2009

Management's Discussion and Analysis of Results and Financial Condition

February 10, 2010

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1. Highlights

The financial and operating highlights for the Corporation for the periods indicated are as follows. Refer to section 2 of this MD&A for additional information.

(Canadian dollars in millions except per share figures)	Fourth Quarter			Full Year		
	2009	2008	Change $	2009	2008 [1]	Change $
Financial						
Operating revenues	2,348	2,498	(150)	9,739	11,082	(1,343)
Operating loss before a special provision [1]	(83)	(146)	63	(316)	(39)	(277)
Operating loss	(83)	(146)	63	(316)	(164)	(152)
Non-operating expense	(83)	(44)	(39)	(355)	(170)	(185)
Loss before non-controlling interest, foreign exchange and income taxes	(166)	(190)	24	(671)	(334)	(337)
Loss for the period	(56)	(727)	671	(24)	(1,025)	1,001
Operating margin before a special provision % [1]	-3.5%	-5.8%	2.3 pp	-3.2%	-0.4%	(2.8) pp
Operating margin %	-3.5%	-5.8%	2.3 pp	-3.2%	-1.5%	(1.7) pp
EBITDAR before a special provision [1][2]	167	108	59	679	934	(255)
EBITDAR [2]	167	108	59	679	809	(130)
EBITDAR margin before a special provision % [1][2]	7.1%	4.3%	2.8 pp	7.0%	8.4%	(1.4) pp
EBITDAR margin % [2]	7.1%	4.3%	2.8 pp	7.0%	7.3%	(0.3) pp
Cash, cash equivalents and short-term investments	1,407	1,005	402	1,407	1,005	402
Free cash flow	(52)	(428)	376	(399)	(985)	586
Adjusted debt/equity ratio %	80.1%	89.6%	(9.5) pp	80.1%	89.6%	(9.5) pp
Loss per share - Basic and diluted	($0.25)	($7.27)	$7.02	($0.18)	($10.25)	$10.07
Operating Statistics			Change %			Change %
Revenue passenger miles (millions) (RPM)	10,885	10,845	0.4	47,884	50,519	(5.2)
Available seat miles (millions) (ASM)	13,841	13,571	2.0	59,343	62,074	(4.4)
Passenger load factor %	78.6%	79.9%	(1.3) pp	80.7%	81.4%	(0.7) pp
Passenger revenue per RPM (cents)	18.6	20.1	(7.3)	17.7	19.2	(7.6)
Passenger revenue per ASM (cents)	14.6	16.0	(8.8)	14.3	15.6	(8.4)
Operating revenue per ASM (cents)	17.0	18.4	(7.8)	16.4	17.9	(8.1)
Operating expense per ASM ("CASM") (cents)	17.6	19.5	(9.8)	16.9	17.9	(5.4)
CASM, excluding fuel expense (cents)	13.2	13.6	(3.2)	12.8	12.4	3.3
Average number of full-time equivalent (FTE) employees (thousands) [3]	22.5	23.6	(4.8)	22.9	24.2	(5.3)
Aircraft in operating fleet at period end [4]	332	333	(0.3)	332	333	(0.3)
Average fleet utilization (hours per day) [5]	8.6	8.8	(2.3)	9.2	9.6	(4.2)
Average aircraft flight length (miles) [5]	823	827	(0.5)	847	863	(1.9)
Fuel price per litre (cents) [6]	72.6	95.8	(24.2)	69.4	90.4	(23.2)
Fuel litres (millions)	825	822	0.4	3,510	3,763	(6.7)

(1) *A provision related to investigations and proceedings related to alleged anti-competitive cargo pricing activities of $125 million was recorded in the first quarter of 2008.*
(2) *See section 21 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before the provision for cargo investigations and proceedings to operating income (loss) and EBITDAR to operating income (loss).*
(3) *Reflects FTE employees at Air Canada. Excludes FTE employees at Jazz.*
(4) *Includes Jazz aircraft covered under the Jazz CPA.*
(5) *Excludes charter operations. Also excludes third party carriers operating under capacity purchase arrangements, other than Jazz aircraft covered under the Jazz CPA.*
(6) *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.

Air Canada's 2009 MD&A provides the reader with a view and analysis, from the perspective of management, of Air Canada's financial results for the fourth quarter of 2009 and for the full year 2009. This MD&A should be read in conjunction with Air Canada's audited consolidated financial statements and notes for 2009. All financial information has been prepared in accordance with Generally Accepted Accounting Principles in Canada ("GAAP"), unless indicated otherwise.

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 22 "Glossary". Except as otherwise noted, this MD&A is current as of February 9, 2010.

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 Air Canada, see section 19 "Risk Factors" of this MD&A.

The Corporation issued a news release dated February 10, 2010 reporting on its results for the fourth quarter of 2009 and for the full year 2009. This news release is available on SEDAR at **sedar.com** and at **aircanada.com**.

For further information on Air Canada's public disclosure file, including Air Canada's Annual Information Form, consult SEDAR at **sedar.com** or Air Canada's website at **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 communications, including 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. Forward-looking statements are identified by the use of terms and phrases such as "anticipate", "believe", "could", "estimate", "expect", "intend", "may", "plan", "predict", "project", "will", "would", and similar terms and phrases, including references to assumptions.

Forward-looking statements, by their nature, are based on assumptions, including those described herein and are subject to important risks and uncertainties. Forward-looking statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, industry, market, credit and economic conditions, the ability to reduce operating costs and secure financing, 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 19 "Risk Factors" of this MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of the date of this MD&A and are subject to change after such date. However, Air Canada disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

Assumptions were made by Air Canada in preparing and making forward-looking statements. Air Canada assumes that the North American economy will start to slowly recover in 2010. In addition, Air Canada expects that the Canadian dollar will trade, on average, at C$1.06 per U.S. dollar in the first quarter of 2010 and C$1.04 per U.S. dollar for the full year 2010 and that the price of fuel will average 69 cents per litre in the first quarter of 2010 and for the full year 2010 (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 2009, Air Canada, together with Jazz Air LP ("Jazz"), operated an average of 1,331 scheduled flights daily and carried almost 31 million passengers and provided direct passenger service to 156 destinations and, through commercial agreements with other unaffiliated regional airlines, to an additional 11 destinations, for a total of 167 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 as well as 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 26 member airlines. Through its membership in the Star Alliance® network, Air Canada is able to offer its customers access to approximately 1,077 destinations in 175 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges.

Air Canada is in the process of concluding arrangements for the implementation of a transatlantic alliance with Continental Airlines, Lufthansa and United Airlines, (which, when concluded, is intended to be effective as of January 1, 2010) and which will enable Air Canada to offer its customers more value, choice and transparency when making their transatlantic travel plans.

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 its cargo services division (doing business as "Air Canada Cargo") and from tour operator services provided by its wholly-owned subsidiary, Touram Limited Partnership (doing business as "Air Canada Vacations").

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

Air Canada Vacations is one of Canada's leading tour operators. Based in Montreal and Toronto, Air Canada Vacations operates its business in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, South America, and Asia) by developing, marketing and distributing vacation travel packages. Air Canada Vacations also offers cruise packages in the Caribbean, North America and Europe. Air Canada Vacations markets its products through its website (www.aircanadavacations.com) and a network of independent travel agencies across Canada.

4. Strategy

For Air Canada and the rest of the airline industry, 2009 was a year of tremendous challenges. In the latter part of 2008, Air Canada began adjusting its operations by reducing its capacity and its cost structure to manage through arguably the most challenging economic environment in decades. By mid-year 2009, Air Canada's immediate goal of stabilizing its finances and reducing the risk associated with the expiry of its labour collective agreements in 2009 and the risk associated with the pension solvency deficit as described in section 10.6 of this MD&A was largely realized and strategies had been put in place in an effort to minimize the effects of the weak economic environment.

In 2010, in an effort to improve its ability to generate income and grow its business profitably, Air Canada's priorities, which are further discussed below, include:

- Expanding international operations;
- Generating incremental revenues and achieving significant cost savings through a company-wide cost transformation program (the "CTP");
- Refocusing on customer service and further developing and promoting premium class travel; and
- Fostering culture change throughout the Corporation.

<u>Expanding international operations</u>

Air Canada will seek opportunities to grow its international operations in 2010 by leveraging the advantages of its extensive route rights, its newly refurbished fleet – one of the youngest in North America, its world-class global hub at Toronto, and strong international gateways at Montreal and Vancouver. Air Canada believes it is well positioned to grow its share of traffic between Canada, and Europe and Asia.

Air Canada recently expanded its service to seven additional U.S. cities, fortifying its Toronto hub and strengthening the airline's position as the leading transborder carrier with the most daily flights between Canada and the U.S. of any airline. Air Canada's strategy is to leverage its Toronto hub to make it a global transfer point for domestic, transborder and international travelers. Furthermore, by partnering with leading global carriers, Air Canada's transatlantic joint venture will further enhance the airline's international growth strategy.

In 2009, Air Canada provided scheduled service directly to 54 destinations in Europe, the Middle East, Asia, Australia, the Caribbean, Central America and South America. Air Canada plans on expanding its international network in 2010. This expansion will be fuelled by the addition of routes to Europe and Asia, including Toronto – Montreal – Brussels, Toronto – Barcelona, Montreal – Barcelona, Toronto – Copenhagen, Toronto – Athens, Montreal – Athens, Calgary – Tokyo and St. John's – London, England. Air Canada also expects to grow its capacity to China through increased frequencies and the use of larger aircraft.

Air Canada believes that its investment in new Boeing 777 aircraft and industry-leading on-board product across its fleet, including personal in-flight entertainment systems and in-seat power outlets accessible at virtually every seat, showcase the advantages of flying Air Canada. Air Canada is also one of the most respected brands in Canada and it plans to leverage this strength to attract premium revenue with a concentrated focus on its international service. The mix of types and sizes of aircraft in its fleet is designed to provide the airline with greater flexibility to respond to changing market demand more quickly and efficiently. For additional information on Air Canada's planned fleet for 2010 and beyond, refer to section 9 of this MD&A.

The value of Air Canada's network is enhanced through its Star Alliance network as well as under a newly-formed revenue sharing transatlantic joint venture in the process of being implemented among Air Canada, Lufthansa, Continental and United Airlines. Air Canada's participation in this joint venture is expected to provide the airline's customers with more options between Canada and Europe, Africa, the Middle East, India and the Commonwealth of Independent States (CIS), including western Russia.

In addition, the new Canada-EU air services agreement that came into effect in December 2009 will provide Air Canada with additional traffic right opportunities in the coming years.

Generating incremental revenues and achieving significant cost savings

A key objective of Air Canada's business strategy is to consistently improve unit revenue and cost productivity.

Early in 2009, with the assistance of a leading aviation consultancy firm, Air Canada launched a major company-wide cost transformation program (the "CTP") which is targeting $500 million in annualized revenue gains and cost savings. Through extensive management analysis and benchmarking, over 125 initiatives have been identified to date. Although the vast majority of the initiatives relate to cost savings such as contract renegotiation, operational process improvements and productivity gains, several relate to target revenue optimization. In 2009, Air Canada surpassed its CTP target by $20 million.

As fuel costs constitute the largest percentage of the total operating costs of the airline, Air Canada continues to aggressively focus on managing fuel consumption. Since the implementation of its fuel efficiency program in mid-2006, Air Canada generated cumulative savings of close to $80 million. In 2009, this program generated savings of $12 million and reduced the airline's fuel consumption by 18 million litres, and reduced CO2 emissions by 45,000 tonnes. Fuel efficiency program initiatives range from simple weight reduction initiatives and flight profile optimization which do not affect on-time performance or passenger connections to more innovative weight savings initiatives such as a potable water management program to reduce the carriage and weight of unnecessary water and a Zero Fuel Weight (ZFW) accuracy program which enables the calculation of accurate flight plans. In 2010, Air Canada's fuel saving initiatives will focus on several programs such as the optimization of all Air Canada's routes to establish the most efficient flight plan. In addition, Air Canada is working together with air traffic control service providers to optimize airspace management and take advantage of new navigation technologies to reduce time and fuel consumption used to approach airports. Moreover, Air Canada is evaluating several new aerodynamic technologies to further improve aircraft fuel efficiency.

Refocusing on customer service and further developing and promoting premium class

Air Canada's success depends on meeting and exceeding the expectations of its customers, attracting new ones and providing all customers with the service they deserve when flying with Air Canada.

Virtually all aircraft operated by Air Canada have new seats with personal in-flight entertainment systems and in-seat power outlets accessible at every seat in the economy, Executive and Executive First cabins. For aircraft that fly international routes (not including U.S. transborder and Caribbean routes), all seats in the Executive First cabin convert to lie-flat beds. The airline also offers its customers a far-reaching network which is enhanced by its strong international Star Alliance partners and will be further enhanced with the implementation of the transatlantic joint venture mentioned earlier. Through its relationship with Aeroplan, one of the premier loyalty programs in the world, Air Canada customers have the ability to earn and redeem points on a worldwide basis.

In 2009, Air Canada was rewarded for the consistent high quality work of its employees and their dedication to offering customers a superior product with the following awards:

- Top honours by readers of Business Traveler's "Best in Business Travel" award program, more first place awards than any other airline in the world in the influential magazine's annual reader survey;
- Voted by the readers of Business Traveler magazine as Best North American Airline for Business Class Service and Best North American Airline for International Travel and as offering Best Flight Attendants in North America; and Best In-Flight Services in North America; and
- Honoured by another influential business travel magazine when Global Traveler named Air Canada the Best Airline in North America and Best Airline in Canada.

Air Canada continues to seek ways to improve the travel experience of its business travelers as this segment of its customer base is an important component in its strategy to drive the airline to sustained profitability. In 2010, the airline will be placing further emphasis on understanding what business travelers value most in enhancements and their travel preferences, and identifying areas where further improvements could be made.

