-delivery deposits. New aircraft financing amounted to $435 million and was mainly related to committed delivery financing and additional pre-delivery financing.

Collateral Deposits under Fuel Derivatives

The types of derivative instruments used by the Corporation within its hedging program, such as swaps and the put options within collar structures expose the Corporation to the potential of posting cash collateral deposits. The drastic decrease in fuel prices observed in the fourth quarter of 2008 has resulted in a significant negative fair value for the Corporation's portfolio of fuel hedges. Once the fair value in favour of the counterparty of certain fuel derivatives exceeds the credit thresholds with those counterparties, the Corporation is responsible for extending collateral to the counterparties. At January 31, 2008, the total cash collateral deposits held by counterparties amounted to $158 million ($328 million at December 31, 2008 and nil at December 31, 2007). If oil prices remain at the current levels throughout 2009, the collateral currently extended would cover the expected losses on fuel hedging contracts maturing in 2009 and would not generate additional cash outflows to the Corporation. This collateral requirement has put additional pressure on liquidity in the short term. If fuel prices remain at the current levels throughout 2009, the lower fuel prices will provide significant cash savings to the Corporation.

At December 31, 2008, Air Canada's sensitivity on cash collateral deposits was approximately US$5 million for every US$1 change in commodity prices (with increases to commodity prices benefiting the Corporation by lowering cash collateral deposit requirements and decreases having the reverse impact), excluding any benefits from favourable foreign exchange positions. As at February 12, 2009, due to the termination discussed below and settled contracts, Air Canada's sensitivity on cash collateral deposits was reduced to approximately $3 million for every US$1 change in commodity prices, excluding any benefits from favourable foreign exchange positions.

In the fourth quarter of 2008, the Corporation used various strategies to mitigate its collateral deposit risk exposure. Air Canada pursued its systematic hedging program by adding positions with new counterparties providing additional credit, bought put options to limit its exposure to further price reductions for the first half of 2009 and terminated options and swap contracts with a fair value of US$129 million for a total of 2.165 million barrels covering the end of 2008 and 2009 (or 17% of its outstanding positions) to avoid additional exposure on these positions. Air Canada also benefited from the offsetting impact of favourable foreign exchange hedging positions which reduced the collateral requirements with some counterparties where Air Canada has both fuel and foreign currency hedging instruments.

In January 2009, the Corporation terminated fuel derivative contracts with a fair market value of US$146 million for 3.34 million barrels covering 2009 and 2010 (or 35% of its outstanding position) to avoid additional exposure on these positions. The collateral held by the counterparty exceeded the amount owing by Air Canada therefore no additional cash outflows resulted. The decision to terminate positions in late 2008 and early 2009 has been beneficial to the Corporation as fuel prices have continued to drop.

Refer to section 12 of this MD&A for a discussion on fuel price risk.

9.4 Consolidated Cash Flow Movements

The following table provides the reader with the cash flow movements for the Corporation for the periods indicated:

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2008**	**2007**	**Change $**	**2008**	**2007 (2)**	**Change $**
Net cash provided by (used for) operating activities	$ (91)	$ 80	$ (171)	$ 103	$ 553	$ (450)
Fuel hedge collateral deposits, net of receipts	(322)	-	(322)	(322)	-	(322)
Changes in non-cash working capital	135	(30)	165	117	(83)	200
Cash flows from (used for) operating activities	(278)	50	(328)	(102)	470	(572)
Additions to capital assets	(150)	(942)	792	(883)	(2,703)	1,820
Free cash flow(1)	**(428)**	**(892)**	**464**	**(985)**	**(2,233)**	**1,248**
Proceeds from sale and leaseback transactions	**-**	-	-	708	-	708
Short-term investments	111	(2)	113	206	86	120
Other	48	(13)	61	159	(32)	191
Cash flows from (used for) investing activities (excluding additions to capital assets)	**159**	**(15)**	**174**	**1,073**	**54**	**1,019**
Borrowings	558	821	(263)	**871**	1,914	(1,043)
Reduction of long-term debt and capital leases	(284)	(199)	(85)	**(992)**	(504)	(488)
Other	(3)	20	(23)	**5**	(16)	21
Cash flows from (used for) financing activities	**271**	**642**	**(371)**	**(116)**	**1,394**	(1,510)
Net increase (decrease) in cash and cash equivalents	2	(265)	267	(28)	(785)	757
Net increase (decrease) in short-term investments	(111)	2	(113)	(206)	(86)	(120)
Net decrease in cash, cash equivalents and short-term investments	**$ (109)**	**$ (263)**	**$ 154**	**$ (234)**	**$ (871)**	**$ 637**

(1) Free cash flow is a non-GAAP measure used by the Corporation and is not likely to be comparable to measures presented by other public companies. Air Canada considers free cash flow to be an indicator of the financial strength and performance of its business because it shows how much cash is available to repay debt, meet ongoing financial obligations and reinvest in the Corporation.

(2) Reflects the results of Air Canada for 2008 and the results of the Air Canada Services segment, which excluded the consolidation of Jazz, for 2007.

Air Canada's free cash flow for the fourth quarter of 2008 improved $464 million from the fourth quarter of 2007 and $1,248 million in 2008 versus the same period in 2007. The improvement in free cash flow was related to a reduction in capital expenditures, due to fewer aircraft deliveries in 2008, largely offset by an unfavourable change in operating cash flows. The decrease in operating cash flows versus the same periods in 2007 was primarily driven by the requirement to fund the fuel hedge collateral deposits and, to a lesser extent, a deterioration in Air Canada's operating results and the impact of higher past service cost contributions under the Corporation's pension plans. Operating cash flows also included the impact of fuel derivatives which matured during the period, including a payment of $160 million in the fourth quarter of 2008 relating to terminated derivative contracts as described in section 12 of this MD&A. This loss on fuel derivatives was largely offset by realized gains on foreign exchange derivatives of $157 million.

9.5 Contractual Obligations

The table below provides Air Canada's current contractual obligations for 2009, for the next four years and after 2013.

(Canadian dollars in millions)	2009	2010	2011	2012	2013	Thereafter	Total
Long-term debt obligations	$ 487	$ 239	$ 257	$ 275	$ 325	$ 1,699	$ 3,282
Debt consolidated under AcG-15	70	136	378	90	37	323	1,034
Capital lease obligations	106	110	113	173	124	456	1,082
Interest repayment obligations (1)	312	273	231	199	166	504	1,685
Operating lease obligations (2)	416	398	354	331	293	860	2,652
Committed capital expenditures (3)	141	79	119	438	1,081	3,556	5,414
Total contractual obligations (4)	**$ 1,532**	**$ 1,235**	**$ 1,452**	**$ 1,506**	**$ 2,026**	**$ 7,398**	**$ 15,149**

(1) The interest repayment obligations relate to long-term debt, debt consolidated under AcG-15 and capital leases.
(2) The operating lease obligations above mainly relate to US dollar aircraft operating leases.
(3) The committed capital expenditures above mainly relate to US dollar aircraft-related expenditures. These expenditures also include purchases relating to system development costs, facilities and leasehold improvements.
(4) Total contractual obligations exclude commitments for goods and services required in the ordinary course of business. Also excluded are other long-term liabilities mainly due to reasons of uncertainty of timing of cash flows and items which are non-cash in nature.

Refer to section 9.6 below for information on Air Canada's pension plan funding obligations.

Fair Value Test

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 to prepay lease obligations as a result of value tests, these amounts would be 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 $896 million (US$731 million). The maximum payable amount declines over time to nil upon lease expiry. As the Corporation does not expect to have to prepay any significant 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. However, there can be no assurance that aircraft fair values will not decrease in the future such that the Corporation would be required to prepay significant amounts.

9.6 Pension Funding Obligations

Air Canada's cash pension funding contributions in 2008 and 2007 were as follows:

(Canadian dollars in millions)	2008	2007
Past service domestic registered plans	$ 189	$ 134
Current service domestic registered plans	165	160
Other pension arrangements (1)	102	84
Pension funding contributions	**$ 456**	**$ 378**

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

As at January 1, 2008, the solvency deficit in the registered domestic plans was $1,175 million. As at January 1, 2009, based on preliminary estimates, the solvency deficit in the registered pension plans is estimated to be approximately $3,200 million. The final funding obligation for 2009 will be determined based on the January 1, 2009 valuation, which will be completed in the first half of 2009. Based on pension funding legislation and regulations as at December 31, 2008, this preliminary estimate of the solvency deficit would be funded over five years requiring an approximate $410 million increase to cash funding obligations for 2009 versus 2008. For years 2010 to 2013, assuming no gains or losses in future years, current funding legislation and regulations would require an approximate $530 million increase to cash funding obligations versus 2008. However, several factors may impact required contributions, including regulatory developments, assumptions and methods used and changes in the economic conditions, mainly the return on fund assets and changes in interest rates. There can be no assurance that required contributions will be in line with preliminary estimates provided. These funding projections are updated annually

Air Canada is actively monitoring and pursuing a number of initiatives, certain of which are beyond the control of Air Canada, which may reduce the cash funding obligations in and after 2009 as further described below:

- Temporary solvency funding relief proposed by the Government of Canada;
- The asset smoothing method, if any, that could be applied to the value of assets; and
- A review of the legislative and regulatory framework of pension plans by the Government of Canada, which is currently underway.