Although one of the airline's objectives is to further develop and promote premium class, providing a good travel experience to every single one of its customers is equally important to Air Canada. As such, Air Canada's goal is to deliver friendly, professional and "best in class" service on a consistent basis to all its customers, including

those customers who travel with the airline less frequently. To achieve that, Air Canada has been refocusing its efforts on ensuring it has the appropriate products and services in place.

Although customer satisfaction levels are steadily improving as a result of Air Canada's investment in its fleet and onboard products, its award-winning Maple Leaf Lounges, its concierge program and its loyalty program, Air Canada is continuously working to improve its interaction with customers through policy and procedural changes. Air Canada's objective is to make its policies more simple, efficient and customer-friendly.

Air Canada revised its checked bag policy on January 19, 2010 to permit travelers one free checked bag for travel to the U.S. and Europe, and charge a fee for the second bag of $30 for flights to/from the U.S., and $50 for flights to/from Europe. These revised bag policy changes more closely align Air Canada's policies with those prevailing among international carriers on transatlantic routes and are more generous than those of U.S. carriers on transborder routes, which charge for all checked bags.

Air Canada believes that the elimination of the call centre fee, changes to the "pets in cabin" policy, making more Aeroplan redemption seats available and more generous meal and hotel packages being offered to customers during disrupted operations are helping to improve customer service and thus increasing customer loyalty. In addition, the use of new technologies such as the Air Canada iPhone App, which won the "Best Mobile Application" at the Canadian New Media Awards in 2009, the Blackberry App, as well as the self-service rebooking tool allow the airline to communicate more effectively with customers in times of disrupted operations and provide customers with more choices to plan their travel.

In addition, based on extensive feedback received from customers over the last year, the airline has recently enhanced its frequent flyer program to ensure it remains competitive with other airline offerings and to provide an added incentive for customers to choose Air Canada for their travel needs.

Fostering culture change throughout the Corporation

A key objective of Air Canada's business strategy is to foster a more entrepreneurial corporate culture. The challenging economic environment has highlighted the fact that fundamental culture changes are required for the airline to be better placed to achieve sustained profitability. This corporate culture focuses on leadership, ownership, entrepreneurship and the ability to be more nimble to seize opportunities and react more quickly to challenges. Although this objective may take some time to achieve, Air Canada has begun the change process by communicating to all its employees the type of culture it envisions to allow the airline to prosper. In pursuit of this goal, the airline has taken actions to simplify processes, empower employees and is continually seeking means to actively foster culture change. The recent prestigious industry honours awarded by The Global Traveler and Business Traveler Magazine are an indication that employees are participating in the airline's transformation especially through a renewed focus on customer service.

5. Overview

Air Canada's results of operations for the fourth quarter of 2009 and the full year 2009 are discussed in section 7 and 8, respectively, of this MD&A.

In summary, Air Canada's results of operations for 2009 compared to 2008 are as follows:

Air Canada recorded a net loss of $24 million or $0.18 per diluted share in 2009 compared to a net loss of $1,025 million or $10.25 per diluted share in 2008. The net loss recorded in 2009 included foreign exchange gains of $657 million which were primarily attributable to a stronger Canadian dollar at December 31, 2009 versus December 31, 2008. The December 31, 2009 noon day exchange rate was US$1 = C$1.0466 while the December 31, 2008 noon day exchange rate was US$1 = C$1.2246.

In 2009, Air Canada recorded an operating loss of $316 million, a deterioration of $277 million from the operating loss (before a provision for cargo investigations and proceedings) of $39 million recorded in 2008. EBITDAR amounted to $679 million in 2009 compared to EBITDAR (before a provision for cargo investigations and proceedings) of $934 million in 2008, a decrease of $255 million.

In 2009, Air Canada recorded operating revenues of $9,739 million, a decrease of $1,343 million or 12% from the operating revenues of $11,082 million recorded in 2008. The decrease in operating revenues was mainly due to a passenger revenue decline of $1,214 million or 12% from 2008. The passenger revenue decrease was due to a lower system yield and reduced traffic. Yield declined 7.6% from 2008. Traffic decreased 5.2% on a capacity reduction of 4.4%, resulting in a passenger load factor decrease of 0.7 percentage points. RASM decreased 8.4% over 2008 due to the yield decline and, to a lesser extent, the decrease in system passenger load factor.

In 2009, Air Canada recorded operating expenses of $10,055 million, a decrease of $1,066 million or 10% from the operating expenses of $11,121 million recorded in 2008. The decrease in operating expenses was achieved in spite of $230 million in additional expenses related to the weaker Canadian dollar versus the U.S. dollar. Reduced fuel expense of $971 million or 28% versus 2008 was the main factor in the year-over-year decrease in operating expenses. Operating expense reductions were recorded in all major line categories with the exception of aircraft maintenance, aircraft rent, capacity purchase fees paid to Jazz and communications and information technology expenses.

In 2009, CASM decreased 5.4% from 2008. Excluding fuel expense, CASM increased 3.3% from 2008. The value of the Canadian dollar versus the U.S. dollar was weaker in the first three quarters of 2009 and stronger in the fourth quarter of 2009 when compared to the same periods in 2008. For the full year 2009, the overall impact of a weaker average Canadian dollar versus the U.S. dollar on U.S. denominated operating expenses accounted for approximately 40% of the CASM increase (excluding fuel expense) year-over-year. Other factors in the CASM increase (excluding fuel expense) included a growth in aircraft maintenance expense, increased Jazz CPA expense, higher unit costs of ownership, and the impact of the capacity reduction. The 3.3% increase in CASM (excluding fuel expense) for 2009 was in line with 3.0% to 3.5% CASM (excluding fuel expense) increase projected in Air Canada's news release dated November 6, 2009.

6. Significant Events in 2009

In order to strengthen its position to manage through the economic downturn and in an effort to mitigate its liquidity risks, Air Canada entered into the following significant transactions in 2009:

- A public offering for 160,500,000 units at a price of $1.62 per unit with each unit comprised of one Class B voting share or Class A variable voting share and one-half of a warrant which provided net proceeds of $249 million;
- A secured term credit facility (the "Credit Facility") which provided financing proceeds of $600 million, less fees of $20 million. The terms of the Credit Facility permit, on or before the first anniversary and subject to satisfaction of certain conditions, Air Canada to request an increase to the facility by up to an additional $100 million by obtaining new commitments from either the existing or new lenders. The Credit Facility is a five-year facility with the first principal repayment due in August 2010, and bears interest at 12.75%. Air Canada's obligations under the Credit Facility are secured by a first priority security interest and hypothec over substantially all the present and after-acquired property of Air Canada and its subsidiaries. The Credit Facility also provided for warrants entitling the debt holders to acquire up to 10% of the shares of the Corporation, which at the time of the issuance of the warrants represented 10 million shares in the Corporation. As part of the transactions related to the closing of the Credit Facility, existing financing arrangements of $166 million were repaid as follows:
    - A revolving credit facility was repaid in full in the amount of $49 million. The rights of the lender under the revolving credit facility were assigned to the lenders under the Credit Facility;
    - A spare engine financing was partially repaid in the amount of $38 million. This represented the repayment related to 22 engines under a spare engine financing agreement, with 10 engines remaining under the agreement with a loan value of $72 million as at December 31, 2009;
    - A secured loan with Aeroplan Canada Inc. ("Aeroplan") was repaid in full in the amount of $79 million. Aeroplan is a participating lender under the Credit Facility.
- The extension or renewal of labour agreements for 21 months with all of the Corporation's Canadian-based unions completed by July 2009 which provide for no increases to wage rates and no changes to group insurance coverage, benefits, or pension benefit levels during the contract extension or renewal periods;
- Pension funding agreements with the Corporation's Canadian-based unions (the "Pension MOUs") and the adoption of the Air Canada Pension Funding Regulations, 2009 (the "Air Canada 2009 Pension Regulations"). The Air Canada 2009 Pension Regulations relieve Air Canada from making any special (past service cost) payments for the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contributions shall equal the lesser of (i) $150 million, $175 million, and $225 million in respect of 2011, 2012, and 2013, respectively and (ii) the maximum past service contributions permitted under the Income Tax Act. Pursuant to the Pension MOUs, on October 26, 2009, the Corporation issued, to a trust, 17,647,059 Class B voting shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of sale of such shares by the trust are to be contributed to the pension plans;
- An agreement with a supplier, in consideration of various contractual commitments, which provided non-refundable proceeds of $230 million. For accounting purposes, the recognition of these proceeds was deferred in order to be applied to reduce the cost of these contractual commitments as they are incurred;
- Amendments to credit card processing agreements with one of its principal credit card processors which revise the levels of unrestricted cash (as defined per the agreement and generally based on the aggregate sums of cash, cash equivalents and short-term investments) required to be maintained;

- An extension of the repayment date of a short-term loan of $78 million (US$75 million) entered into in 2008 which was originally due in 2009, to 2013;
- The sale and leaseback of three Boeing 777 aircraft. The sale and leaseback transactions were substantially completed in November 2009 and provided initial cash proceeds of $95 million (net of deposits). Additional net cash proceeds of $20 million were received in January 2010;
- The sale and leaseback of one Boeing 777 aircraft for aggregate proceeds of $172 million and the requirement repayment of a debt obligation related to the aircraft of $128 million, which included a prepayment fee of $14 million;
- An agreement amending the terms of the Jazz CPA, effective August 1, 2009, which provides for a reduction to rates paid under the agreement;
- Financing arrangements secured by spare parts, spare engines and a Boeing 777 aircraft which provided aggregate proceeds of $267 million, net of fees of $8 million. As discussed above, $38 million of the spare engine financing was repaid on closing of the Credit Facility;
- During 2009, Air Canada entered into various inventory financing arrangements under which it acquired $117 million of spare parts inventories in exchange for the issuance of bills of exchange. Subsequent to the arrangements, Air Canada completed various transactions in relation to certain bills of exchange resulting in gains of $4 million being recorded in non-operating income (expense) in 2009. As at December 31, 2009, the remaining inventory is valued at $43 million which represented its estimated net realizable value. The expected final payment due in 2010 under the financing arrangements is $11 million (US$11 million);
- Repayment of pre-delivery financing of $83 million on a Boeing 777 aircraft received during the first quarter of 2009; and
- In 2009, the net return of collateral deposits on fuel derivatives amounted to $285 million, while the settlement of fuel derivative contracts in favour of counterparties amounted to $280 million.

7. Results of Operations – Fourth Quarter of 2009 versus Fourth Quarter of 2008

The following table and discussion compares the results of Air Canada for the fourth quarter of 2009 to its results for the fourth quarter of 2008.

	Fourth Quarter		Change	
(Canadian dollars in millions except per share figures)	**2009**	**2008**	**$**	**%**
Operating revenues				
Passenger	$ 2,030	$ 2,182	$ (152)	(7)
Cargo	110	113	(3)	(3)
Other	208	203	5	2
	2,348	**2,498**	**(150)**	**(6)**
Operating expenses				
Aircraft fuel	601	792	(191)	(24)
Wages, salaries, and benefits	418	444	(26)	(6)
Airport and navigation fees	228	230	(2)	(1)
Capacity purchase with Jazz	227	237	(10)	(4)
Depreciation and amortization	165	174	(9)	(5)
Aircraft maintenance	202	157	45	29
Food, beverages and supplies	69	70	(1)	(1)
Communications and information technology	64	72	(8)	(11)
Aircraft rent	85	80	5	6
Commissions	46	40	6	15
Other	326	348	(22)	(6)
	2,431	**2,644**	**(213)**	**(8)**
Operating loss	**(83)**	**(146)**	**63**	
Non-operating income (expense)				
Interest income	2	11	(9)	
Interest expense	(87)	(88)	1	
Interest capitalized	-	6	(6)	
Loss on assets	(25)	(5)	(20)	
Gain on financial instruments recorded at fair value	22	32	(10)	
Other	5	-	5	
	(83)	(44)	(39)	
Loss before the following items	**(166)**	**(190)**	**24**	
Non-controlling interest	(4)	(4)	-	
Foreign exchange gain (loss)	108	(527)	635	
Recovery of (provision for) income taxes	6	(6)	12	
Loss for the period	**$ (56)**	**$ (727)**	**$ 671**	
EBITDAR (1)	**$ 167**	**$ 108**	**$ 59**	
Loss per share - Basic and diluted	**$ (0.25)**	**$ (7.27)**	**$ 7.02**	

(1) See section 21 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income.

System passenger revenues decreased 7.0% from the fourth quarter of 2008

Compared to the fourth quarter of 2008, passenger revenues decreased $152 million or 7.0% to $2,030 million in the fourth quarter of 2009 due to a system yield decrease. In the fourth quarter of 2009, passenger revenues from the premium cabin accounted for 22% of the total decrease in system passenger revenues. The decrease in premium cabin revenues was driven by a 7.2% decline in yield as premium cabin traffic was essentially unchanged from the same period in 2008.

In the fourth quarter of 2009, Air Canada increased its overall capacity by 2.0% from the fourth quarter of 2008. Capacity in the North American market was reduced by 1.0% while capacity in the international market was increased by 5.0%, from the same quarter in 2008. Components of the year-over-year change in fourth quarter system passenger revenues included:

- A system traffic increase of 0.4% on a capacity increase of 2.0%, which resulted in a 1.3 percentage point decline in system passenger load factor compared to the fourth quarter of 2008. The system capacity growth of 2.0% in the fourth quarter of 2009 compared to the fourth quarter of 2008 was in line with the 1.0% to 2.0% ASM capacity increase projected in Air Canada's news release dated November 6, 2009.
- A system yield decline of 7.3% from the fourth quarter of 2008, which was due to a weak economy, greater fare discounting in an effort to stimulate traffic and reduced fuel surcharges year-over-year. This was an improvement from the second and third quarters of 2009 where yield declined 8.9% and 11.2%, respectively, from the corresponding periods in 2008. In the fourth quarter of 2009, the economy cabin reflected a yield decline of 7.6% while the premium cabin reflected a yield decline of 7.2% compared to the same quarter in 2008. All markets reflected yield decreases with the exception of the U.S. transborder market.
- A RASM decrease of 8.8% from the fourth quarter of 2008, which was due to both the yield decline and the decrease in passenger load factor. This was an improvement from the second and third quarters of 2009 where RASM declined 11.3% and 10.2%, respectively, from the corresponding periods in 2008.

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

Fourth Quarter 2009 Versus Fourth Quarter 2008	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	(7.9)	(0.6)	(1.3)	(0.5)	(6.7)	(7.3)
US transborder	(3.7)	(1.8)	(5.0)	(2.5)	1.4	(1.9)
Atlantic	(4.8)	6.7	2.4	(3.3)	(7.0)	(10.8)
Pacific	(9.7)	6.5	4.2	(1.8)	(13.4)	(15.2)
Other	(10.8)	(0.1)	3.3	2.6	(13.7)	(10.7)
System	**(7.0)**	**2.0**	**0.4**	**(1.3)**	**(7.3)**	**(8.8)**

Domestic passenger revenues decreased 7.9% from the fourth quarter of 2008

Domestic passenger revenues of $883 million in the fourth quarter of 2009 decreased $77 million or 7.9% from the fourth quarter of 2008 due to a lower yield and reduced traffic. In the fourth quarter of 2009, Air Canada reduced its domestic capacity by 0.6% from the fourth quarter of 2008. Capacity reductions on transcontinental routes were largely offset by capacity increases on routes to the Maritimes and within central and western Canada. Components of the year-over-year change in fourth quarter domestic passenger revenues included:

- A traffic decline of 1.3% on a capacity reduction of 0.6%, which resulted in a 0.5 percentage point decline in passenger load factor. All major domestic services reflected passenger load factor decreases with the exception of transcontinental routes, linking Toronto, Montreal and Ottawa with major western Canadian cities, including Winnipeg, Calgary, Edmonton and Vancouver.
- A yield decrease of 6.7% from the fourth quarter of 2008, which reflected the continued weak economic environment and greater fare discounting in an effort to stimulate traffic. All major domestic services recorded yield declines with the exception of Rapidair routes, linking Toronto and Montreal/Ottawa.
- A RASM decline of 7.3% from the fourth quarter of 2008, which was mainly due to the lower yield but also to the decrease in passenger load factor.

U.S. transborder passenger revenues decreased 3.7% from the fourth quarter of 2008

U.S. transborder passenger revenues of $405 million in the fourth quarter of 2009 decreased $16 million or 3.7% from the fourth quarter of 2008 due to lower traffic as yield grew 1.4% year-over-year. In the fourth quarter of 2009, U.S. transborder capacity was reduced by 1.8% from the fourth quarter of 2008. Components of the year-over-year change in fourth quarter U.S. transborder passenger revenues included:

- A traffic decline of 5.0% on a capacity reduction of 1.8%, which resulted in a passenger load factor decline of 2.5 percentage points from the fourth quarter of 2008.
- Air Canada's Toronto – Austin and Vancouver – Sacramento routes were suspended in the second half of 2009 while these routes operated in the fourth quarter of 2008. Partly offsetting these capacity decreases was increased capacity to Florida, in order to capitalize on more stable leisure demand, and the introduction of services from Calgary to Portland, as well as services from Calgary to Honolulu and Calgary to Maui and to San Diego.
- A yield increase of 1.4% from the fourth quarter of 2008, which reflected yield improvements on all major U.S. transborder services with the exception of U.S. sun routes and routes from western Canada to western U.S. where additional capacity and aggressive competitive pricing adversely impacted yields. Yield in the economy cabin was unchanged from the same period in 2008 while yield in the premium cabin increased 2.7% year-over-year.
- A RASM decrease of 1.9% from the fourth quarter of 2008, which was due to the passenger load factor decrease.

Atlantic passenger revenues decreased 4.8% from the fourth quarter of 2008

Atlantic passenger revenues of $376 million in the fourth quarter of 2009 decreased $18 million or 4.8% from the fourth quarter of 2008 due to a lower yield as traffic increased 2.4% year-over-year. In the fourth quarter of 2009, Atlantic capacity was increased by 6.7% from the fourth quarter of 2008. Capacity was increased on all major Atlantic services with the exception of Spain and Tel Aviv where capacity was reduced year-over-year. Components of the year-over-year change in fourth quarter Atlantic passenger revenues included:

- A traffic increase of 2.4% on the capacity growth of 6.7%, which resulted in a passenger load factor decrease of 3.3 percentage points from the fourth quarter of 2008.
- The capacity growth in the fourth quarter of 2009 reflected new routes, such as Montreal – Geneva and additional frequencies on Calgary – Frankfurt, which was also partly offset by a suspension earlier in the year of the Toronto – Madrid service for the winter and a reduction in frequencies to Tel Aviv.
- A yield decline of 7.0% from the fourth quarter of 2008, which reflected the continued weak economic environment, increased fare discounting to stimulate traffic and reduced fuel surcharges year-over-year. Additional traffic growth in the fourth quarter was accepted at lower yields in an attempt to fill the capacity growth which resulted in additional pressure placed on yields. Yield declines were reflected on all major Atlantic services with the exception of Spain where yield improved year-over-year.
- A RASM decrease of 10.8% from the fourth quarter of 2008, which was due to both the lower yield and the passenger load factor decrease.

Pacific passenger revenues decreased 9.7% from the fourth quarter of 2008

Pacific passenger revenues of $199 million in the fourth quarter of 2009 decreased $21 million or 9.7% from the fourth quarter of 2008 due to a lower yield as traffic grew 4.2% year-over-year. In the fourth quarter of 2009, capacity was increased by 6.5% from the fourth quarter of 2008 with growth reflected on all major Pacific services with the exception of Korea where capacity was reduced year-over-year. Components of the year-over-year change in fourth quarter Pacific passenger revenues included:

- A traffic increase of 4.2% on the capacity increase of 6.5%, which resulted in passenger load factor decline of 1.8 percentage points from the fourth quarter of 2008. Air Canada increased its capacity in the fourth quarter on the Pacific with the re-introduction of the Toronto – Narita non-stop service with a Boeing 777 aircraft and additional frequencies from Vancouver to China.
- A yield decline of 13.4% from the fourth quarter of 2008, which reflected the continued weak economic environment, continued fare discounting in an effort to stimulate traffic and significantly reduced fuel surcharges year-over-year. Additional traffic growth in the fourth quarter was accepted at lower yields in

an attempt to fill the capacity growth, which resulted in additional pressure placed on yields. Yield decreases were reflected on all major Pacific services.

- A RASM decrease of 15.2% from the fourth quarter of 2008, which was largely due to the decline in yield but also to the decrease in passenger load factor.

Other passenger revenues decreased 10.8% from the fourth quarter of 2008

Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) of $167 million in the fourth quarter of 2009 decreased $20 million or 10.8% from the fourth quarter of 2008 due to reduced yields as overall traffic increased 3.3% year-over-year. Capacity growth on the South Pacific and Caribbean was mostly offset by a capacity reduction on routes to Mexico. Components of the year-over-year change in fourth quarter other passenger revenues included:

- A traffic increase of 3.3% on the capacity reduction of 0.1%, which resulted in a passenger load factor improvement of 2.6 percentage points versus the same period in 2008.
- A yield decline of 13.7% from the fourth quarter of 2008, which reflected a weak economic environment, increased fare discounting to stimulate traffic, continued competitive pricing pressure and reduced fuel surcharges year-over-year. Yield decreases were reflected on all major services.
- A RASM decrease of 10.7% from the fourth quarter of 2008, which was due to the decline in yield.

Cargo revenues decreased 3% from the fourth quarter of 2008

Fourth quarter 2009 cargo revenues amounted to $110 million and were $3 million or 3% below the fourth quarter of 2008. This represented a marked improvement compared to the much greater year-over-year reduction in revenues recorded in the first three quarters of 2009.

Cargo traffic increased by 25% in the fourth quarter compared to the same period last year, on strong traffic growth in Pacific and Atlantic markets. This compared to the first nine months of the 2009 where non-freighter traffic declined an average of 15% on a year-over-year basis. In 2008, however, weak economic conditions were already adversely affecting traffic levels during the fourth quarter. System cargo yield per revenue ton mile (RTM) was down 22% versus 2008 mainly due to lower fuel surcharges, increased competitive pressure on rates in certain markets and, to a lesser extent, the unfavourable impact of a stronger Canadian dollar on foreign denominated currencies.

Factors contributing to the year-over-year change in fourth quarter cargo revenues included:

- A decrease in domestic cargo revenues of 13% on a 6% traffic increase and an 18% decline in yield per RTM. Domestic capacity was down 5% versus the fourth quarter of 2008.
- A decrease in Atlantic revenues of 13% on 17% more traffic and a 25% lower yield per RTM. Atlantic capacity was up 7% versus the fourth quarter of 2008.
- An increase in Pacific revenues of 18% on 40% more traffic and a 15% lower yield per RTM. Pacific capacity was up 7% versus the fourth quarter of 2008.
- A stronger Canadian dollar versus the fourth quarter of 2008 which had a negative impact on foreign currency denominated revenues of $4 million in the fourth quarter of 2009.

Other revenues increased 2% from the fourth quarter of 2008

Other revenues of $208 million in the fourth quarter of 2009 increased $5 million or 2% from the fourth quarter of 2008, primarily due to an $18 million increase in third party revenues at Air Canada Vacations, mainly driven by higher passenger volumes. This increase was partly offset by lower aircraft sublease revenues in the quarter largely driven by the unfavourable impact of a stronger Canadian dollar on U.S. denominated aircraft leases and the sale of two Airbus A340-300 aircraft which were subleased to a third party in the fourth quarter of 2008.

CASM decreased 9.8% from the fourth quarter of 2008. Excluding fuel expense, CASM decreased 3.2% from the fourth quarter of 2008

Operating expenses were $2,431 million in the fourth quarter of 2009, a decrease of $213 million or 8% from the fourth quarter of 2008. In the fourth quarter of 2009, a stronger Canadian dollar versus the U.S. dollar compared to the fourth quarter of 2008 reduced operating expenses by $105 million from the fourth quarter of 2008.

Unit cost in the fourth quarter of 2009, as measured by operating expense per available seat mile (CASM), decreased 9.8% over the fourth quarter of 2008. Excluding fuel expense, CASM decreased 3.2% year-over-year. The main contributing factors in the CASM decrease (excluding fuel expense) were the favourable impact of a stronger Canadian dollar versus the U.S. dollar, which accounted for approximately 85% of the CASM decrease (excluding fuel expense), and lower wages, salaries and benefits expense. Partly offsetting these decreases to CASM (excluding fuel expense) was a $45 million year-over-year increase in aircraft maintenance expense from the same period in 2008.

The 3.2% decrease in CASM (excluding fuel expense) for the fourth quarter of 2009 was in line with the 3% to 4% CASM (excluding fuel expense) decrease projected in Air Canada's news release dated November 6, 2009.

The following table compares Air Canada's operating expenses per ASM for the fourth quarter of 2009 to Air Canada's operating expenses per ASM for the corresponding period in 2008.

	Fourth Quarter		Change	
(cents per ASM)	**2009**	**2008**	**cents**	**%**
Wages and salaries	2.61	2.71	(0.10)	(3.7)
Benefits	0.41	0.56	(0.15)	(26.8)
Ownership (DAR) (1)	1.81	1.87	(0.06)	(3.2)
Airport user fees	1.65	1.70	(0.05)	(2.9)
Capacity purchase with Jazz	1.64	1.74	(0.10)	(5.7)
Aircraft maintenance	1.46	1.16	0.30	25.9
Food, beverages and supplies	0.49	0.52	(0.03)	(5.8)
Communications and information technology	0.46	0.53	(0.07)	(13.2)
Commissions	0.33	0.29	0.04	13.8
Other	2.35	2.56	(0.21)	(8.2)
Operating expense, excluding fuel expense (2)	**13.21**	**13.64**	**(0.43)**	**(3.2)**
Aircraft fuel	4.36	5.84	(1.48)	(25.3)
Total operating expense	**17.57**	**19.48**	**(1.91)**	**(9.8)**

(1) DAR refers to the combination of Depreciation and amortization, and Aircraft rent.
(2) Refer to section 21 "Non-GAAP Financial Measures" in this MD&A for additional information.

Fuel expense decreased 24% from the fourth quarter of 2008

Fuel expense amounted to $601 million in the fourth quarter of 2009, a decrease of $191 million or 24% from the fourth quarter of 2008. Factors contributing to the year-over-year change in fourth quarter fuel expense included:

- A lower base fuel price, which accounted for a decrease of $112 million.
- The favourable impact of a stronger Canadian dollar versus the U.S. dollar, which accounted for a decrease of $55 million to fuel expense in the fourth quarter of 2009.
- Fuel hedging losses of $85 million in the fourth quarter of 2009 versus fuel hedging losses of $111 million in the fourth quarter of 2008, a favourable variance of $26 million compared to the fourth quarter of 2008.

The table below provides Air Canada's fuel cost per litre, excluding and including hedging, for the periods indicated.

	Fourth Quarter		Change	
(Canadian dollars in millions except where indicated)	**2009**	**2008**	**$**	**%**
Aircraft fuel expense - GAAP [(1)]	$ 599	$ 788	$ (189)	(24)
Add: *Fuel hedging gains (losses) included in aircraft fuel expense*	(85)	(111)	26	23
Add: Net cash settlements on maturing fuel derivatives (designated under hedge accounting and economic hedges)[(2)]	12	91	(79)	(87)
Economic cost of fuel - Non-GAAP [(3)]	**$ 526**	**$ 768**	**$ (242)**	**(32)**
Fuel consumption (thousands of litres)	824,911	822,011	2,900	-
Fuel costs per litre (cents) - GAAP	72.6	95.8	(23.2)	(24)
Fuel costs per litre (cents) - excluding fuel hedges	62.3	82.2	(19.9)	(24)
Economic fuel costs per litre (cents) - Non-GAAP	63.7	93.2	(29.5)	(32)

(1) Fuel expense excludes fuel related to third party carriers, other than Jazz, operating under capacity purchase agreement.