In November 2008, the Government of Canada proposed temporary solvency funding relief for defined benefit pension plans under federal regulation. The proposed funding relief would allow plans to extend their solvency funding payment schedule to 10 years from five years in respect of solvency deficiencies that emerged in 2008, subject to certain conditions. In particular, both members and retirees would need to agree to the extended schedule, or the difference between the 5-year and 10-year payment schedules would need to be secured by a letter of credit. Under the proposal for funding relief, one of these two conditions would need to be met by December 31, 2009. If agreement by plan members and retirees or a letter of credit were not secured by the end of 2009, the plan would be required to fund the deficiency over the following five years. This measure, if implemented by the Government of Canada, would reduce 2009 pension funding by approximately $165 million versus the preliminary estimate of funding requirements in the January 1, 2009 valuation report, when completed. Funding reductions in subsequent years would be dependent upon satisfying one of the two conditions as noted above. There can be no assurance that the proposed relief will be implemented.

The Pension Benefits Standards Act and Regulations allow the use of an asset smoothing method over five years, limited to 110% of the market value of plan assets, to determine minimum funding requirements on a solvency basis. Any such smoothing method would also have to comply with actuarial practice and be accepted by regulators. In January 2009, the Government of Canada announced that it will work with the body that regulates federally regulated pension plans to consider additional funding flexibility options regarding asset smoothing. Air Canada will monitor these developments to determine the impact, if any, on Air Canada's pension funding obligations. Based on preliminary estimates, if a smoothed asset value limited to 110% of market value were to be used to determine Air Canada's minimum funding requirement, cash funding obligations for year 2009 would be reduced by a further $85 million.

Given the economic uncertainty and the uncertain outcome of the pension funding regulations, Air Canada's actual funding obligations for 2009 cannot be determined with any reasonable degree of certainty however they will rise significantly over 2008 levels. If the provisions outlined above are finalized, and assuming preliminary estimates, Air Canada estimates funding requirements for 2009 would increase by approximately $150 million versus 2008, which would result in estimated aggregate pension funding payments of approximately $605 million during 2009. The estimated funding payments of $605 million include the estimated impact of funding changes to current service costs as well as other pension arrangements which amount to a reduction of approximately $10 million. Management is monitoring the government's actions and dialoguing with government officials on this matter. Until the government finalizes this proposal and the funding valuation is completed during the first half of 2009, uncertainty as to the amount and timing of additional pension funding continue to exist. Any increase in funding obligations for 2009 would be paid in the second half of the year as the funding in the first half of the year is based on the January 1, 2008 actuarial valuation reports.

9.7 Capital Expenditures and Related Financing Arrangements

Boeing

In November 2005, Air Canada concluded agreements with Boeing for the acquisition of Boeing 777 and Boeing 787 aircraft.

As at December 31, 2008, 15 of the 16 Boeing 777 firm aircraft under the purchase agreement with Boeing had been delivered, with the remaining firm aircraft delivery expected in the first quarter of 2009. The seven aircraft delivered in 2007 were financed under a loan guarantee facility with the Export-Import Bank of the United States ("EXIM"). In January 2008, the Corporation received a commitment for loan guarantee support from EXIM for all nine 2008 Boeing 777 firm aircraft deliveries. 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. As at February 12, 2009, eight of the nine 2008 Boeing 777 aircraft have been delivered, three of these aircraft were financed using the EXIM facility and the other five aircraft were, concurrently with their purchase, sold by and leased back to Air Canada. The five leases are accounted for as operating leases with 12-year terms. All leases are at market rates at their inception date. These sale and leaseback transactions replace an equivalent number of aircraft loan guarantee commitments provided by EXIM. The table below assumes that Air Canada's remaining Boeing 777 firm aircraft expected for delivery in 2009 will be financed under the loan guarantee facility with EXIM.

In July 2009, the Corporation expects to take delivery of one Boeing 777-300ER aircraft on a 10-year operating lease.

Boeing notified Air Canada that its first Boeing 787 aircraft originally scheduled for delivery in February 2010 has been rescheduled for delivery for the second half of 2012, with additional deliveries, originally scheduled for completion between 2010 and 2014, being delayed by approximately three years. Air Canada will be seeking compensation from Boeing. Air Canada is evaluating alternatives to mitigate any potential impact of this delay.

Projected Planned and Committed Capital Expenditures

The table below provides Air Canada's current projected planned and committed capital expenditures for 2009, for the next four years and after 2013.

(Canadian dollars in millions)	2009	2010	2011	2012	2013	Thereafter
Projected committed expenditures	$ 141	$ 79	$ 119	$ 438	$ 1,081	$ 3,556
Projected planned but uncommitted expenditures	108	118	72	121	111	
Total projected expenditures (1) (2)	249	197	191	559	1,192	
Projected financing on committed expenditures	(130)	-	-	(315)	(862)	
Total projected expenditures, net of financing	**$ 119**	**$ 197**	**$ 191**	**$ 244**	**$ 330**	

(1) US dollar amounts are converted using the December 31, 2008 noon day exchange rate of 1US$ = Cdn$1.2246. 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, 2008.

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

9.8 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	
	January 31, 2009	December 31, 2007
Issued and outstanding shares		
Class A variable voting shares	15,402,859	16,654,049
Class B voting shares	84,597,141	83,345,951
Total issued and outstanding shares	**100,000,000**	**100,000,000**
Class A variable voting and Class B voting shares potentially issuable		
Stock options	1,701,447	1,720,092
Performance share units	1,680,159	551,251
Total shares potentially issuable	**3,381,606**	**2,271,343**
Total outstanding and potentially issuable shares	**103,381,606**	**102,271,343**

On December 10, 2008, ACE announced its intention to seek court and shareholder approvals for a plan of arrangement, pursuant to which it will proceed with a liquidation and its net assets, including its shares in Air Canada, will be distributed, in an orderly fashion, after providing for outstanding liabilities and costs of the transaction. As announced by ACE on January 21, 2009, subject to court and regulatory approvals, the special meeting of shareholders of ACE, initially scheduled for February 27, 2009, has been postponed to April 7, 2009.

10. Quarterly Financial Data

Prior to May 24, 2007, Air Canada had two reportable segments: Air Canada Services (which is now referred to as Air Canada) and Jazz. Segment information provided useful information to shareholders as it enabled them to distinguish between the results of operations, cash and other assets and liabilities of the two segments. Effective May 24, 2007, Air Canada no longer consolidates the operations of Jazz. **For comparative purposes, the following table summarizes quarterly financial results and major operating statistics for Air Canada, excluding the consolidation of Jazz operations, for the last eight quarters.**

($ millions, except per share figures)	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
Operating revenues	**$ 2,540**	**$ 2,639**	**$ 2,954**	**$ 2,513**	**$ 2,727**	**$ 2,782**	**$ 3,075**	**$ 2,498**
Aircraft fuel	(585)	(636)	(716)	(615)	(715)	(848)	(1,064)	(792)
Ownership (DAR) (1)	(207)	(211)	(210)	(202)	(234)	(242)	(243)	(254)
Other operating expenses	(1,826)	(1,704)	(1,677)	(1,624)	(1,790)	(1,685)	(1,656)	(1,598)
Operating expenses	**(2,618)**	**(2,551)**	**(2,603)**	**(2,441)**	**(2,739)**	**(2,775)**	**(2,963)**	**(2,644)**
Operating income (loss) before the under-noted item	**(78)**	**88**	**351**	**72**	**(12)**	**7**	**112**	**(146)**
Provision for cargo investigations (2)	-	-	-	-	(125)	-	-	-
Operating income (loss)	**(78)**	**88**	**351**	**72**	**(137)**	**7**	**112**	**(146)**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	44	67	(78)	(37)	(151)	115	(244)	(581)
Net income (loss)	**$ (34)**	**$ 155**	**$ 273**	**$ 35**	**$ (288)**	**$ 122**	**$ (132)**	**$ (727)**
Revenue passenger miles (millions)	11,814	12,580	14,789	11,446	12,331	12,884	14,458	10,845
Available seat miles (millions)	14,735	15,220	18,144	14,715	15,407	15,581	17,515	13,571
Passenger load factor (%)	80.2	82.7	81.5	77.8	80.0	82.7	82.5	79.9
RASM (cents) (3)	14.7	15.3	14.6	14.7	15.0	15.7	15.7	16.0
CASM (cents)	17.7	16.8	14.3	16.6	17.8	17.8	16.9	19.5
CASM, excluding fuel expense (cents) (3)	13.8	12.6	10.4	12.4	13.1	12.4	10.8	13.6
Fuel price per litres (cents) (4)	62.9	67.2	64.7	67.5	75.2	89.2	101.0	95.8
EBITDAR before the provision for cargo investigations (5)	**$ 129**	**$ 299**	**$ 561**	**$ 274**	**$ 222**	**$ 249**	**$ 355**	**$ 108**
EBITDAR (5)	**$ 129**	**$ 299**	**$ 561**	**$ 274**	**$ 97**	**$ 249**	**$ 355**	**$ 108**
Earnings (loss) per share - Basic and diluted (6)	**$(0.34)**	**$ 1.55**	**$ 2.73**	**$ 0.35**	**$(2.88)**	**$ 1.22**	**$(1.32)**	**$ (7.27)**