(2) Excluding early terminated hedging contracts in the fourth quarter of 2009 for $20 million covering 2010 fuel consumption.

(3) The economic cost of fuel is a non-GAAP measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada uses this measure to calculate Air Canada's cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period. It excludes non-cash accounting gains and losses from fuel derivative instruments.

Wages, salaries and benefits expense amounted to $418 million in the fourth quarter of 2009, a decrease of $26 million or 6% from the fourth quarter of 2008

Wages and salaries expense totaled $362 million in the fourth quarter of 2009, a decrease of $7 million or 2% from the fourth quarter of 2008. The decrease in wages and salaries was mainly due to a reduction of an average of 1,131 full-time equivalent ("FTE") employees or 4.8% versus the same period in 2008. Partly offsetting this decrease was an increase in average wages for 0.8% compared to the fourth quarter of 2008. In addition, in the fourth quarter of 2009, Air Canada recorded expenses of $5 million related to a non-unionized staff reduction program. No such expenses were recorded in the same period in 2008.

Employee benefits expense amounted to $56 million in the fourth quarter of 2009, a decrease of $19 million or 29**%** from the fourth quarter of 2008. The decrease was mainly due to reduced pension and post-employment benefits expenses as a result of revised actuarial assumptions. The actuarial assumptions used for recording pension expense under GAAP differ from those used in determining the solvency deficit. Refer to section 10.6 of this MD&A for a discussion related to Air Canada's pension funding obligations.

Capacity purchase costs with Jazz decreased 4% from the fourth quarter of 2008

Capacity purchase costs with Jazz, pursuant to the Jazz CPA, amounted to $227 million in the fourth quarter of 2009 compared to $237 million in the fourth quarter of 2008, a decrease of $10 million or 4%. This year-over-year decrease in capacity purchase costs was mainly due to the impact of reduced flying which accounted for a decrease of $8 million, the favourable impact of foreign exchange on U.S. denominated Jazz CPA charges paid by Air Canada, which accounted for a decrease of $6 million, and the impact of the reduction to the mark-up on Jazz CPA rates pursuant to an amendment to the Jazz CPA effective August 1, 2009, which accounted for a decrease of $8 million. Partly offsetting these decreases was a year-over-year increase in Jazz CPA rates of $12 million, of which $8 million was related to additional maintenance costs due to the aging of Jazz's fleet.

Ownership costs decreased 2% from the fourth quarter of 2008

Ownership costs, comprised of depreciation and amortization, and aircraft rent expense, of $250 million in the fourth quarter of 2009 decreased $4 million or 2% from the fourth quarter of 2008. Factors contributing to the year-over-year change in the fourth quarter ownership costs included:

- Changes in aircraft residual values, which accounted for a decrease of $9 million to depreciation expense.
- The impact of a stronger Canadian dollar versus the U.S. dollar, which accounted for a decrease of $7 million to aircraft rent expense.

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

- The addition of new Boeing 777 aircraft to Air Canada's operating fleet, which accounted for an increase of $14 million.

Aircraft maintenance expense increased 29% from the fourth quarter of 2008

In the fourth quarter of 2009, aircraft maintenance expense of $202 million increased $45 million or 29% from the fourth quarter of 2008. Factors contributing to the year-over-year change in fourth quarter aircraft maintenance expense included:

- A net increase of $41 million in airframe maintenance, which was largely due to the timing and scope of airframe events related to the fleets of Airbus A319, A320 and Boeing 767-300 aircraft. In particular, scheduled heavy maintenance was required on the Airbus A319 aircraft which were delivered in the mid-1990s. The impact of cost reduction initiatives resulted in savings of approximately $9 million to maintenance costs in the fourth quarter of 2009.
- A net increase of $19 million in engine maintenance, which was mainly due to an industry campaign for the removal of high pressure turbine blades on the A320 aircraft engine, which resulted in the removal of the blades at an earlier stage than anticipated. A higher volume of engine events related to Boeing 777 and Embraer E175 aircraft also contributed to the increase.
- A net increase of $9 million in component maintenance, which was mainly due to the Boeing 777, Embraer E175 and E190 aircraft requiring maintenance that was no longer covered by warranty. In an effort to lower these costs, Air Canada recently entered into long-term contracts with several vendors pursuant to which Air Canada sold certain of its Boeing 777 component inventory for proceeds of $20 million and obtained more advantageous pricing.

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

- The impact of a stronger Canadian dollar versus the U.S. dollar on U.S. denominated maintenance expenses, mainly engine and component maintenance, which accounted for a decrease of $10 million to aircraft maintenance expense compared to the fourth quarter of 2008.

Food, beverages and supplies expense decreased 1% from the fourth quarter of 2008

In the fourth quarter of 2009, food, beverages and supplies expense of $69 million decreased $1 million or 1% from the fourth quarter of 2008 despite a passenger traffic growth of 0.4%. The impact of cost reduction initiatives including reduced contract rates were factors in this decrease compared to the same period in 2008.

Communications and information technology expense decreased 11% from the fourth quarter of 2008

In the fourth quarter of 2009, communications and information technology expense of $64 million decreased $8 million or 11% from the fourth quarter of 2008 and included the impact of reduced information technology project spend and savings achieved through renegotiation of a major information technology supplier contract.

Commission expense increased 15% from the fourth quarter of 2008

In the fourth quarter of 2009, commission expense of $46 million increased $6 million or 15% from the fourth quarter of 2008, on a passenger revenue decrease of 7%. The impact of higher passenger sales and a change in the commission structure at Air Canada Vacations resulted in additional commission expense of $3 million in the fourth quarter of 2009. The introduction of a 7% commission for Canadian travel agents to sell Tango fares for flights within Canada has resulted in additional commission expense, however, overall, based on management's analysis, the benefits of these initiatives have outweighed the costs by enabling the Corporation to generate increased passenger revenues.

Other operating expenses decreased 6% from the fourth quarter of 2008

Other operating expenses amounted to $326 million in the fourth quarter of 2009, a decrease of $22 million or 6% from the fourth quarter of 2008. The decrease in other operating expenses was mainly driven by favourable rate adjustments on foreign currency transactions.

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

	Fourth Quarter		Change	
(Canadian dollars in millions)	**2009**	**2008**	**$**	**%**
Air Canada Vacations' land costs	$ 47	$ 49	$ (2)	(4)
Credit card fees	45	44	1	2
Terminal handling	45	45	-	-
Building rent and maintenance	35	35	-	-
Miscellaneous fees and services	33	30	3	10
Crew expenses (meals, transportation and hotels)	29	30	(1)	(3)
Remaining other expenses	92	115	(23)	(20)
	$ 326	**$ 348**	**$ (22)**	**(6)**

Non-operating expense amounted to $83 million in the fourth quarter of 2009

Non-operating expense amounted to $83 million in the fourth quarter of 2009 compared to non-operating expense of $44 million in the fourth quarter of 2008. Factors contributing to the year-over-year change in fourth quarter non-operating expense included:

- Net interest expense increased $14 million from the fourth quarter of 2008 due to:
    - A $9 million decrease in interest income, which was driven by lower rates of interest;
    - A $1 million decrease in interest expense, which was mainly due to the impact of new financing transactions completed in 2009. In addition, in the fourth quarter of 2009, Air Canada recorded a charge of $8 million in interest expense related to the sale and leaseback of three Boeing aircraft. These increases were offset by the impact of lower average interest rates year-over-year, the favourable impact of foreign exchange on interest expense in the fourth quarter of 2009, and by a reduction of interest expense on aircraft pre-delivery payments related to Boeing 777 aircraft versus the same period in 2008;
    - A lower amount of capitalized interest of $6 million compared to 2008.
- In the fourth quarter of 2009, Air Canada recorded a loss on assets of $24 million pertaining to the sale and leaseback of three Boeing 777 aircraft. This compared to a loss on assets of $5 million recorded in the fourth quarter of 2008.
- Gains related to fair value adjustments on derivative instruments amounted to $22 million in the fourth quarter of 2009 versus gains of $32 million in the fourth quarter of 2008. The mark-to-market gains on financial instruments recorded in 2009 were mainly related to the change in the fair value of fuel derivatives.

Gains on foreign exchange amounted to $108 million in the fourth quarter of 2009

Gains on foreign exchange, which were mainly related to U.S. denominated long-term debt, amounted to $108 million in the fourth quarter of 2009 compared to losses of $527 million in the fourth quarter of 2008. The gains in the fourth quarter of 2009 were mainly attributable to a stronger Canadian dollar at December 31, 2009 compared to September 30, 2009. The December 31, 2009 noon day exchange rate was US$1 = C$1.0466 while the September 30, 2009 noon day exchange rate was US$1 = C$1.0722.

Income tax recovery of $6 million in the fourth quarter of 2009

Air Canada recorded an income tax recovery of $6 million on a pre-tax loss of $62 million in the fourth quarter of 2009, which related mainly to an adjustment to current taxes payable.

8. Results of Operations – Full Year of 2009 versus Full Year of 2008

The following table and discussion compares the results of Air Canada for 2009 to its results for 2008.

	Full Year		Change	
(Canadian dollars in millions except per share figures)	**2009**	**2008**	**$**	**%**
Operating revenues				
Passenger	$ 8,499	$ 9,713	$ (1,214)	(12)
Cargo	358	515	(157)	(30)
Other	882	854	28	3
	9,739	**11,082**	**(1,343)**	**(12)**
Operating expenses				
Aircraft fuel	2,448	3,419	(971)	(28)
Wages, salaries, and benefits	1,751	1,877	(126)	(7)
Airport and navigation fees	971	1,001	(30)	(3)
Capacity purchase with Jazz	973	948	25	3
Depreciation and amortization	660	694	(34)	(5)
Aircraft maintenance	759	659	100	15
Food, beverages and supplies	291	314	(23)	(7)
Communications and information technology	293	286	7	3
Aircraft rent	335	279	56	20
Commissions	186	194	(8)	(4)
Other	1,388	1,450	(62)	(4)
	10,055	**11,121**	**(1,066)**	**(10)**
Operating loss before the undernoted item	**(316)**	**(39)**	**(277)**	
Provision for cargo investigations	-	(125)	125	
Operating loss	**(316)**	**(164)**	**(152)**	
Non-operating income (expense)				
Interest income	14	57	(43)	
Interest expense	(373)	(319)	(54)	
Interest capitalized	4	37	(33)	
Loss on assets	(95)	(34)	(61)	
Gain on financial instruments recorded at fair value	95	92	3	
Other	-	(3)	3	
	(355)	(170)	(185)	
Loss before the following items	**(671)**	**(334)**	**(337)**	
Non-controlling interest	(15)	(12)	(3)	
Foreign exchange gain (loss)	657	(655)	1,312	
Recovery of (provision for) income taxes	5	(24)	29	
Loss for the period	**$ (24)**	**$ (1,025)**	**$ 1,001**	
EBITDAR before the provision for cargo investigations [(1)]	**$ 679**	**$ 934**	**$ (255)**	
EBITDAR [(1)]	**$ 679**	**$ 809**	**$ (130)**	
Loss per share – Basic and diluted	**$ (0.18)**	**$ (10.25)**	**$ 10.07**	

(1) See section 21 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before the provision for cargo investigations and proceedings to operating income (loss) and EBITDAR to operating income (loss).

System passenger revenues decreased 12.5% from 2008

Compared to 2008, passenger revenues decreased $1,214 million or 12.5% to $8,499 million in 2009 due to lower yield and traffic. A decline in passenger revenues from the premium cabin accounted for $405 million or over 33% of the total decrease in system passenger revenues. In 2009, Air Canada reduced its overall capacity by 4.4%. Capacity in the North American market was reduced by 5.1% while capacity in the international market was reduced by 3.7%, from 2008. Components of the year-over-year change in system passenger revenues included:

- A traffic decline of 5.2% on a capacity reduction of 4.4%, which resulted in a 0.7 percentage point decrease in passenger load factor compared to 2008. The system capacity reduction of 4.4% in 2009 compared to 2008 was in line with the 4.25% to 4.75% ASM capacity reduction projected in Air Canada's news release dated November 6, 2009.
- A system yield decrease of 7.6% from 2008, which was due to a weak economy, reduced high-yield business travel and increased competitive pricing activities. A reduction in fuel surcharges was also a factor in the yield decline year-over-year.
- A weaker Canadian dollar in 2009 versus 2008, which had a positive impact on foreign currency denominated revenues of $184 million in 2009.
- A RASM decrease of 8.4% versus 2008, which was mainly due to the yield decline, but also to the decrease in passenger load factor.

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

Year 2009 Versus Year 2008	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	(12.6)	(3.7)	(4.1)	(0.3)	(8.7)	(9.1)
US transborder	(12.5)	(7.7)	(9.6)	(1.6)	(3.2)	(5.1)
Atlantic	(8.6)	1.4	(0.6)	(1.7)	(8.0)	(9.9)
Pacific	(16.7)	(12.5)	(11.7)	0.8	(5.7)	(4.8)
Other	(15.8)	(1.7)	(2.3)	(0.5)	(13.8)	(14.4)
System	**(12.5)**	**(4.4)**	**(5.2)**	**(0.7)**	**(7.6)**	**(8.4)**

The table below describes year-over-year percentage changes in system passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% Change)				
System	**Q1**	**Q2**	**Q3**	**Q4**	**Full Year**
Passenger Revenue	(13.0)	(16.1)	(13.2)	(7.0)	(12.5)
Capacity (ASMs)	(10.3)	(5.4)	(3.3)	2.0	(4.4)
Traffic (RPMs)	(10.9)	(7.9)	(2.1)	0.4	(5.2)
Passenger Load Factor (pp Change)	(0.5)	(2.2)	1.0	(1.3)	(0.7)
Yield	(2.3)	(8.9)	(11.2)	(7.3)	(7.6)
RASM	(3.0)	(11.3)	(10.2)	(8.8)	(8.4)

Domestic passenger revenues decreased 12.6% from 2008

Domestic passenger revenues of $3,591 million in 2009 decreased $517 million or 12.6% from 2008 due to an 8.7% decline in yield and a 4.1% decrease in traffic. In 2009, capacity reductions were reflected on all major services with the exception of routes to the Maritimes and within central and western Canada. Components of the year-over-year change in domestic passenger revenues included:

- A traffic decline of 4.1% on a capacity reduction of 3.7%, which resulted in a 0.3 percentage point decline in passenger load factor. All major domestic services reflected passenger load factor decreases with the exception of transcontinental routes.

- A yield decrease of 8.7% from 2008, which reflected the continued weak economic environment resulting in a decline in higher yielding product bookings and greater fare discounting in an effort to stimulate traffic. All major domestic services recorded yield declines.
- A weaker Canadian dollar in 2009 versus 2008, which had a positive impact on foreign currency denominated revenues of $38 million in 2009.
- A RASM decline of 9.1% from 2008, which was primarily due to the lower yield.

The table below describes year-over-year percentage changes in domestic passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% Change)				
Canada	Q1	Q2	Q3	Q4	Full Year
Passenger Revenue	(11.4)	(17.0)	(13.3)	(7.9)	(12.6)
Capacity (ASMs)	(7.3)	(5.8)	(1.5)	(0.6)	(3.7)
Traffic (RPMs)	(8.3)	(8.2)	0.7	(1.3)	(4.1)
Passenger Load Factor (pp Change)	(1.0)	(2.1)	1.8	(0.5)	(0.3)
Yield	(3.3)	(9.5)	(13.6)	(6.7)	(8.7)
RASM	(4.4)	(11.9)	(11.7)	(7.3)	(9.1)

U.S. transborder passenger revenues decreased 12.5% from 2008

U.S. transborder passenger revenues of $1,641 million in 2009 decreased $235 million or 12.5% from 2008 due to lower traffic and a reduced yield. Capacity was reduced on all major U.S. transborder services with the exception of routes to Florida. Components of the year-over-year change in U.S. transborder passenger revenues included:

- A traffic decline of 9.6% on a capacity reduction of 7.7%, which resulted in a passenger load factor decline of 1.6 percentage points from 2008.
- A yield decrease of 3.2% from 2008, which reflected the continued weak economic environment and greater fare discounting in an effort to stimulate traffic as well as more aggressive pricing as a result of competitive growth on U.S. leisure routes. Yield declines were reflected on all major U.S. transborder services with the exception of U.S. short-haul business routes between Eastern Canada and Northeastern U.S.
- A weaker Canadian dollar in 2009 versus the fourth quarter of 2008, which had a positive impact on foreign currency denominated revenue of $60 million in 2009.
- A RASM decrease of 5.1% from 2008, which was due to both the yield decline and the decrease in passenger load factor.

The table below describes year-over-year percentage changes in U.S. transborder passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% Change)				
U.S. transborder	Q1	Q2	Q3	Q4	Full Year
Passenger Revenue	(17.2)	(14.4)	(13.1)	(3.7)	(12.5)
Capacity (ASMs)	(13.7)	(4.7)	(8.8)	(1.8)	(7.7)
Traffic (RPMs)	(14.4)	(9.5)	(8.0)	(5.0)	(9.6)
Passenger Load Factor (pp Change)	(0.7)	(3.9)	0.7	(2.5)	(1.6)
Yield	(3.4)	(5.4)	(5.4)	1.4	(3.2)
RASM	(4.1)	(10.2)	(4.6)	(1.9)	(5.1)

Atlantic passenger revenues decreased 8.6% from 2008

Atlantic passenger revenues of $1,721 million in 2009 decreased $162 million or 8.6% from 2008 due to a lower yield and, to a lesser extent, a decrease in traffic. In 2009, Atlantic capacity increased 1.4% from 2008. Capacity was increased on all major Atlantic services with the exception of the U.K. and the Tel Aviv markets where capacity was reduced year-over-year. Components of the year-over-year change in Atlantic passenger revenues included:

- A traffic decrease of 0.6% on a capacity growth of 1.4%, which resulted in a passenger load factor decrease of 1.7 percentage points from 2008.
- A yield decline of 8.0% from 2008, which reflected the continued weak economic environment and increased fare discounting to stimulate traffic. The premium cabin reflected a significant yield decrease as pricing actions were taken to offer additional discounted Executive First fares and products in an effort to stimulate premium traffic. Yield declines were reflected on all major Atlantic services.
- A weaker Canadian dollar in 2009 versus 2008, which had a positive impact on foreign currency denominated revenues of $23 million in 2009.
- A RASM decrease of 9.9% from 2008, which was due to both the lower yield and the decrease in passenger load factor.

The table below describes year-over-year percentage changes in Atlantic passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% Change)				
Atlantic	Q1	Q2	Q3	Q4	Full Year
Passenger Revenue	(12.7)	(11.1)	(6.7)	(4.8)	(8.6)
Capacity (ASMs)	(9.7)	(0.1)	6.8	6.7	1.4
Traffic (RPMs)	(12.9)	(1.6)	5.9	2.4	(0.6)
Passenger Load Factor (pp Change)	(2.7)	(1.3)	(0.8)	(3.3)	(1.7)
Yield	0.1	(9.7)	(11.8)	(7.0)	(8.0)
RASM	(3.4)	(11.0)	(12.6)	(10.8)	(9.9)

Pacific passenger revenues decreased 16.7% from 2008

Pacific passenger revenues of $829 million in 2009 decreased $166 million or 16.7% from 2008 due largely to an 11.7% decrease in traffic. In 2009, capacity was reduced by 12.5% from 2008 with reductions reflected on all major Pacific services with the exception of Hong Kong where capacity was increased year-over-year. Components of the year-over-year change in Pacific passenger revenues included:

- A traffic decrease of 11.7% on the capacity reduction of 12.5%, which resulted in passenger load factor improvement of 0.8 percentage points from 2008. Air Canada increased its capacity to Hong Kong through the use of a larger aircraft (from an Airbus A340 to a Boeing 777 aircraft), but reduced frequencies on Korea, including the year-over-year suspension of the Toronto non-stop service, reduced frequencies on Vancouver – China, and suspended Toronto – Narita service in the first quarter of 2009, however, this was partially offset by the re-introduction of Toronto – Narita non-stop service in the fourth quarter of 2009.
- A yield decline of 5.7% from 2008, which reflected the continued weak economic environment, increased fare discounting in an effort to stimulate traffic, concerns over H1N1 predominantly impacting Japan and to a lesser extent China and Korea, as well as reduced fuel surcharges year-over-year. The premium cabin reflected a significant yield decrease as pricing actions were taken to offer additional discounted Executive First fares in an effort to stimulate traffic. Yield decreases were reflected on all major Pacific services.
- A weaker Canadian dollar in 2009 versus 2008, which had a positive impact on foreign currency denominated revenues of $46 million in 2009.
- A RASM decrease of 4.8% from 2008, which was due to the yield decline.

The table below describes year-over-year percentage changes in Pacific passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% Change)				
Pacific	Q1	Q2	Q3	Q4	Full Year
Passenger Revenue	(12.3)	(19.8)	(21.9)	(9.7)	(16.7)
Capacity (ASMs)	(26.0)	(12.6)	(14.8)	6.5	(12.5)
Traffic (RPMs)	(20.5)	(15.7)	(12.6)	4.2	(11.7)
Passenger Load Factor (pp Change)	6.2	(3.1)	2.1	(1.8)	0.8
Yield	10.2	(4.9)	(10.6)	(13.4)	(5.7)
RASM	18.5	(8.3)	(8.4)	(15.2)	(4.8)

Other passenger revenues decreased 15.8% from 2008

Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) of $717 million in 2009 decreased $134 million or 15.8% from 2008 due to a lower yield and, to a lesser extent, a decrease in traffic. Components of the year-over-year change in other passenger revenues included:

- A traffic decrease of 2.3% on the capacity reduction of 1.7%, which resulted in a passenger load factor decrease of 0.5 percentage points compared to 2008.
- An overall yield decline of 13.8% from 2008, which reflected a weak economic environment, increased fare discounting to stimulate traffic, competitive pricing actions, especially in South America, South Pacific and on the Caribbean, the impact over H1N1 concerns on traffic to and from Mexico and reduced fuel surcharges year-over-year. Although both the economy and premium cabins reflected yield declines, the premium cabin reflected a more pronounced decrease as pricing actions were taken to offer additional discounted Executive First fares in an effort to stimulate traffic.
- A weaker Canadian dollar in 2009 versus 2008, which had a positive impact on foreign currency denominated revenues of $17 million in 2009.
- A RASM decrease of 14.4% from 2008, which was largely due to the yield decline.

The table below describes year-over-year percentage changes in other passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% Change)				
Other	Q1	Q2	Q3	Q4	Full Year
Passenger Revenue	(11.2)	(23.3)	(20.1)	(10.8)	(15.8)
Capacity (ASMs)	4.2	(6.6)	(7.2)	(0.1)	(1.7)
Traffic (RPMs)	1.4	(8.0)	(7.6)	3.3	(2.3)
Passenger Load Factor (pp Change)	(2.2)	(1.2)	(0.4)	2.6	(0.5)
Yield	(12.4)	(16.7)	(13.5)	(13.7)	(13.8)
RASM	(14.8)	(17.9)	(13.9)	(10.7)	(14.4)

Cargo revenues decreased 30% from 2008

Cargo revenues amounted to $358 million in 2009 and were $157 million or 30% below 2008 on a 7% reduction to cargo capacity. One half of the revenue decline in 2009 was due to significantly reduced fuel surcharge rates and the cancellation, in 2008, of freighter flying. Weak economic conditions, especially in the first nine months of 2009, resulted in reduced traffic volumes and increased competitive pressure on rates which also contributed to the revenue decline.

Freighter revenues declined $29 million as no MD-11 freighter aircraft were operated in 2009 versus one MD-11 freighter which operated to Europe in the first six months of 2008. Freighter operations were terminated in June 2008.

Non-freighter revenues decreased $129 million or 26%, reflecting a 6% system-wide traffic reduction mainly in North American markets. System cargo yield decreased 22% due to significantly lower fuel surcharges and competitive pressure on rates.

Factors contributing to the year-over-year change in cargo revenues included:

- A decrease in domestic cargo revenues of 35% on 29% less traffic and a 9% decline in yield per RTM. The termination of the Canada Post contract in September 2008 accounted for around three quarters of the traffic decrease. Domestic capacity was down 12% versus 2008.
- A decrease in Atlantic non-freighter revenues of 30% on 6% less traffic and a 26% lower yield per RTM.
- A decrease in Pacific revenues of 21% on flat traffic and a 21% lower yield per RTM. Pacific capacity was down 10%.
- A system traffic decline of 11% (including the impact of the freighter termination in June 2008) and a yield per RTM decline of 22%.
- A weaker Canadian dollar versus 2008 had a positive impact on foreign currency denominated revenues of $11 million in 2009.

Other revenues increased 3% from 2008

Other revenues of $882 million in 2009 increased $28 million or 3% from 2008, primarily due to an increase of $46 million in third party revenues at Air Canada Vacations, mainly the result of higher passenger volumes, and an increase of $11 million in aircraft sublease revenues. Various factors, including a decrease in revenues from Aeroplan for services related to information technology, amounting to a net decrease of $28 million partly offset these increases.

CASM decreased 5.4% from 2008. Excluding fuel expense, CASM increased 3.3% from 2008

Operating expenses were $10,055 million in 2009, a decrease of $1,066 million or 10% from 2008. A reduction in fuel expense of $971 million or 28% was a major factor in the year-over-year decrease in operating expenses. This operating expense reduction was achieved in spite of the unfavourable impact of a weaker average Canadian dollar versus the U.S. dollar in 2009 on U.S. denominated operating expenses which resulted in additional operating expenses of $230 million in 2009.

CASM in 2009 decreased 5.4% over 2008. Excluding fuel expense, CASM increased 3.3% year-over-year. The 3.3% increase in CASM (excluding fuel expense) for 2009 was in line with 3.0% to 3.5% CASM (excluding fuel expense) increase projected in Air Canada's news release dated November 6, 2009.

The unfavourable impact of a weaker average Canadian dollar versus the U.S. dollar accounted for approximately 44% of the CASM growth (excluding fuel expense) in 2009. In addition to the impact of foreign exchange, other factors accounting for the CASM growth included: growth in aircraft maintenance expenses, increased Jazz CPA expenses, higher unit costs of ownership, and the impact of the capacity reduction. The capacity reduction impacts CASM (excluding fuel expense) disproportionately as Air Canada's cost structure is such that its fixed costs do not fluctuate proportionately with changes in capacity in the short term. Partly offsetting these increases to CASM (excluding fuel expense) was a reduction in employee benefits expense, the result of revised actuarial assumptions.

The following table compares Air Canada's operating expenses per ASM for 2009 to Air Canada's operating expenses per ASM for 2008.

	Full Year		Change	
(cents per ASM)	2009	2008	cents	%
Wages and salaries	2.51	2.46	0.05	2.0
Benefits	0.44	0.56	(0.12)	(21.4)
Ownership (DAR) (1)	1.68	1.57	0.11	7.0
Airport user fees	1.64	1.61	0.03	1.9
Capacity purchase with Jazz	1.64	1.53	0.11	7.2
Aircraft maintenance	1.28	1.06	0.22	20.8
Food, beverages and supplies	0.49	0.51	(0.02)	(3.9)
Communications and information technology	0.49	0.46	0.03	6.5
Commissions	0.31	0.31	-	-
Other	2.34	2.34	-	-
Operating expense, excluding fuel expense (2)	**12.82**	**12.41**	**0.41**	**3.3**
Aircraft fuel	4.13	5.51	(1.38)	(25.0)
Total operating expense	**16.95**	**17.92**	**(0.97)**	**(5.4)**

(1) DAR refers to the combination of Depreciation and amortization, and Aircraft rent.
(2) Refer to section 21 "Non-GAAP Financial Measures" in this MD&A for additional information.