(1) DAR refers to the combination of Aircraft rent and Depreciation and amortization expenses.
(2) A provision for cargo investigations of $125 million was recorded in the first quarter of 2008.
(3) System RASM includes the impact of removing $26 million from the fourth quarter of 2007.
(4) Includes fuel handling and is net of fuel hedging results.
(5) See section 20 "Non-GAAP Financial Measures" in this MD&A for additional information.
(6) Earnings (loss) per share – basic and diluted are the consolidated Air Canada figures as reported under GAAP.

The table below summarizes quarterly financial results for Jazz for the first and second quarter of 2007. Effective May 24, 2007, Jazz results are no longer consolidated within Air Canada.

($ millions)	Q1 2007	Q2 2007
Jazz		
Operating revenues	**$ 364**	**$ 249**
Ownership (DAR) (1)	(40)	(26)
Other operating expenses	(288)	(197)
Operating expenses	**(328)**	**(223)**
Operating income	**36**	**26**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(1)	1
Net income	**$ 35**	**$ 27**

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

The table below summarizes quarterly consolidated financial results for the Corporation for the last eight quarters. The results below reflect the consolidation of Jazz only up to May 24, 2007. Refer to section 2 of this MD&A for additional information.

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($ millions, except per share figures)	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
Consolidated Total								
Operating revenues	**$ 2,510**	**$ 2,622**	**$ 2,954**	**$ 2,513**	**$ 2,727**	**$ 2,782**	**$ 3,075**	**$ 2,498**
Operating expenses	**(2,552)**	**(2,508)**	**(2,603)**	**(2,441)**	**(2,739)**	**(2,775)**	**(2,963)**	**(2,644)**
Operating income (loss) before the under-noted item	**(42)**	**114**	**351**	**72**	**(12)**	**7**	**112**	**(146)**
Provision for cargo investigations (1)	-	-	-	-	(125)	-	-	-
Operating income (loss)	**(42)**	**114**	**351**	**72**	**(137)**	**7**	**112**	**(146)**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	8	41	(78)	(37)	(151)	115	(244)	(581)
Net income (loss)	**$ (34)**	**$ 155**	**$ 273**	**$ 35**	**$ (288)**	**$ 122**	**$ (132)**	**$ (727)**
Earnings (loss) per share - Basic and diluted	**$(0.34)**	**$ 1.55**	**$ 2.73**	**$ 0.35**	**$(2.88)**	**$ 1.22**	**$(1.32)**	**$(7.27)**

(1) A provision for cargo investigations of $125 million was recorded in the first quarter of 2008.

11. Selected Annual Information

The following table provides selected annual consolidated information for the Corporation for the years 2006 through to 2008. 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 2008 are not directly comparable to its consolidated results for 2007, which included consolidation of Jazz only up to May 24, 2007, and for 2006, which included full-year consolidation of Jazz.

Consolidated total	**2008**	**2007**	**2006**
Operating revenues	$ 11,082	$ 10,599	$ 10,167
Special charge for Aeroplan miles (1)	-	-	(102)
Operating revenues	11,082	10,599	10,065
Operating expenses (2)	(11,121)	(10,104)	(9,806)
Operating income (loss) before undernoted item	**(39)**	**495**	**259**
Provision for cargo investigations (3)	(125)	-	-
Operating income (loss)	**(164)**	**495**	**259**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(861)	(66)	(74)
Net income (loss)	**$ (1,025)**	**$ 429**	**$ 185**
EBITDAR (4)	$ 809	$ 1,375	$ 1,214
EBITDAR excluding special charges (4)	$ 934	$ 1,375	$ 1,336
Earning (loss) per share			
- Basic	$ (10.25)	$ 4.29	$ (0.83)
- Diluted	$ (10.25)	$ 4.27	$ (0.83)
Cash, cash equivalents and short-term investments	$ 1,005	$ 1,239	$ 2,245
Total assets	$ 11,364	$ 11,820	$ 11,749
Total long-term liabilities (5)	$ 7,131	$ 6,579	$ 5,911

(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) 2008 includes a provision for cargo investigations of $125 million.
(4) Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).
(5) Total long-term liabilities include long-term debt (including current portion) and capital leases, pension and other benefit liabilities and other long-term liabilities.

12. Financial Instruments and Risk Management

As described in section 16 of this MD&A, the Corporation adopted Canadian Institute of Chartered Accountants ("CICA") sections 3862 and 3863 effective January 1, 2008. These new standards enhance disclosures with respect to financial instruments.

Risk Management

The Corporation is exposed to the following risks as a result of holding financial instruments: market risk, credit risk, fuel price risk, interest rate risk, foreign exchange risk and liquidity risk. The following is a description of these risks and how they are managed by the Corporation.

Market Risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices.

The Corporation uses derivative instruments to reduce market exposures from changes in foreign currency rates, interest rates, and fuel prices. The Corporation uses derivative instruments only for risk management purposes and not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be offset by changes in cash flows related to the risk being hedged.

Credit Risk

Credit risk is the risk of loss due to a counterparty's inability to meet its obligations. As at December 31, 2008, the Corporation's credit risk exposure consists mainly of the carrying amounts of cash, cash equivalents and short-term investments and accounts receivable as well as collateral deposits for fuel derivatives extended to counterparties. Cash and short-term investments are in place with major financial institutions, the Canadian government 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. Credit rating guidelines are used in determining counterparties for fuel hedging. In order to manage its exposure to credit risk and assess credit quality, the Corporation reviews counterparty credit ratings on a regular basis and sets credit limits when deemed necessary.

As of January 31, 2009, the Corporation had $158 million in collateral deposits extended to fuel hedge counterparties ($328 million as of December 31, 2008).

In 2008, a counterparty defaulted under a number of derivative agreements with the Corporation. As a result, the Corporation recorded a loss of $6 million and $2 million related to these foreign exchange and fuel derivatives, respectively. The loss is recorded in non-operating income (expense).

Fuel Price Risk

In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, the Corporation enters into derivative contracts with financial intermediaries. Throughout 2008, a systematic hedging strategy was applied by adding hedging positions on a regular basis. There are regular reviews to adjust the strategy in light of market changes. During 2008, fuel prices experienced extreme volatility and declined from a peak of US$145 per barrel of WTI crude oil in mid-2008 to US$34 per barrel of WTI crude oil in December 2008, which triggered collateral deposit requirements. The Corporation does not purchase or hold any derivative financial instruments for trading purposes.

As of December 31, 2008, approximately 35% of the Corporation's anticipated purchases of fuel for 2009 are hedged at an average WTI-equivalent capped price of USD$100 per barrel, of which 79% is subject to an average WTI-equivalent floor price of US$86 per barrel. The Corporation's contracts to hedge anticipated jet fuel purchases over the 2009 period is comprised of jet fuel, heating oil and crude oil-based contracts. The Corporation also hedged approximately 14% of its 2010 anticipated jet fuel purchases in crude oil-based contracts at an average capped price of US$110 per barrel and which are subject to an average floor price of US$103 per barrel.

The following table outlines the notional volumes per barrel along with the weighted average floor and ceiling price for each year currently hedged by type of derivative instruments. These average contract prices represent the equivalent price in WTI using the forward prices for WTI, heating oil, and jet fuel as at December 31, 2008.

At December 31, 2008				
Derivative Instruments	**Term**	**Volume (BBLs)**	**WTI-equivalent Average Floor Price (US$ per barrel)**	**WTI-equivalent Average Capped Price (US$ per barrel)**
Call Options (1)	2009	1,620,000	n/a	127
Swaps (1)	2009	1,455,000	100	100
	2010	1,250,000	100	100
Collars (1)	2009	4,760,000	82	92
	2010	1,960,000	106	116
Put options (2)	2009	1,200,000	40	n/a

(1) Air Canada is expected to generate fuel hedging gains if oil prices increase above the average capped price and is exposed to fuel hedging losses if oil prices decrease below the average floor price.

(2) Given the recent significant decrease in oil prices, Air Canada also purchased crude oil put options. Air Canada is expected to generate fuel hedging gains if oil prices decrease below the average floor price. Their objective is to protect against potential additional collateral requirements caused from further price decreases. The fair value of these derivative instruments increases as crude oil prices decrease, therefore offsetting in part the exposure on the total portfolio and limiting the collateral requirements. The premium paid related to these contracts was $4 million (US$3 million).

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 ("Accumulated Other Comprehensive Income") 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. The Corporation also holds certain fuel derivative instruments that do not qualify for hedge accounting, but which still constitute good economic hedges. 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.

At December 31, 2008, the fair value of the outstanding fuel derivatives was $420 million in favour of the counterparties ($77 million in favour of the Corporation in 2007). Fuel derivatives include both derivatives designated and not designated under fuel hedge accounting and are recorded within current liabilities on Air Canada's consolidated statement of financial position. In 2008, the total decrease in the fair value of the Corporation's fuel derivatives amounted to $531 million in 2008 (a gain of $160 million in 2007). Of the fair value loss, a loss of $606 million was recorded in other comprehensive income ("OCI") and the remaining $74 million was recorded as a gain in non-operating income (expense) in 2008.

The accounting treatment in either OCI or non-operating expense, as described above, does not alter the economic impact of the Corporation's fuel hedging program. During 2008, the fuel derivative contracts matured with a fair value in favour of the Corporation for $129 million ($61 million in 2007) generating cash inflows which helped the Corporation, along with fuel surcharges, managing the significant jet fuel price increases it faced in the first half of 2008. The benefit to fuel expense was $79 million in 2008 ($36 million in 2007).

During 2008, fuel derivative contracts were terminated with fair values in favour of the counterparties for $160 million. The value of the AOCI balance recognized in connection with these derivatives will be taken into fuel expense in the period where the derivative was scheduled to mature. As at December 31, 2008, the balance in AOCI was $606 million. The estimated net amount of existing losses reported in AOCI that is expected to be reclassified to net income (loss) during the following 12 months is $418 million before tax.

Subsequent to December 31, 2008, the Corporation modified its fuel hedge portfolio with the termination of swap and put option contracts for cash settlements of $156 million under hedge accounting and $16 million not under hedge accounting, both in favour of the counterparty. The value of the AOCI balance recognized in connection with these derivatives will be taken into fuel expense in the period where the derivative was scheduled to mature.

At January 31, 2009, the fair value of outstanding fuel derivatives was $251 million in favour of the counterparties. The deposits held in collateral with counterparties was $158 million and are expected to cover the hedging losses from maturing contracts throughout 2009 and a portion of 2010, if oil prices remain at current levels.

At January 31, 2009, approximately 34% of Air Canada's anticipated purchases of jet fuel for 2009 are hedged at an average WTI-equivalent capped price of US$99 per barrel, of which 45% is subject to an average WTI-equivalent floor price of US$81 per barrel. Air Canada has also hedged approximately 13% of its 2010 anticipated jet fuel purchases in crude oil-based contracts hedged at an average capped price of US$110 per barrel, of which 87% is subject to an average floor price of US$101 per barrel.

The following table outlines the notional volumes per barrel along with the weighted average floor and ceiling price for each year currently hedged by type of derivative instruments, updated for the terminated trades subsequent to December 31, 2008:

At January 31, 2009				
Derivative Instruments	**Term**	**Volume (BBLs)**	**WTI-equivalent Average Floor Price (US$ per barrel)**	**WTI-equivalent Average Capped Price (US$ per barrel)**
Call Options (1)	2009	4,180,000	n/a	108
	2010	400,000	n/a	134
Swaps (1)	2009	1,215,000	99	99
	2010	1,070,000	99	99
Collars (1)	2009	2,200,000	71	83
	2010	1,560,000	102	112
Put options (2)	2009	1,000,000	40	n/a

(1) Air Canada is expected to generate fuel hedging gains if oil prices increase above the average capped price and is exposed to fuel hedging losses if oil prices decrease below the average floor price.

(2) Given the recent significant decrease in oil prices, Air Canada also purchased crude oil put options. Air Canada is expected to generate fuel hedging gains if oil prices decrease below the average floor price. Their objective is to protect against potential additional collateral requirements caused from further price decreases. The fair value of these derivative instruments increases as crude oil prices decrease, therefore offsetting in part the exposure on the total portfolio and limiting the collateral requirements.

Interest Rate Risk

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

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

The ratio of fixed to floating rate debt outstanding is designed to maintain flexibility in the Corporation's capital structure and is based upon a long-term objective of 60% fixed and 40% floating. The ratio at December 31, 2008 was 58% fixed and 42% floating, including the effects of interest rate swap positions.

The following are the current derivatives employed in interest rate risk management activities and the adjustments recorded in 2008:

- In 2008, the Corporation entered into, and subsequently terminated three cross-currency interest rate swap agreements with terms of March 2019, May 2019, and June 2019, respectively, relating to Boeing 777 aircraft financing with an aggregate notional value of $300 million (US$283 million). These swaps converted US denominated debt principal and interest payments into Canadian denominated debt at a foreign exchange rate of par (US$1/CAD$1) and converted from a fixed interest rate of 5.208% and

5.640% to a floating interest rate. These derivative instruments were not designated as hedges for accounting purposes and were fair valued on a quarterly basis. In 2008, a gain of $4 million was recorded in gain on financial instruments recorded at fair value related to these derivatives. These swaps were terminated on October 1, 2008 with a fair value of $4 million in favour of the Corporation.

- As at December 31, 2008, the Corporation had entered into two interest rate swap agreements with terms of July 2022 and January 2024 relating to two Boeing 767 aircraft financing agreements with an aggregate notional value of $118 million (US$96 million) ($103 million (US$104 million) in 2007). These swaps convert the lease payments on the two aircraft leases from fixed to floating rates. The fair value of these contracts as at December 31, 2008 was $21 million in favour of the Corporation ($7 million in favour of the Corporation in 2007). These derivative instruments have not been designated as hedges for accounting purposes and are fair valued on a quarterly basis. In 2008, a gain of $14 million was recorded in gain on financial instruments recorded at fair value related to these derivatives ($3 million in 2007).

- 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. In 2006, the Corporation 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 had 15-year terms from the expected delivery date of the aircraft and their maturities ranged from June 2021 to December 2022. The Corporation settled the interest rate swaps upon delivery of the related aircraft. The Corporation did not apply hedge accounting to these derivative instruments. During 2008, the Corporation's one remaining Embraer 190 aircraft interest rate swap contract matured, with a fair value of $2 million in favour of the counterparty ($2 million in favour of the counterparty in 2007). No gain or loss was recorded in 2008 (a net loss of $10 million on 11 contracts was recorded in 2007).

Interest income includes $47 million in 2008 ($84 million in 2007) related to cash, cash equivalents, short-term investments and collateral deposits for fuel derivatives which are classified as held-for-trading. Interest expense reflected on Air Canada's consolidated statement of operations relates to financial liabilities recorded at amortized cost.

Foreign Exchange Risk

Foreign exchange risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

The Corporation's risk management objective is to reduce cash flow risk related to foreign denominated cash flows.

Air Canada's cash inflows are primarily in Canadian dollars, while a large portion of its outflows are in US dollars. This unbalanced mix results in an annual US dollar shortfall from operations. In order to mitigate this imbalance, Air Canada has adopted the practice of converting excess revenues from offshore currencies into US dollars. In 2008, this conversion generated coverage of approximately 30% of the imbalance. The remaining 70% was covered through the use of a variety of foreign exchange derivatives, including spot transactions, which had maturity dates corresponding to the forecasted shortfall dates. The level of foreign exchange derivatives expiring at any one point in time is dependent upon a number of factors, which include the amount of foreign revenue conversion available, US dollar net cash flows, as well as the amount attributed to aircraft and debt payments. As a result of the significant drop in the price of fuel, the Corporation's US dollar requirements have also declined proportionally.

The majority of the Corporation's outstanding debt is denominated in US dollars. The US dollar debt acts as an economic hedge against the related aircraft, which is routinely purchased, leased or subleased to third parties, and sold by Air Canada in US dollars.

The Corporation is also exposed to foreign exchange risk on foreign currency denominated trade receivables and foreign currency denominated net cash flows.

As noted below, given the substantial depreciation of the Canadian dollar during the fourth quarter of 2008, the Corporation chose to terminate certain of its foreign currency contracts in order to realize on the positive mark-to-market cash value of these derivatives. Consistent with the Corporation's risk management objectives, new derivative positions are being entered into at current foreign exchange rates.