The following summarizes the main factors in the year-over-year change in operating expenses:

Fuel expense decreased 28% from 2008

Fuel expense amounted to $2,448 million in 2009, a decrease of $971 million or 28% from 2008. Factors contributing to the year-over-year change in fuel expense included:

- A lower base fuel price, which accounted for a decrease of $1,362 million.
- A volume-related decrease of $235 million, which included the impact of the termination of freighter flying in June 2008.

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

- Fuel hedging losses of $419 million in 2009 versus fuel hedging gains of $79 million in 2008, an unfavourable variance of $498 million compared to 2008.
- The unfavourable impact of a weaker average Canadian dollar versus the U.S. dollar, which accounted for an increase of $128 million to fuel expense in 2009.

The table below provides Air Canada's fuel cost per litre, excluding and including hedging, for the periods indicated.

	Full Year		Change	
(Canadian dollars in millions except where indicated)	2009	2008	$	%
Aircraft fuel expense - GAAP [1]	$ 2,437	$ 3,401	$ (964)	(28)
Add: *Fuel hedging gains (losses) included in aircraft fuel expense*	(419)	79	(498)	(630)
Add: Net cash settlements on maturing fuel derivatives (designated under hedge accounting and economic hedges)[2]	88	(129)	217	168
Economic cost of fuel - Non-GAAP [3]	**$ 2,106**	**$ 3,351**	**$ (1,245)**	**(37)**
Fuel consumption (thousands of litres)	3,509,918	3,762,698	(252,780)	(7)
Fuel costs per litre (cents) - GAAP	69.4	90.4	(21.0)	(23)
Fuel costs per litre (cents) - excluding fuel hedges	57.5	92.5	(35.0)	(38)
Economic fuel costs per litre (cents) - Non-GAAP	60.0	89.0	(29.0)	(33)

(1) Fuel expense excludes fuel related to third party carriers, other than Jazz, operating under capacity purchase agreement.

(2) Excluding early terminated hedging contracts both in Q1 2009 for $172 million covering 2009 and 2010 fuel consumption and in the fourth quarter of 2009 for $20 million covering 2010 fuel consumption.

(3) Economic cost of fuel is Air Canada's best estimate of the cash cost of fuel. It is a non-GAAP measure used by the Corporation and may not be comparable to measures presented by other public companies.

Wages, salaries and benefits expense amounted to $1,751 million in 2009, a decrease of $126 million or 7% from 2008.

Wages and salaries expense totaled $1,492 million in 2009, a decrease of $36 million or 2% from 2008. Factors contributing to the year-over-year change in wage and salaries expense included:

- A decrease of an average of 1,286 full-time equivalent ("FTE") employees or 5.3%, which was mainly the result of the 4.4% ASM capacity reduction.
- In 2009, Air Canada recorded expenses of $25 million related to the "Sharing our Success" employee profit sharing program versus expenses of $29 million in 2008.

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

- The impact of a year-over-year increase in average wages of 1.8%, mainly due to contractual progression increases for unionized employees.
- In 2009, Air Canada recorded expenses of $30 million related to staff reduction programs compared to expenses of $21 million in 2008.
- In 2008, Air Canada reversed previously recorded stock-based compensation expense of $5 million. No such reversal occurred in 2009.

Employee benefits expense amounted to $259 million in 2009, a decrease of $90 million or 26**%** from 2008, mainly due to reduced pension expense and post-employment benefits expenses as a result of revised actuarial assumptions.

Airport and navigation fees decreased 3% from 2008

In 2009, airport and navigation fees of $971 million decreased $30 million or 3% from 2008, on a 3% reduction in aircraft frequencies. Effective January 1, 2010, the Greater Toronto Airports Authority (GTAA) reduced both landing fees and terminal charges by 10% at Toronto Pearson International Airport. Based on current levels of activity, Air Canada estimates that this rate reduction would result in annual savings of $30 million.

Capacity purchase costs with Jazz increased 3% from 2008

Capacity purchase costs with Jazz, pursuant to the Jazz CPA, amounted to $973 million in 2009 compared to $948 million in 2008, an increase of $25 million or 3%. This year-over-year increase in capacity purchase costs was mainly due to the unfavourable impact of foreign exchange on U.S. denominated Jazz CPA charges paid by Air Canada, which accounted for an increase of $30 million, a year-over-year increase in Jazz CPA rates of $42 million, and other costs amounting to $1 million. Partially offsetting these increases was the impact of reduced flying which accounted for a decrease of $34 million, and the impact of the reduction to the mark-up on Jazz CPA rates pursuant to an amendment to the Jazz CPA effective August 1, 2009, which accounted for a decrease of $14 million.

Ownership costs increased 2% from 2008

Ownership costs, comprised of depreciation and amortization, and aircraft rent expense, of $995 million in 2009 increased $22 million or 2% from 2008. Factors contributing to the year-over-year change in ownership costs included:

- The addition of new Boeing 777 aircraft to Air Canada's operating fleet, which accounted for an increase of $49 million.
- The impact of a weaker Canadian dollar versus the U.S. dollar, which accounted for an increase of $25 million to aircraft rent expense.

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

- Changes in aircraft residual values, the result of a weaker Canadian dollar versus the U.S. dollar, which accounted for a decrease of $44 million to depreciation expense.
- A decrease of $10 million to aircraft rent expense as a result of reduced MD-11 freighter flying as no MD-11 freighter aircraft were operated in 2009 versus one MD-11 freighter operated in the first six months of 2008.

Aircraft maintenance expense increased 15% from 2008

In 2009, aircraft maintenance expense of $759 million increased $100 million or 15% from 2008. Factors contributing to the year-over-year change in aircraft maintenance expense included:

- A net increase of $103 million in airframe maintenance, which was largely due to the timing and scope of airframe events related to the fleets of Airbus A319, A320 and Boeing 767-300 aircraft. In particular, scheduled heavy overhaul maintenance was required on the Airbus A319 aircraft which were delivered in the mid-1990s.
- The impact of a weaker Canadian dollar versus the U.S. dollar on U.S. denominated maintenance expenses, mainly engine and component maintenance, which accounted for an increase of $37 million to aircraft maintenance expense compared to 2008.
- A net increase of $7 million in components maintenance, which was largely due to a higher level of components maintenance activity and increased rates year-over-year.

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

- A net decrease of $12 million in engine maintenance, which was largely due to the removal of Airbus A340 aircraft from Air Canada's operating fleet during 2008 and lower aircraft maintenance expense related the Airbus A320 and Boeing 767-300 aircraft. Partly offsetting these decreases was the impact of a higher volume of engine maintenance which was mainly due to an industry campaign for the removal of high pressure turbine blades on the A320 aircraft engine, which resulted in the removal of the blades at an earlier stage than anticipated. Also offsetting these decreases was a higher volume of engine events related to Boeing 777 and Embraer E175 aircraft.
- A net decrease of $17 million due to an overall reduction in maintenance expenses related to the preparation of aircraft for return to lessors or for sublease to third parties.

Food, beverages and supplies expense decreased 7% from 2008

In 2009, food, beverages and supplies expense of $291 million decreased $23 million or 7% from 2008 on a 5.2% decrease in passenger traffic. The impact of cost reduction initiatives and reduced contract rates were factors in the decrease to food, beverage and supplies expense compared to the same period in 2008.

Communications and information technology expense increased 3% from 2008

In 2009, communications and information technology expense of $293 million increased $7 million or 3% from 2008. The unfavourable impact of a weaker Canadian dollar versus the U.S. dollar on U.S. denominated expenses was partly offset by a reduction in information technology project spend and savings achieved through renegotiation of a major information technology supplier contract.

Commission expense decreased 4% from 2008

In 2009, commission expense of $186 million decreased $8 million or 4% from 2008. The impact of a 12.5% passenger revenue decrease versus 2008 was partly offset by the combination of higher passenger sales and a change in commission structure at Air Canada Vacations which resulted in an increase of $8 million to commission expense in 2009. In June 2009, Air Canada introduced a 7% commission for Canadian travel agents to sell Tango fares for flights within Canada. Although these initiatives have resulted in additional commission expense, overall, based on management's analysis, the benefits of these initiatives have outweighed the costs by enabling the Corporation to generate increased passenger revenues.

Other operating expenses decreased 4% from 2008

Other operating expenses amounted to $1,388 million in 2009, a decrease of $62 million or 4% from 2008. Factors contributing to the year-over-year change in other expenses included:

- An increase in expenses related to ground packages at Air Canada Vacations of $27 million compared to 2008, which was mainly due to higher passenger volumes.
- A reduction in credit card fees of $22 million compared to 2008, which was primarily the result of lower passenger sales.
- A decrease in "remaining other expenses" of $75 million, which reflected the impact of various cost reduction initiatives and the impact of the capacity reduction. Favourable rate adjustments on foreign currency transactions accounted for $37 million of the decrease to other operating expenses.

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

	Full Year		Change	
(Canadian dollars in millions)	2009	2008	$	%
Air Canada Vacations' land costs	$ 250	$ 223	$ 27	12
Terminal handling	188	180	8	4
Credit card fees	175	197	(22)	(11)
Building rent and maintenance	131	137	(6)	(4)
Crew expenses (meals, transportation and hotels)	118	117	1	1
Miscellaneous fees and services	117	112	5	4
Remaining other expenses	409	484	(75)	(15)
	$ 1,388	**$ 1,450**	**$ (62)**	**(4)**

Non-operating expense amounted to $355 million in 2009

Non-operating expense amounted to $355 million in 2009 compared to non-operating expense of $170 million in 2008. Factors contributing to the year-over-year change in 2009 non-operating expense included:

- Net interest expense increased $130 million from 2008 due to:
    - A $43 million decrease in interest income which was due to both lower rates of interest and lower cash balances;
    - A $54 million increase in interest expense which was mainly due to the impact of new financing transactions completed in 2009, and the unfavourable impact of foreign exchange on interest expense. These increases were partly offset by the impact of lower average interest rates year-over-year. In addition, in 2009, Air Canada recorded charges amounting to $25 million related to the sale and leaseback transaction of four Boeing 777 aircraft and a charge of $9 million related to the termination of the capital leases of two Airbus A340 aircraft and the subsequent sale of these aircraft. These increases were partly offset by a reduction of interest expense on aircraft pre-delivery payments related to Boeing 777 aircraft versus the same period in 2008;
    - A lower amount of capitalized interest of $33 million compared to 2008.
- In 2009, Air Canada recorded an impairment charge of $68 million related to previously capitalized costs incurred pertaining to the development of a new reservation system, referred to as Polaris. Air Canada is currently working towards the implementation of certain components of the solution such as web and fare technology but has suspended activity relating to the implementation of the reservation system. In addition, Air Canada recorded a loss on assets of $24 million pertaining to the sale and leaseback of three Boeing 777 aircraft.
- In 2008, Air Canada recorded an impairment charge of $38 million relating to the retirement of its fleet of Boeing 767-200 aircraft and gains amounting to $7 million pertaining to the sale of aircraft-related inventory.
- Gains related to fair value adjustments on derivative instruments amounted to $95 million in 2009 versus gains of $92 million in 2008. The mark-to-market gains on financial instruments recorded in 2009 were mainly related to the change in the fair value of fuel derivatives.

Gains on foreign exchange amounted to $657 million in 2009

Gains on foreign exchange, which were mainly related to U.S. denominated long-term debt, amounted to $657 million in 2009 compared to losses of $655 million in 2008. The gains in 2009 were mainly attributable to a stronger Canadian dollar at December 31, 2009 compared to December 31, 2008. The December 31, 2009 noon day exchange rate was US$1 = C$1.0466 while the December 31, 2008 noon day exchange rate was US$1 = C$1.2246.

Income tax recovery of $5 million in 2009

Air Canada recorded an income tax recovery of $5 million on a pre-tax loss of $29 million in 2009, which related mainly to an adjustment to current taxes payable. In 2008, a provision for income taxes of $24 million was recorded on a pre-tax loss of $1,001 million which reflected future income tax being reclassified from other comprehensive income to income for realized gains on fuel derivatives. Potential recovery of future income taxes on the 2008 loss was offset by a valuation allowance.

9. Fleet

The following table provides Air Canada's operating fleet as at December 31, 2009 (excluding aircraft operated by Jazz under the Jazz CPA):

	Total seats	Number of operating aircraft[1]	Average age	Owned[2]	Capital Lease [2]	Consolidated under AcG-15 [2]	Operating Lease
Air Canada							
Widebody Aircraft							
Boeing 777-300	349	12	1.8	3	1	-	8
Boeing 777-200	270	6	2.1	4	-	-	2
Boeing 767-300	191-213	30	16.3	1	8	6	15
Airbus A330-300	265	8	9.2	-	8	-	-
Narrowbody Aircraft				-	-	-	-
Airbus A321	174	10	7.8	-	-	5	5
Airbus A320	146	41	16.7	-	-	-	41
Airbus A319	120	35	12.0	-	17	15	3
EMBRAER E190	93	45	2.8	45	-	-	-
EMBRAER E175	73	15	4.3	15	-	-	-
Total		**202**	**9.7**	**68**	**34**	**26**	**74**

(1) Excludes aircraft which have been removed from service.
(2) Owned aircraft as well as capital 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 order to support the expansion of its international operations and deliver a superior aircraft product in the international market to and from Canada, Air Canada progressively introduced 18 Boeing 777 aircraft into its fleet starting in 2007. During 2009, the Corporation took delivery of its last two planned Boeing 777 aircraft, one of which was leased under an operating lease.

In addition to its investment in new aircraft, Air Canada completed a major refurbishment program of its existing aircraft in 2009. All aircraft in its operating fleet were refurbished with the exception of three Boeing 767-300ER aircraft where a light interior renovation was completed. The new fleet-wide amenities include digital quality in-seat monitors with touch-screen controls offering hundreds of hours of audit and video on demand programming, USB ports at every seat, standard in-seat power within reach of every customer and industry leading lie-flat bed suites in Executive First.