The following are the current derivatives employed in foreign exchange risk management activities and the adjustments recorded in 2008 and as at January 31, 2009:

- As at December 31, 2008, the Corporation had entered into foreign currency forward contracts and option agreements converting US dollars and Euros into Canadian dollars on $632 million (US$516 million) and $5 million (EUR 3 million) which mature in 2009 and 2010 (2007 - $2,132 million (US$2,158 million) and $26 million (EUR 18 million) of future purchases in 2008 and 2009). The fair value of these foreign currency contracts as at December 31, 2008 was $64 million in favour of the Corporation (2007 - $124 million in favour of the counterparties). These derivative instruments have not been designated as hedges for accounting purposes and are fair valued on a quarterly basis. In 2008, a gain of $327 million was recorded in foreign exchange gain (loss) related to these derivatives (2007 - $(221) million loss).

- As at January 31, 2009, the Corporation had entered into foreign currency forward contracts and option agreements converting US dollars and Euros into Canadian dollars on $367 million (US$297 million) and $5 million (EUR 3 million) which mature in 2009 and 2010. The fair value of these foreign currency contracts as at January 31, 2009 was $51 million in favour of the Corporation. These derivative instruments have not been designated as hedges for accounting purposes and are fair valued on a quarterly basis.

- The cross-currency swap, as described above under interest rate risk management, acted as an economic hedge of the foreign exchange risk on the financing related to two Boeing 777 aircraft with a principal amount of $300 million (US$283 million).

- The Corporation had entered into currency swap agreements for 16 CRJ aircraft operating leases until lease terminations between 2007 and 2011. The final 11 currency swap agreements matured in January 2008 with a nominal fair value (2007 - $10 million in favour of the Corporation for five agreements). No gain or loss was recorded during the period (2007 - nil). These currency swaps with third parties had a nominal fair value in favour of the Corporation as at December 31, 2007 and had a notional amount of $78 million (US$79 million). These were not designated as hedges for hedge accounting purposes.

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

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

	Fourth Quarter		Full Year	
($ millions)	**2008**	**2007**	**2008**	**2007**
Ineffective portion of fuel hedges	$ 59	$ (20)	$ 83	$ (12)
Fuel derivatives not under hedge accounting	(40)	14	(9)	26
Cross-currency interest rate swaps	(2)	-	4	-
Other	15	5	14	12
Gain (loss) on financial instruments recorded at fair value	$ 32	$ (1)	$ 92	$ 26

Liquidity risk

Liquidity risk is the risk that the Corporation will encounter difficulty in meeting obligations associated with its financial liabilities and other contractual obligations.

For additional information on Air Canada's liquidity risks, refer to section 9.3 of this MD&A.

Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: foreign exchange risk; interest rate risk; and other price risk, which includes commodity price risk.

The Corporation uses derivative instruments to reduce market exposures from changes in foreign currency rates, interest rates, and fuel prices. The Corporation uses derivative instruments only for risk management purposes and not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be offset by changes in cash flows related to the risk being hedged.

Asset-Backed Commercial Paper ("ABCP")

The Corporation has $37 million ($29 million, net of a fair value adjustment) in non-bank sponsored ABCP which has been recorded in deposits and other assets. The carrying value as at December 31, 2008 was 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. No adjustments to the carrying value were recorded in 2008.

13. Off-Balance Sheet Arrangements

The following is a summary of Air Canada's 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, 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 $127 million as at December 31, 2008 ($119 million as at December 31, 2007), 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 or similar extra-contractual 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 and pursuant to contractual agreements between the Corporation and each of its officers and directors, 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 and similar extra-contractual liabilities and certain related contractual indemnities described above.

14. Related Party Transactions

At December 31, 2008, ACE held a 75% ownership interest in Air Canada. Air Canada has various related party transactions with ACE and Aveos Fleet Performance Inc. ("Aveos") (formerly called ACTS Aero Technical Support & Services Inc. ("Aveos")), which conducts the business previously operated by ACTS LP ("ACTS") prior to the sale of ACTS announced by ACE and completed on October 16, 2007.

Summary of Significant Related Party Agreements

The Relationship between the Corporation and Aveos

In 2008, ACTS LP settled certain contracts with Air Canada for $11 million, in relation to the sale of assets of ACTS LP. These contracts were accounted for as equity transactions, with a resulting dilution loss of $3 million recorded in non-controlling interest.

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 Aveos (formerly ACTS Aero), a new entity established to purchase the assets of ACTS LP, with ACE retaining a 23% interest in Aveos as at the date of this transaction.

On closing of the ACTS sale, the following transactions were recorded by Air Canada:

- Proceeds of $28 million for the sale of a building to Aveos.
- Proceeds of $17 million for the settlement of a related party receivable with ACTS.
- Proceeds of $20 million pursuant to the Non-Compete and Repair Schemes Transfer Agreement ("Repair Schemes and Non-Compete Agreement") described below.
- The funding of a letter of credit in the amount of $101 million related to the Pension and Benefits Agreement described below.

Aveos is a related party to Air Canada due to ACE's investment in both entities.

The ACTS Maintenance Agreements, the ACTS Master Services Agreement, and the General Services Agreements, all between Air Canada and ACTS, and the Repair Schemes and Non-Compete Agreement described below were assigned from ACTS to Aveos upon closing of the ACTS sale.

Pension and Benefits Agreement

The Corporation, ACTS and Aveos entered into a Pension and Benefits Agreement effective as of October 16, 2007, as amended ("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 and who became employees of Aveos on October 16, 2007 and (ii) those 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 (i.e. Aveos) upon closing of the ACTS Sale). Under the Pension and Benefits Agreement, Aveos is required to establish new defined benefit and defined contribution pension plans as well as other employee and retiree benefit arrangements (including health, life and disability) (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 are to be transferred to Aveos 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 Aveos 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 are to be paid by Air Canada through quarterly payments to Aveos 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 are to be transferred to Aveos, the current service pension cost and the current service and interest costs for other employee benefits are expensed by Air Canada with a full offset recorded as an amount charged to affiliates (Aveos).

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 commence employment with Aveos pursuant to the Transition MOA, as described further below. 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 will be made quarterly during the five years beginning after the unionized employees are transferred to Aveos, 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 Aveos, 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 Aveos are charged to Aveos.

The Pension and Benefits Agreement also required that Air Canada provide letters of credit to Aveos 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 initially totaled $101 million, subject to adjustment once the exact amounts of the relevant solvency deficiencies and accounting liabilities as at October 16, 2007 were 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 Aveos. The face amount of the letters of credit decreases as the related quarterly funding payments described above are made. During 2008, as described below under "Agreement with Aveos on Revised Payment Terms", the Corporation and Aveos also agreed to temporarily cancel certain letters of credit in the amount of $40 million. Aveos 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.

In 2008, Air Canada, Aveos, and the union representing the employees assigned to Aveos continued discussions regarding the options under which certain unionized employees would commence employment directly with Aveos and the creation of a separate bargaining unit for those employees at Aveos. On January 8, 2009, these same parties entered into a Memorandum of Agreement (the "Transition MOA") in order to resolve certain remaining issues and in order to (i) facilitate the orderly transition of certain Air Canada employees to Aveos and (ii) to establish terms and conditions of employment that will apply to those Air Canada employees who elect to become employees of Aveos. In relation to the Transition MOA, the Corporation and Aveos also entered into certain ancillary agreements (the "Ancillary Transition Agreements") to address commercial issues relating to the transition of employees contemplated by the Transition MOA. Before taking effect, the parties must complete a mediation and, if necessary, arbitration of certain issues they have not yet resolved but have agreed to submit to these processes, and the application to separate the bargaining unit must be ordered by the Canada Industrial Relations Board.

Non-Compete and Repair Schemes Transfer Agreement

Aveos and Air Canada are parties to a Non-Compete and Repair Schemes Transfer Agreement, effective as of October 16, 2007. Generally described, repair schemes are processes and methods which may be used in the maintenance and repair of aircraft and related equipment. The Non-Compete and Repair Schemes Transfer 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 Aveos to Air Canada of an undivided joint ownership interest in the repair schemes owned or developed by Aveos 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 CCAA, the Corporation had already granted ACTS full and exclusive right to these schemes on a royalty free basis.

The Non-Compete and Repair Schemes Transfer 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 Non-Compete and Repair Schemes Transfer 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 million. These proceeds were recorded in financing activities on Air Canada's consolidated statement of cash flows and a credit of $20 million was recorded in contributed surplus ($15 million after future income tax) as the transaction was recorded at the Corporation's carrying amount of nil.

The Non-Compete and Repair Schemes Transfer Agreement was assigned to Aveos upon closing of the ACTS sale.

Agreement with Aveos on Revised Payment Terms

Air Canada and Aveos entered into an agreement dated October 28, 2008 pursuant to which Air Canada has agreed to temporarily extend payment terms to Aveos under certain related party agreements. In exchange for the extended payment terms, certain letters of credit related to the Pension and Benefits Agreement, as described above, were canceled. The cancellation of the letters of credit provided cash to Air Canada of approximately $40 million and is offset by the impact of extended payment terms to Aveos of $22 million, for a net cash flow benefit of $18 million to the Corporation.