At December 31, 2009, pursuant to the Jazz CPA, Jazz operated an operating fleet of 130 aircraft with an average age of 14.6 years comprised of the following aircraft:

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

An additional five Bombardier CRJ-200 aircraft and two Bombardier CRJ-100 aircraft are planned to be removed from the Jazz fleet during 2010, reducing Jazz's operating fleet to 123 by May 2010.

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

Fleet Plan	Actual			Planned			
	December 31, 2008	New Deliveries	December 31, 2009	2010 Fleet Changes	December 31, 2010	2011 Fleet Changes	December 31, 2011
Boeing 777-300	**10**	2	**12**	-	**12**	-	**12**
Boeing 777-200	**6**	-	**6**	-	**6**	-	**6**
Boeing 767-300	**30**	-	**30**	-	**30**	(3)	**27**
Airbus A330-300	**8**	-	**8**	-	**8**	-	**8**
Airbus A321	**10**	-	**10**	-	**10**	-	**10**
Airbus A320	**41**	-	**41**	-	**41**	-	**41**
Airbus A319	**35**	-	**35**	-	**35**	-	**35**
EMBRAER 190	**45**	-	**45**	-	**45**	-	**45**
EMBRAER 175	**15**	-	**15**	-	**15**	-	**15**
Total	**200**	2	**202**	-	**202**	(3)	**199**
Average age (years)	**8.8**		**9.7**		**10.7**		**11.6**

10. Financial and Capital Management

10.1 Financial Position

The following table provides a condensed statement of financial position of Air Canada as at December 31, 2009 and as at December 31, 2008.

(Canadian dollars in millions)	December 31, 2009	December 31, 2008
Assets		
Cash, cash equivalents and short-term investments	$ 1,407	$ 1,005
Other current assets	1,244	1,398
Current assets	2,651	2,403
Property and equipment	6,369	7,469
Intangible assets	916	997
Deposits and other assets	470	495
	$ **10,406**	**$ 11,364**
Liabilities		
Current liabilities	$ 3,002	$ 3,678
Long-term debt and capital leases	4,054	4,691
Pension and other benefit liabilities	1,163	1,585
Other long-term liabilities	540	458
	8,759	**10,412**
Non-controlling interest	**201**	**190**
Shareholders' equity	**1,446**	**762**
	$ 10,406	**$ 11,364**

Movements in current assets and liabilities are described below under "Working Capital".

Property and equipment amounted to $6,369 million at December 31, 2009, a reduction of $1,100 million from December 31, 2008. The reduction was mainly due to the impact of depreciation expense of $602 million in 2009, the sale of two Airbus A340 aircraft and the sale and leaseback of three Boeing 777 aircraft partly offset by additions to capital assets.

Long-term debt and capital leases, including the current portion, amounted to $4,522 million at December 31, 2009, a decrease of $832 million from December 31, 2008. The decrease in long-term debt and capital leases from December 31, 2008 was mainly due to the appreciation of the Canadian dollar and the resulting favourable impact of $702 million on Air Canada's U.S. dollar debt and capital leases. Borrowings of $926 million, including those under the Credit Facility described in section 6 of this MD&A, were more than offset by long-term debt and capital lease repayments of $1,237 million. In addition, the sale and leaseback of a Boeing 777 aircraft was accounted for as a capital lease which resulted in an increase to total long-term debt of $158 million.

The decline in pension and other benefits liabilities of $422 million from December 31, 2008 was primarily due to pension funding of $389 million in 2009. Refer to section 10.6 of this MD&A for a discussion related to Air Canada's pension funding obligations.

Shareholders' equity increased by $684 million due mainly to comprehensive income of $422 million and the equity offering completed in October 2009, which raised net proceeds of $249 million.

10.2 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, 2009 and as at December 31, 2008.

(Canadian dollars in millions)	December 31, 2009	December 31, 2008	Change $
Total long-term debt and capital leases	$ 4,054	$ 4,691	$ (637)
Current portion of long-term debt and capital leases	468	663	(195)
Total long-term debt and capital leases including current portion	4,522	5,354	(832)
Non-controlling interest	201	190	11
Less cash, cash equivalents and short-term investments	(1,407)	(1,005)	(402)
Net debt and non-controlling interest	**3,316**	**4,539**	**(1,223)**
Capitalized operating leases [(1)]	2,513	2,093	420
Adjusted net debt and non-controlling interest	**5,829**	**6,632**	**(803)**
Less pre-delivery (PDP) financing included in long-term debt	-	(81)	81
Adjusted net debt and non-controlling interest, excluding PDP financing	**$ 5,829**	**$ 6,551**	**$ (722)**
Shareholders' equity	**$ 1,446**	**$ 762**	**$ 684**
Adjusted net debt to net debt plus equity ratio, excluding PDP financing	**80.1%**	**89.6%**	**(9.5) pp**

(1) Adjusted net debt is a non-GAAP measure used by the Corporation and may not 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 $335 million for the twelve months ended December 31, 2009 and $279 million for the twelve months ended December 31, 2008. 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, 2009, adjusted net debt and non-controlling interest, including capitalized operating leases and excluding PDP financing, decreased $722 million from December 31, 2008. The value of capitalized operating leases increased by $420 million primarily as a result of an increase in aircraft rent expense, mainly due to the impact of a weaker average Canadian dollar during 2009 versus 2008, and the sale and leaseback transactions of Boeing 777 aircraft completed in 2009. This was more than offset by a decrease in net debt of $1,223 million. Net debt declined mainly due to the impact of a stronger Canadian dollar as at December 31, 2009 versus the exchange rate as at December 31, 2008, which accounted for $702 million, and the impact of certain of transactions to increase liquidity completed in 2009. For additional information related to these transactions, refer to section 6 of this MD&A.

The adjusted net debt to net debt plus equity ratio for Air Canada decreased to 80.1% at December 31, 2009 from 89.6% at December 31, 2008.

Shareholders' equity was favourably impacted by comprehensive income of $422 million recorded in 2009, which included foreign exchange gains of $657 million, and net proceeds of $249 million from the equity offering completed in 2009, which is further described in section 6 of this MD&A.

10.3 Liquidity

At December 31, 2009, cash, cash equivalents and short-term investments amounted to $1,407 million, or 14% of 2009 operating revenues. Refer to section 13 of this MD&A for a discussion on Air Canada's liquidity risks.

Working capital

The following table provides additional information on Air Canada's working capital balances at December 31, 2009 as compared to December 31, 2008.

(Canadian dollars in millions)	December 31, 2009	December 31, 2008	Change $
Cash and short-term investments	$ 1,407	$ 1,005	$ 402
Accounts receivable	701	702	(1)
Collateral deposits for fuel derivatives	43	328	(285)
Other current assets	500	368	132
Accounts payable and accrued liabilities	(1,215)	(1,262)	47
Fuel derivatives in current liabilities	(31)	(420)	389
Advance ticket sales	(1,288)	(1,333)	45
Current portion of long-term debt and capital leases	(468)	(663)	195
	$ **(351)**	**$ (1,275)**	**$ 924**

The working capital deficiency of $351 million has improved by $924 million from December 31, 2008, largely due to the financing activities undertaken by Air Canada, as described in section 6 of this MD&A and working capital generated from operating activities which amounted to approximately $450 million. This was partly offset by pension funding payments of $389 million and the impact of capital expenditures of $232 million in 2009.

Collateral deposits for fuel derivatives

The Corporation currently holds, within its derivative portfolio, swaps and put option contracts which could expose the Corporation to the potential of posting cash collateral deposits. Once the fair value in favour of the counterparties of certain fuel derivatives exceeds certain agreed credit thresholds with those counterparties, the Corporation is responsible for extending collateral to the counterparties to cover their exposure.

As at January 31, 2010, the total cash collateral deposits held by counterparties amounted to $55 million ($43 million at December 31, 2009 and $328 million at December 31, 2008). If oil prices remain at their current levels for 2010, the collateral extended would cover the expected losses on existing fuel hedging contracts maturing in 2010 and would not generate additional cash outflows to the Corporation. Refer to section 13 of this MD&A for a discussion on fuel price risk.

At December 31, 2009, Air Canada's sensitivity on cash collateral deposits was approximately US$2.5 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).

Consolidated Cash Flow Movements

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

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2009**	**2008**	**Change $**	**2009**	**2008**	**Change $**
Net cash from operating activities	$ 43	$ 25	$ 18	$ 188	$ 559	$ (371)
Fuel hedge collateral deposits, net	62	(322)	384	268	(322)	590
Pension funding	(60)	(116)	56	(389)	(456)	67
Changes in non-cash working capital	(55)	135	(190)	(234)	117	(351)
Cash flows used for operating activities	(10)	(278)	268	(167)	(102)	(65)
Additions to capital assets	(42)	(150)	108	(232)	(883)	651
Free cash flow [(1)]	**(52)**	**(428)**	**376**	**(399)**	**(985)**	**586**
Proceeds from contractual commitment	-	-	-	230	-	230
Proceeds from sale of assets	7	11	(4)	103	38	65
Proceeds from sale leaseback transactions	380	-	380	552	708	(156)
Funding of Aveos letter of credit	-	40	(40)	-	59	(59)
Short-term investments	(125)	111	(236)	214	206	8
Other	(8)	(3)	(5)	(29)	62	(91)
Cash flows from investing activities (excluding additions to capital assets)	**254**	**159**	**95**	**1,070**	**1,073**	**(3)**
Borrowings	3	558	(555)	926	871	55
Issue of common shares & warrants	249	-	249	256	-	256
Reduction of long-term debt and capital lease obligations	(381)	(284)	(97)	(1,237)	(992)	(245)
Other	-	(3)	3	-	5	(5)
Cash flows from (used for) financing activities	**(129)**	**271**	**(400)**	**(55)**	**(116)**	**61**
Net increase (decrease) in cash and cash equivalents	73	2	71	616	(28)	644
Net increase (decrease) in short-term investments	125	(111)	236	(214)	(206)	(8)
Net increase (decrease) in cash, cash equivalents and short-term investments	**$ 198**	**$ (109)**	**$ 307**	**$ 402**	**$ (234)**	**$ 636**

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

Air Canada's free cash flow improved $376 million from the fourth quarter of 2008 and $586 million when compared to the full year 2008. The improvement in free cash flow was mainly due to the impact of reduced capital expenditures, a reduction in fuel hedge collateral deposits requirements, improved cash operating results and the impact of lower past service cost contributions as a result of the adoption of new pension funding regulations in July 2009. Partly offsetting these favourable changes was unfavourable changes in non-cash working capital balances. Working capital in 2009 was negatively impacted by the decrease in advance ticket sales and passenger revenues; however this trend improved during the fourth quarter of 2009. Also negatively impacting working capital in 2009 was the expiry of the Aeroplan accelerated payment agreement, reached in 2008.

10.4 Capital Expenditures and Related Financing Arrangements

Air Canada has 37 firm orders for Boeing 787 aircraft with The Boeing Company ("Boeing"). Air Canada also holds purchase options for 13 Boeing 787 aircraft and purchase rights for 10 Boeing 787 aircraft and 18 Boeing 777 aircraft. Air Canada's first Boeing 787 aircraft is scheduled for delivery in the second half of 2013.

For the firm aircraft orders, the Corporation has financing commitments from Boeing and the engine manufacturer covering 31 of the 37 Boeing 787 aircraft. The financing terms for 28 out of the 31 covered aircraft is for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments. For the remaining three out of the 31 covered aircraft, the financing under the commitment covers up to 90% of the capital expenditure and the term to maturity is 15 years with principal payments made on a mortgage style basis resulting in equal installment payments of principal and interest over the term to maturity.

The table below provides Air Canada's current projected, planned and committed capital expenditures for 2010, for the next four years and after 2014.

(Canadian dollars in millions)	2010	2011	2012	2013	2014	Thereafter
Projected committed expenditures	$ 74	$ 47	$ 121	$ 731	$ 979	$ 2,860
Projected planned but uncommitted expenditures	60	93	112	118	50	
Total projected expenditures [1] [2]	134	140	233	849	1,029	
Projected financing on committed expenditures	-	-	-	(566)	(775)	
Total projected expenditures, net of financing	**$ 134**	**$ 140**	**$ 233**	**$ 283**	**$ 254**	

(1) U.S. dollar amounts are converted using the December 31, 2009 noon day exchange rate of US$1 = C$1.0466 Final aircraft delivery prices include estimated escalation and interest on deferred delivery payments.
(2) The dollar amounts reflected above do not include obligations pertaining to day-to-day operations.

10.5 Contractual Obligations

The table below provides Air Canada's current contractual obligations for 2010, for the next four years and after 2014.

(Canadian dollars in millions)	2010	2011	2012	2013	2014	Thereafter	Total
Long-term debt, capital leases and interest repayment obligations [1]	$ 761	$ 1,004	$ 734	$ 773	$ 593	$ 2,025	$ 5,890
Operating lease obligations [2]	419	375	355	322	257	902	2,630
Committed capital expenditures [3]	74	47	121	731	979	2,860	4,812
Total contractual obligations [4] [5]	**$ 1,254**	**$ 1,426**	**$ 1,210**	**$ 1,826**	**$ 1,829**	**$ 5,787**	**$ 13,332**

(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 U.S. dollar aircraft operating leases.
(3) The committed capital expenditures above mainly relate to U.S. 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.
(5) The table above excludes the future minimum non-cancelable commitment under the capacity purchase agreement with Jazz of $732 million for 2010 and the minimum annual commitment to purchase Aeroplan® Miles from Aeroplan of $211 million for 2010. Future commitments for 2011 and beyond are not yet determinable.

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 24 aircraft under lease of which 23 are accounted for as capital leases and the remainder relate to leasing entities that are consolidated under AcG-15. Under the test, the Corporation may be required to prepay certain lease amounts or to provide additional collateral, 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, 2010, assuming the related tests establish an aircraft value of nil, is $599 million (US$572 million). The maximum payable amount declines over time to nil upon lease expiry. In July 2009, additional collateral of $8 million in the form of cash deposits were made under the fair value test. As the Corporation does not expect to have to prepay or provide additional collateral in 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.