The extended payment terms to Aveos are reduced over the course of one year, with the first reduction starting approximately six months from the date of the agreement, and with a corresponding return of the letters of credit to Aveos. By October 2009, the letters of credit would be reinstated to the levels then required under the Pension and Benefits Agreement between the two parties.

Maintenance Agreements

Aveos and Air Canada are parties to a general terms and related services agreements effective October 1, 2006, pursuant to which Aveos 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. Aveos 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. Aveos serves as the Corporation's non-exclusive repair agency in respect of other services provided. The services agreement relating to aircraft heavy maintenance services, which expires in October 2011, will be extended to June 2013 conditional upon the issuance of an order of the Canada Industrial Relations Board establishing that Aveos is a distinct employer, bound by separate collective agreements and providing for the transition of employees from Air Canada to Aveos which are fully within the scope of the Transition MOA and the Ancillary Transition Agreements mentioned above. The services agreement relating to engine maintenance expires in October 2013, except in respect of certain engine types, for which the parties have agreed to extend the term to December 31, 2018. The services agreement relating to paint services expires in October 2009 and each of the other maintenance agreements referred to above expire in October 2013.

Master Services Agreement (MSA)

Aveos and Air Canada are parties to an amended and restated master services agreement (the "Aveos MSA"), effective January 1, 2007, pursuant to which the Corporation provides Aveos 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 Aveos to the Corporation. Aveos may elect to terminate any services under the Aveos MSA or the entire Aveos MSA upon six months' prior written notice, with the exception of services relating to information technology which Aveos cannot terminate prior to the expiry of the Aveos MSA. Air Canada may elect to terminate any services under the Aveos MSA or the entire Aveos 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.

General Services Agreements

Aveos and Air Canada are parties to an amended and restated general services agreement (the "Aveos GSA"), effective as of June 22, 2007, pursuant to which the Corporation provides Aveos with the services of a group of unionized employees for which the Corporation is reimbursed by Aveos for all costs, including salary and benefits, on a fully allocated basis. The Aveos 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 Aveos for proceeds of $28 million effective as of October 16, 2007. In connection with the sale, Air Canada and Aveos entered into a land sublease for certain land contiguous with the building and a service contract whereby the Corporation provides Aveos certain services related to the operation of the building.

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

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.

Air Canada has received notice from ACE that the substantive majority of these service agreements will be terminated in 2009.

Share Purchase Rights Sold by Air Canada to ACE

In 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 million. 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 million.

Warrants purchased from ACE

On November 26, 2007, Air Canada purchased certain share warrants held by ACE for consideration of $4 million, which was paid in 2007 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

In 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 million. The consideration is accounted for on Air Canada's consolidated statement of financial position in contributed surplus. Air Canada Vacations remains consolidated within the results of the Corporation.

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

(Canadian dollars in millions)	December 31, 2008	December 31, 2007
Accounts receivable		
ACE	$ 2	$ 9
Aveos	120	75
	$ 122	**$ 84**
Prepaid Maintenance		
Aveos	$ 5	$ 24
	$ 5	**$ 24**
Accounts payable and accrued liabilities		
Aveos	$ 99	$ 88
	$ 99	**$ 88**

Revenues and expenses with related parties are summarized as follows:

	Fourth Quarter		Full Year	
(Canadian dollars in millions)	2008	2007	2008	2007
Revenues				
Property rental revenues from ACE and Aveos	$ 7	$ 8	$ 29	$ 39
Revenues from information technology services to Aveos	4	3	15	14
Revenues from corporate services and other to ACE and Aveos	(7)	(1)	15	16
Cargo Revenues from Aveos	-	1	-	1
Other Revenues	-	1	-	1
	$ 4	**$ 12**	**$ 59**	**$ 71**
Expenses				
Maintenance expense for services from Aveos	$ 110	$ 127	$ 478	$ 632
Recovery of wages, salary and benefit expense for employees assigned to ACE and Aveos	(58)	(86)	(277)	(362)
Other Expenses	1		1	
	$ 53	**$ 41**	**$ 202**	**$ 270**

15. 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, a company that provides loyalty program services to the Corporation and purchases seats from Air Canada under the Aeroplan Commercial Participation and Services Agreement ("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, certain employees who perform work for ACE and others who are contractually assigned to Aveos 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 2008 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 Aveos and Aeroplan, for those employees who are contractually assigned, and to ACE, 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, 2008 ($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, 2008	December 31, 2007
Weighted average assumptions used to determine the accrued benefit liability		
Discount rate	7.35%	5.75%
Rate of compensation increase (1)	2.50%	2.50%
Weighted average assumptions used to determine the accrued benefit cost		
Discount rate	5.75%	5.00%
Expected long-term rate	7.15%	7.15%
Rate of compensation increase (2)	2.50%	2.50%

(1) As a result of the pay awards, a rate of compensation increase of 1.75% was used in 2007 and 2008 in determining the net benefit obligation for the pension plan and 2.50% for the remaining years.

(2) A rate of compensation increase of 1.75% was used in 2007 and 2008 in determining the net benefit pension expense and 2.50% for the remaining years.

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. An increase of 0.25% results in a decrease of $305 million to the pension obligation and $10 million to the pension expense. A decrease of 0.25% results in an increase of $313 million to the pension obligation and $9 million to the pension expense.

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 existed 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. The determination of the long-term rate considers recent fund performance, including the significant drop in the value of plan assets during 2008, and historical returns, to the extent that the past is indicative of the expected long-term, prospective rate. There can be no assurance that the plan will earn the assumed rate of return. A sensitivity analysis on pension expense assuming a change in the expected return on plan assets is provided below.

Asset Allocation

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

	2008	2007	Target allocation
Equity	52.9%	58.9%	59.0%
Bonds and Mortgages	43.5%	36.1%	41.0%
Cash and temporary investments	3.6%	5.0%	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.

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.

Sensitivity Analysis

Sensitivity analysis on the 2008 pension expense based on different actuarial assumptions with respect to discount rate and expected return on plan assets is as follows:

	0.25 percentage point	
Impact on 2008 pension expense in $ millions	**Decrease**	**Increase**
Discount rate on obligation assumption	$ 9	$ (9)
Long-term rate of return on plan assets assumption	$ 28	$ (28)

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. An 8.25% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2007 (9.25% was assumed for 2007). The rate is assumed to decrease gradually to 5% by 2015. 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 $21 million.

Income Taxes

The Corporation utilizes the assets and 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, 2008, Air Canada has substantial tax attributes largely in the form of loss carry forwards 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.

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 discount rates to be applied in the analysis and future cash flows to be generated by the assets, including the estimated useful life of the assets. Discount rates are determined with reference to estimated risk adjusted market rates of return for similar cash flows and were increased in 2008 reflecting a higher risk premium. The Corporation performs sensitivity analysis on the discount rates applied. The discount rates used are subject to measurement uncertainty.

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 within 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 upon emergence from CCAA. Since that time, the intangible assets have been reduced by a tax allocation of $914 million. 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.

16. Changes in Accounting Policies

Capital Disclosures and Financial Instruments – Presentation and Disclosure

Effective January 1, 2008, the Corporation adopted three new CICA accounting standards: section 1535, *Capital Disclosures*, section 3862, *Financial Instruments – Disclosures* and section 3863, *Financial Instruments – Presentation*.

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

Sections 3862 and 3863 replace section 3861, *Financial Instruments – Disclosure and Presentation*, revising and enhancing its disclosure requirements in certain areas, and carrying forward unchanged its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. Refer to section 12 of this MD&A for information on the Corporation's financial instruments.

Inventories

Effective January 1, 2008, the Corporation adopted CICA section 3031, *Inventories*, which replaced section 3030, *Inventories*. Section 3031 provides more extensive guidance on measurement, and expands disclosure requirements to increase transparency. The Corporation's accounting policy for aircraft fuel inventory is consistent with the measurement requirements in the new standard and, as a result, no adjustment was recorded on the transition, however, additional disclosures have been included in Air Canada's interim unaudited consolidated financial statements commencing in the first quarter of 2008.

Future Accounting Standard Changes

Goodwill and Intangible Assets

In February 2008, the CICA issued section 3064, Goodwill and Intangible Assets, which provides guidance on the recognition, measurement, presentation and disclosure for goodwill and intangible assets, other than the initial recognition of goodwill or intangible assets acquired in a business combination. The standard is effective for fiscal years beginning on or after October 1, 2008, and requires retroactive application to prior period financial statements. The Corporation has evaluated the impact of this new standard for adoption on January 1, 2009 and does not expect any significant impact on its consolidated financial statements.

Business Combinations, Consolidated Financial Statements and Non-controlling Interests

The CICA issued three new accounting standards in January 2009: section 1582, *Business Combinations*, section 1601, *Consolidated Financial Statements*, and section 1602, *Non-controlling interests*. These new standards will be effective for fiscal years beginning on or after January 1, 2011. The Corporation is in the process of evaluating the requirements of the new standards.

Section 1582 replaces section 1581, and establishes standards for the accounting for a business combination. It provides the Canadian equivalent to International Financial Reporting Standard IFRS 3 – *Business Combinations*. The section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011.

Sections 1601 and 1602 together replace section 1600 – *Consolidated Financial Statements.* Section 1601, establishes standards for the preparation of consolidated financial statements. Section 1601 applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of International Financial Reporting Standard IAS 27 - *Consolidated and Separate Financial Statements* and applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011.

International Financial Reporting Standards

The Canadian Accounting Standards Board has confirmed January 1, 2011 as the changeover date for Canadian publicly accountable enterprises to start using International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board. IFRS uses a conceptual framework similar to Canadian GAAP, but there are significant differences in recognition, measurement and disclosures.

As a result, the Corporation has developed a plan to convert its consolidated financial statements to IFRS establishing a cross-functional IFRS team represented by managers in the areas of Accounting, Taxation, IT and Data Systems, Internal Control and Processes, Planning, Compensation, Treasury, Investor Relations and Legal. Updates regarding the progress of the conversion plan are provided to the Corporation's Audit Committee on a quarterly basis.

The plan addresses the impact of IFRS on Accounting policies and implementation decisions, Infrastructure, Business activities and Control activities. A summary status of the key elements of the changeover plan is as follows:

Accounting policies and implementation decisions

- Key activities:
  - Identification of differences in Canadian GAAP and IFRS accounting policies;
  - Selection of the Corporation's ongoing IFRS policies;
  - Selection of the Corporation's IFRS 1 *First-time Adoption of International Financial Reporting Standards* ("IFRS 1") choices;
  - Development of financial statement format;
  - Quantification of effects of change in initial IFRS 1 disclosures and 2010 financial statements.
- Status:
  - The Corporation has identified differences between accounting policies under Canadian GAAP and accounting policy choices under IFRS, both on an ongoing basis and with respect to certain choices available on conversion, made in accordance with IFRS 1;
  - The Corporation will progress towards the quantification of the identified differences and choices throughout 2009 and 2010.

Infrastructure

- Financial reporting expertise
  - Key activity:
    - Development of IFRS expertise.
  - Status:
    - The Corporation has provided training for key employees and stakeholders. Additional training will be ongoing until full adoption in 2011.

- Information technology and data systems
  - Key activity:
    - Development of systems solution for transition period and post-convergence period.
  - Status:
    - The Corporation is in the process of identifying system requirements and solutions.

Business activities

- Financial covenants
  - Key activities:
    - Identification of impact on financial covenants and business practices;
    - Completion of any required renegotiations/changes.
  - Status:
    - The Corporation is in the process of analyzing the contractual implications of IFRS on any financing relationships and other arrangements.

- Compensation arrangements
  - Key activities:

        - Identification of impact on compensation arrangements;
        - Assessment of required changes.
    - Status:
        - The Corporation is in the process of analyzing any compensation policies that rely on indicators derived from the financial statements.

Control activities

- Internal control over financial reporting
    - Key activities:
        - For all accounting policy changes identified, assessment of Internal Controls over Financial Reporting ("ICFR") design and effectiveness implications;
        - Implementation of appropriate changes.
    - Status:
        - The Corporation is in the process of analyzing any issues with respect to ICFR.

- Disclosure controls and procedures
    - Key activities:
        - For all accounting policy changes identified, assessment of Disclosure Controls and Procedures ("DC&P") design and effectiveness implications;
        - Implementation of appropriate changes.
    - Status:
        - The Corporation is in the process of analyzing any issues with respect to DC&P.

17. Sensitivity of Results

Air Canada's financial results are subject to many different internal and external factors which can have a significant impact on operating results. In order to provide a general guideline, the following table describes, on an indicative basis, the financial impact that changes in certain assumptions would generally have had on Air Canada's operating results. These guidelines were derived from 2008 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) Key Variable		2008 Measure	Sensitivity Factor	Favourable/(Unfavourable) Estimated Operating Income Impact
Revenue Measures				
Passenger yield (cents)	System	19.2	1% increase in yield	$ 93
	Canada	25.2		$ 39
Traffic (RPMs) (millions)	System	50,519	1% increase in traffic	$ 84
	Canada	16,214		$ 36
Passenger load factor	System	81.4	1 percentage point increase	$ 103
RASM (cents)	System	15.6	1% increase in RASM	$ 89
Cost Measures				
Labour and benefits expenses ($ millions)		1,877	1% increase	$ (19)
Fuel – WTI price (US$/barrel) (1)		103.9	US$1/barrel increase to WTI	$ (25)
Fuel – jet fuel price (CAD cents/litre) (1)		92.5	1% increase	$ (35)
Cost per ASM (cents)		17.9	1% increase in CASM	$(111)
Currency Exchange				
Cdn$ to US$	1US$ = Cdn$1.23		1 cent increase (e.g. $1.23 to $1.24)	$ (30)

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

18. 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

Prior to emergence from its restructuring under the CCAA on September 30, 2004, the Corporation had sustained significant losses and the Corporation may sustain significant losses in the future. In 2008, the Corporation recorded an operating loss before a provision for cargo investigations of $39 million. Current economic conditions may result in significant losses for the Corporation. Despite ongoing business initiatives and efforts at securing cost reductions and additional sources of financing, the Corporation may not be able to successfully achieve positive net profitability or realize the objectives of any or all of its initiatives, including those which seek to offset or mitigate risks facing the Corporation, including those relating to economic conditions, liquidity, pension funding, unexpected volatility in fuel costs and other expenses.

Leverage

The Corporation has, and is expected to continue to have and incur, a significant amount of indebtedness, including substantial fixed obligations under aircraft leases and financings, and as a result of challenging economic or other conditions affecting the Corporation, the Corporation may incur greater levels of indebtedness. 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 and Liquidity

The Corporation faces a number of challenges in its business, including in relation to economic conditions, pension plan funding, volatile fuel prices, contractual covenants which could require the Corporation to deposit cash collateral with third parties, foreign exchange rates and increased competition from international, transborder and low-cost domestic carriers. The Corporation's liquidity levels may be adversely impacted by these as well as by other factors and risks identified throughout this MD&A. As part of the Corporation's efforts to meet such challenges and to support the Corporation's business strategy, significant liquidity and significant operating and capital expenditures are, and will 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 overcome challenges and support its business strategy if cash flows from operations and cash on hand are insufficient.

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

The Corporation's credit ratings influence its ability to access capital markets and its liquidity. 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, adversely impact its liquidity, 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.

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).

In May 2004, the Corporation and OSFI agreed on a protocol pursuant to which the solvency funding requirements for the Corporation's registered pension plans provided for in the then-existing federal regulations were amended with effect retroactive to January 1, 2004. The Corporation is required to make substantial annual cash contributions, and the level of those contributions increases 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.

The solvency deficit is influenced primarily by long-term interest rates and by the investment return on plan assets, which in turn may be dependant on a variety of factors, including economic conditions. The interest rate used to calculate benefit obligations for solvency purposes is a prescribed rate derived from the interest rates on long-term Government of Canada bonds. Deteriorating economic conditions may result in significant increases in the Corporation's funding obligations, which could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Refer to section 9.6 of this MD&A for information on Air Canada's pension funding obligations.

Economic and Geopolitical Conditions

Airline operating results are sensitive to economic and geopolitical conditions which can have a significant impact on the Corporation. For example, economic and geopolitical conditions may impact demand for air transportation, as well as the Corporation's operating costs, pension plan contributions and costs and availability of capital and supplies required by the Corporation. Especially in light of the Corporation's substantial fixed cost structure, any prolonged or significant impact arising from economic and geopolitical conditions, including weakness of the Canadian, US or world economies, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Airline fares and passenger demand have fluctuated significantly in the past and may fluctuate significantly in the future. 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. Depressed economic conditions in North America and other areas served by the Corporation, as well as geopolitical instability in various areas of the world, concerns about the environmental impacts of air travel and tendencies towards "green" travel initiatives where consumers reduce their travel activities, could have the effect of reducing demand for air travel in Canada and abroad and could materially adversely impact the Corporation's profitability.

Fuel Costs

Fuel costs constituted the largest percentage of the total operating costs of the Corporation in 2008. 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 2006, 2007 and 2008, fuel prices increased and fluctuated near or at historically high levels. Should fuel prices fluctuate significantly or increase significantly above current 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 2008 volumes, management estimates that a US$1 per barrel movement in the average price of WTI crude oil would have resulted in an approximate Cdn$25 million change in 2008 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 WTI crude oil and jet fuel as well as foreign exchange rates remained constant.

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 2008, a $0.01 increase in the US dollar/Cdn exchange rate (i.e., $1.23 to $1.24 per US dollar) would have had an estimated $30 million unfavourable impact on operating 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.

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. With the exception of the collective agreement with the IBT representing certain airport and call centre employees in the United States, which was renewed in 2008 for a term of three years, the most recent collective agreements with the unions representing the largest groups of employees were concluded in 2003 and 2004 and expire in 2009 (other than the collective agreements covering two groups of crew schedulers, which were concluded more recently). No strikes or lock-outs may lawfully occur during the term of the collective agreements, nor during the negotiations of their renewal until a number of pre-conditions, in respect of the unions for Canadian-based employees, prescribed by the Canada Labour Code, have been satisfied. There can be no assurance that collective agreements will be renewed without labour conflict or action or 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.

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.

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. Carriers against which the Corporation may compete, including US carriers, may undergo (and some of whom who have undergone) substantial reorganizations (including by way of merger with or acquisition by another carrier), creating reduced levels of indebtedness and lower operating costs and may 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 or other carriers against which the Corporation competes 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, financial (including in relation to liquidity and debt coverage ratios) and other 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 reducing the Corporation's liquidity, limiting the Corporation's ability to incur indebtedness, create liens, sell assets, make capital expenditures and engage in acquisitions, mergers or restructurings. Future financing and other major agreements may also be subject to similar covenants which limit Air Canada's operating and financial flexibility, which could materially and adversely affect the Corporation's profitability.

A failure by the Corporation to comply with its contractual obligations (including restrictive, financial and other covenants), or to pay its indebtedness and fixed costs could result in a variety of material adverse consequences, including the acceleration of its indebtedness, the withholding of credit card proceeds by the credit card service providers and the exercise of remedies by its creditors 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.

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.

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 and others. These initiatives, including activities relating to their development and implementation, may be adversely impacted by a wide range of factors, many of which are beyond 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, and the modernization of its 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 delays 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.

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, interruption or misuse 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 available at airports or from airport authorities or otherwise required for the Corporation's operations such as fuel, aircraft and related parts and aircraft maintenance services (including maintenance services obtained from Aveos). In certain cases, goods and services may only be available from a limited number of suppliers and transition to new suppliers may take significant amounts of time and require significant resources. A failure, refusal or inability of a supplier may arise as a result of a wide range of causes, many of which are beyond 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. Pursuant to the terms of the Jazz CPA, the Corporation pays Jazz a number of fees which are determined based upon certain costs incurred by Jazz. The Corporation also 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.

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 International 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.

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. 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, or have led, to proceedings against the Corporation and a number of airlines and other cargo operators in certain jurisdictions including in the European Union where all formal procedural steps preceding a decision have been completed. 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.

During 2008, the Corporation recorded a provision of $125 million as a preliminary estimate. This estimate is based upon the current status of the investigations and proceedings and the Corporation's assessment as to the potential outcome for certain of them. This provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Management has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings and investigations. Additional material provisions may be required.

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.

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.

Future Legal proceedings

Airlines are susceptible to various claims and litigation in the course of operating their business. Future litigation, including an increase in class action claims, could also have a material adverse effect on the Corporation's business and results from operations.

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

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 serious risk of an influenza pandemic. An outbreak of influenza, SARS or of another epidemic disease (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 and cost of air travel is also affected by factors such as geopolitical and economic conditions, war or the threat of war or terrorist attacks, fare levels and weather conditions. Due to these and other factors, operating results for an interim period are not necessarily indicative of operating results for an entire year, and operating results for 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, environment (including noise levels and carbon emissions) 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. For example, new and proposed legislation have been considered or adopted concerning carbon emissions emanating from the aviation industry; such legislative initiatives include, for example, market-based mechanisms called emissions trading systems which are being proposed and implemented to reduce the amount of pollutants in the atmosphere through the trading of emissions credits. The implementation of additional regulations or decisions, including those relating to carbon emissions, and others, whether 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.

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. The need to comply 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 $10 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

As of the date of this MD&A, ACE owns shares of Air Canada representing 75% of the voting interests in Air Canada. Voting control enables ACE to determine substantially all matters requiring security holder approval as a result of its voting interest in Air Canada. ACE would 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 effect or prevent a change in control of Air Canada. This voting control may discourage transactions involving shares in 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

ACE generally has the right at any time to spin-off the Air Canada shares that it owns or to sell a controlling interest in Air Canada to a third party, in either case without the approval of the public shareholders of Air Canada and without providing for a purchase of such shareholders' shares of Air Canada. Sales of substantial amounts of Air Canada's shares by ACE (including through a distribution of Air Canada's shares to ACE shareholders), 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 Initial Public Offering ("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 the prevailing market prices of the shares.

19. Controls and Procedures

Disclosure Controls and Procedures and Internal Controls over Financial Reporting
Disclosure controls and procedures within the Corporation have been designed to provide reasonable assurance that all relevant information is identified to its Disclosure Policy Committee to ensure appropriate and timely decisions are made regarding public disclosure.

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

The Corporation filed certifications, signed by the President and Chief Executive Officer ("CEO") and the Executive Vice President and Chief Financial Officer ("CFO"), with the Canadian Securities Administrators ("CSA") upon filing of the Corporation's 2008 annual filings. In those filings, the Corporation's CEO and CFO certify, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design and effectiveness of the Corporation's disclosure controls and procedures and the design and effectiveness of internal controls over financial reporting. The Corporation's CEO and CFO also certify the appropriateness of the financial disclosures in the Corporation's interim filings with securities regulators. In those interim filings, the Corporation's CEO and CFO also certify the design of the Corporation's disclosure controls and procedures and the design of internal controls over financial reporting.

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

Management's Report on Disclosure Controls and Procedures
Management, with the participation of the Corporation's CEO and CFO, assessed the effectiveness of the Corporation's disclosure controls and processes and concluded, as at December 31, 2008, that such disclosure controls and processes were effective to provide reasonable assurance that:

(i) material information relating to the Corporation was made known to its Disclosure Policy Committee by others; and

(ii) information required to be disclosed by the Corporation in its annual filings, interim filings and other reports filed or submitted by the Corporation under securities legislations was recorded, processed, summarized and reported within the periods specified in securities legislation.

In addition, the evaluation covered the Corporation's processes, systems and capabilities relating to regulatory filings, public disclosures and the identification and communication of material information.

Management's Report on Internal Controls over Financial Reporting
Management, with the participation of the Corporation's CEO and CFO, assessed the effectiveness of the Corporation's internal controls over financial reporting. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control - Integrated Framework. Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2008, the Corporation's internal controls over financial reporting were effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. This evaluation took into consideration the Corporation's Corporate Disclosure Policy and the functioning of its Disclosure Policy Committee.

Changes in Internal Controls over Financial Reporting
There have been no changes to the Corporation's internal controls over financial reporting during the year ended December 31, 2008 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

20. Non-GAAP Financial Measures

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before aircraft rent and depreciation and amortization as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Air Canada presents EBITDAR before and after the provision for cargo investigations as this item could potentially distort the analysis of trends in business performance. 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 before the provision for cargo investigations and EBITDAR for Air Canada (previously "Air Canada Services") are reconciled to operating income (loss) as follows:

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2008**	**2007**	**$ Change**	**2008**	**2007**	**$ Change**
GAAP operating income (loss) before the provision for cargo investigations	$ (146)	$ 72	$ (218)	$ (39)	$ 433	$ (472)
Add back:						
Aircraft rent	80	62	18	279	282	(3)
Depreciation and amortization	174	140	34	694	548	146
EBITDAR before the provision for cargo investigations	**$ 108**	**$ 274**	**$ (166)**	**$ 934**	**$ 1,263**	**$ (329)**
Add back:						
Provision for cargo investigations	-	-	-	(125)	-	(125)
EBITDAR	**$ 108**	**$ 274**	**$ (166)**	**$ 809**	**$ 1,263**	**$ (454)**

Operating Expense excluding Fuel Expense

Air Canada uses operating expense excluding fuel expense to assess the operating performance of its ongoing business without the effects of fuel expense. This item is excluded from Air Canada's results as it could potentially distort the analysis of trends in business performance. Fuel expense fluctuates 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 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, for Air Canada (previously "Air Canada Services") is reconciled to operating expense as follows:

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2008**	**2007**	**$ Change**	**2008**	**2007**	**$ Change**
GAAP operating expense	$ 2,644	$ 2,441	$ 203	$ 11,121	$ 10,213	$ 908
Remove:						
Aircraft fuel	(792)	(615)	(177)	(3,419)	(2,552)	(867)
Operating expense, excluding fuel expense	**$ 1,852**	**$ 1,826**	**$ 26**	**$ 7,702**	**$ 7,661**	**$ 41**

21. 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 and amortization 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 and amortization as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Refer to section 20 of this MD&A for additional information.

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.

Yield — Average passenger revenue per RPM.