10.6 Pension Funding Obligations

The Corporation maintains several defined benefit pension plans as described in section 16 of this MD&A. As at January 1, 2009, based on the actuarial valuations which were used to determine certain pension funding requirements in 2009, the aggregate solvency deficit in the registered pension plans was $2,835 million. Based on preliminary actuarial valuations as at January 1, 2010, the preliminary estimate of the aggregate solvency deficit in the registered plans is estimated to be between $2,500 million and $2,700 million. This preliminary estimate of the solvency deficit range includes the impact of the actual return on plan assets partially offset by a decrease in the discount rate used to value the benefit obligation which has the effect of increasing the benefit obligation. The final actuarial valuations for January 1, 2010 will be completed in the first half of 2010 but, as described below, they will not impact the 2010 pension funding obligations.

In July 2009, the Government of Canada adopted the Air Canada 2009 Pension Regulations. The Air Canada 2009 Pension Regulations relieve the Corporation from making any special (past service cost) payments in respect of the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contribution shall equal the lesser of (i) $150 million, $175 million, and $225 million in respect of 2011, 2012, and 2013, respectively and (ii) the maximum past service contribution permitted under the Income Tax Act.

The Air Canada 2009 Pension Regulations were adopted in coordination with the Pension MOUs identified in section 6 of this MD&A. Pursuant to the Pension MOUs, on October 26, 2009, Air Canada issued to a trust, 17,647,059 Class B voting shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of sale of such shares by the trust are to be contributed to the pension plans. For so long as the trust continues to hold at least 2% of Air Canada's issued and outstanding shares of Air Canada, the trustee will have the right to designate one nominee (who shall not be a member or officer of any of Air Canada's Canadian-based unions) to Air Canada's board of directors, subject to completion of Air Canada's usual governance process for selection and confirmation of director nominees. Current service contributions will continue to be made in the normal course while the Air Canada 2009 Pension Regulations are in effect.

After consideration of the effect of the Air Canada 2009 Pension Regulations, as outlined above, employer pension funding contributions amounted to $389 million in 2009.

(Canadian dollars in millions)	2009 Contributions	2008 Contributions
Past service cost for registered pension plans	$ 140	$ 189
Current service cost for registered pension plans	185	165
Other pension arrangements [1]	64	102
Total	**$ 389**	$ 456

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

The following table provides indicative figures of Air Canada's pension funding obligations, on a cash basis, for 2010 and for the next three years. Actual funding obligations are dependant on a number of factors, including the Air Canada 2009 Pension Regulations described above for past service, the assumptions used in the last filed actuarial valuation reports for current service (including a discount rate of 6.25%), the plan demographics at the valuation date, the existing plan provisions, existing pension legislation and changes in the economic conditions, mainly the return on fund assets and changes in interest rates. Actual contributions which are determined on the basis of future valuation reports filed annually may vary significantly from projections. In addition to changes in plan demographics and experience, actuarial assumptions and methods may be changed from one valuation to the next including be reason of changes in plan experience, financial markets, future expectations, changes in legislation and other factors. As of 2014, the Air Canada 2009 Pension Regulations will cease to have effect and Air Canada's pension funding obligations may vary significantly based on a wide variety of factors, including regulatory developments, assumptions and methods used and changes in the economic conditions, mainly the return on fund assets and changes in interest rates.

(Canadian dollars in millions)	**2010**	**2011**	**2012**	**2013**
Past service domestic registered plans	$ -	$ 138	$ 173	$ 221
Current service domestic registered plans	161	165	170	175
Other pension arrangements [(1)]	78	79	81	83
Projected pension funding obligations	**$ 239**	**$ 382**	**$ 424**	**$ 479**

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

The net deficit, on an accounting basis, at December 31, 2009 for pension benefits was $1,186 million ($1,012 million in 2008). The increase in the accounting deficit is mainly the result of an increase to the accrued benefit obligation resulting from a decrease in the discount rate largely offset by a higher than expected return on plan assets.

10.7 Share Information

An aggregate of 278,147,059 Class A variable voting shares and Class B voting shares in the capital of Air Canada are issued and outstanding. The issued and outstanding shares of Air Canada, along with shares potentially issuable, are as follows:

	Number of Shares	
	At January 31, 2010	**At December 31, 2008**
Issued and outstanding shares		
Class A variable voting shares	59,341,968	15,475,659
Class B voting shares	218,805,091	84,524,341
Total issued and outstanding shares	**278,147,059**	**100,000,000**
Class A variable voting and Class B voting shares potentially issuable		
Warrants	90,250,000	-
Stock options	3,963,474	1,701,447
Performance share units	561,846	559,885
Total shares potentially issuable	**94,775,320**	**2,261,332**
Total outstanding and potentially issuable shares	**372,922,379**	**102,261,332**

Under the Credit Facility identified in section 6 of this MD&A, Air Canada issued to the lenders, concurrently with the first drawdown, warrants for the purchase of five million of Air Canada's Class A variable voting shares or Class B voting shares representing an aggregate of 5% of the total issued and outstanding shares as at the closing date of the Credit Facility, allocated among the lenders based on their pro-rata lending commitments under the Credit Facility. These initial warrants have an exercise price of $1.51 per share, are exercisable at any time and expire four years after the date of issuance. In the event that Air Canada did not grant additional

security over certain assets within 90 days of closing, Air Canada was required to issue to the lenders additional warrants representing up to an additional five million shares or 5% of the total issued and outstanding shares (determined at the time of issuance of such additional warrants) with an average exercise price established based on a volume weighted average price over the five days before issuance, exercisable at any time and expiring four years after the date of issuance. These additional warrants were issued on October 19, 2009 and have an exercise price of $1.44 per share.

Pursuant to the Pension MOUs, on October 26, 2009, Air Canada issued to a trust, 17,647,059 Class B voting shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of sale of such shares by the trust are to be contributed to the pension plans. For so long as the trust continues to hold at least 2% of the issued and outstanding shares of Air Canada, the trustee will have the right to designate one nominee (who shall not be a member or officer of any of Air Canada's Canadian-based unions) to Air Canada's board of directors, subject to completion of Air Canada's usual governance process for selection and confirmation of director nominees.

On October 27, 2009 Air Canada completed a previously announced bought deal public offering pursuant to which it sold to an underwriting syndicate 160,500,000 units (the "Units") of Air Canada at a price of $1.62 per Unit for aggregate gross proceeds to Air Canada of $260 million (net proceeds of $248 million after expenses and underwriter fees). Each Unit was comprised of one Class A variable voting share (the "Variable Voting Shares") or one Class B voting share (the "Voting Shares", and, together with the Variable Voting Shares, the "Shares") of Air Canada, and one-half of one share purchase warrant. Each whole share purchase warrant is defined as a "Warrant". Each Warrant will entitle the holder thereof to acquire one Variable Voting Share or one Voting Share (each, a "Warrant Share") at an exercise price of $2.20 per Warrant Share, at any time prior to 36 months following October 27, 2009. In the event that, prior to the time of expiry of the Warrants, the 20-day volume weighted average trading price of the Variable Voting Shares on the Toronto Stock Exchange ("TSX") is equal to or greater than $4.00 or the 20-day volume weighted average trading price of the Voting Shares on the TSX is equal to or greater than $4.00 (each, an "Acceleration Event"), Air Canada shall have the right, at its option, within 10 business days after the Acceleration Event, to accelerate the time of expiry of the Warrants.

11. Quarterly Financial Data

The following table summarizes quarterly financial results and major operating statistics for Air Canada for the last eight quarters.

($ millions, except per share figures)	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009
Operating revenues	**$ 2,727**	**$ 2,782**	**$ 3,075**	**$ 2,498**	**$ 2,391**	**$ 2,330**	**$ 2,670**	**$ 2,348**
Aircraft fuel	715	848	1,064	792	593	572	682	601
Ownership (DAR) [1]	234	242	243	254	245	248	252	250
Other operating expenses	1,790	1,685	1,656	1,598	1,741	1,623	1,668	1,580
Operating expenses	**2,739**	**2,775**	**2,963**	**2,644**	**2,579**	**2,443**	**2,602**	**2,431**
Operating income (loss) before the undernoted item	**(12)**	**7**	**112**	**(146)**	**(188)**	**(113)**	**68**	**(83)**
Provision for cargo investigations [2]	(125)	-	-	-	-	-	-	-
Operating income (loss)	**(137)**	**7**	**112**	**(146)**	**(188)**	**(113)**	**68**	**(83)**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(151)	115	(244)	(581)	(212)	268	209	27
Net income (loss)	**$ (288)**	**$ 122**	**$ (132)**	**$ (727)**	**$ (400)**	**$ 155**	**$ 277**	**$ (56)**
Revenue passenger miles (millions)	12,331	12,884	14,458	10,845	10,984	11,862	14,153	10,885
Available seat miles (millions)	15,407	15,581	17,515	13,571	13,821	14,735	16,946	13,841
Passenger load factor (%)	80.0	82.7	82.5	79.9	79.5	80.5	83.5	78.6
RASM (cents)	15.0	15.7	15.7	16.0	14.5	13.9	14.1	14.6
CASM (cents)	17.8	17.8	16.9	19.5	18.7	16.6	15.4	17.6
CASM, excluding fuel expense (cents)	13.1	12.4	10.8	13.6	14.4	12.7	11.3	13.2
Fuel price per litres (cents) [3]	75.2	89.2	101.0	95.8	71.4	65.4	68.6	72.6
EBITDAR before the provision for cargo investigations [4]	**$ 222**	**$ 249**	**$ 355**	**$ 108**	**$ 57**	**$ 135**	**$ 320**	**$ 167**
EBITDAR [4]	**$ 97**	**$ 249**	**$ 355**	**$ 108**	**$ 57**	**$ 135**	**$ 320**	**$ 167**
Earnings (loss) per share								
- Basic	**$ (2.88)**	**$ 1.22**	**$ (1.32)**	**$ (7.27)**	**$ (4.00)**	**$ 1.55**	**$ 2.77**	**$ (0.25)**
- Diluted	**$ (2.88)**	**$ 1.22**	**$ (1.32)**	**$ (7.27)**	**$ (4.00)**	**$ 1.55**	**$ 2.44**	**$ (0.25)**

(1) DAR refers to the combination of Depreciation and amortization, and Aircraft rent expenses.
(2) A provision for cargo investigations and proceedings of $125 million was recorded in the first quarter of 2008.
(3) Includes fuel handling and is net of fuel hedging results.
(4) See section 21 "Non-GAAP Financial Measures" in this MD&A for additional information.

12. Selected Annual Information

The following table provides selected annual information for Air Canada for the years 2007 through to 2009.

(Canadian dollars in millions except per share figures)	2009	2008	2007
Operating revenues	$ 9,739	$ 11,082	$ 10,646
Operating expenses	10,055	11,121	10,213
Operating income (loss) before undernoted item	**(316)**	**(39)**	**433**
Provision for cargo investigations	-	(125)	-
Operating income (loss)	**(316)**	**(164)**	**433**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	292	(861)	(4)
Net income (loss)	**$ (24)**	**$ (1,025)**	**$ 429**
EBITDAR	$ 679	$ 934	$ 1,263
EBITDAR excluding provision for cargo investigations	$ 679	$ 809	$ 1,263
Earning (loss) per share			
- Basic	$ (0.18)	$ (10.25)	$ 4.29
- Diluted	$ (0.18)	$ (10.25)	$ 4.27
Cash, cash equivalents and short-term investments	$ 1,407	$ 1,005	$ 1,239
Total assets	$ 10,406	$ 11,364	$ 11,820
Total long-term liabilities (1)	$ 6,140	$ 7,309	$ 6,579
Total liabilities	$ 8,759	$ 10,412	$ 9,193
Shareholders equity	$ 1,446	$ 762	$ 2,443

(1) Total long-term liabilities include long-term debt (including current portion) and capital leases, pension and other benefit liabilities and other long-term liabilities.

13. Financial Instruments and Risk Management

Risk Management

Under its risk management policy, the Corporation manages its interest rate risk, foreign exchange risk, and market risk through the use of various interest rate, foreign exchange, and fuel derivative financial instruments. The Corporation uses derivative financial instruments only for risk management purposes, not for generating trading profit.

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

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 to cause 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 obligations 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, 2009 is 59% fixed and 41% floating, including the effects of interest rate swap positions (58% and 42%, respectively, as at December 31, 2008).

The following are the current derivatives employed in interest rate risk management activities and the adjustments recorded during 2009:

- In 2009, the Corporation entered into an interest rate swap agreement, with a term to November 2011, relating to the Credit Facility, with an original notional value of $600 million systematically declining as payments are made to $450 million by the end of its two-year term. This swap converts the Credit Facility's bankers' acceptance rate setting from "in advance" to "in arrears minus 0.2%". The fair value of this contract as at December 31, 2009 was $1 million in favour of the counterparty. This derivative instrument has not been designated as a hedge for accounting purposes and is recorded at fair value. During 2009, a loss of $1 million was recorded in gain on financial instruments recorded at fair value related to this derivative.

- As at December 31, 2009, the Corporation had two interest rate swap agreements in place with terms to July 2022 and January 2024 relating to two Boeing 767 aircraft financing agreements with an aggregate notional value of $92 million (US$88 million) (2008 - $118 (US$96 million)). These swaps convert the lease payments on the two aircraft leases from fixed to floating rates. The fair value of these contracts as at December 31, 2009 was $12 million in favour of the Corporation ($21 million in favour of the Corporation in 2008). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In 2009, a loss of $9 million was recorded in gain on financial instruments recorded at fair value related to these derivatives (a gain of $14 million in 2008).

Interest income includes $10 million ($47 million in 2008) related to cash and 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.

The Corporation's cash inflows are primarily in Canadian dollars, while a large portion of its outflows are in U.S. dollars. This unbalanced mix results in a U.S. dollar shortfall from operations annually. In order to mitigate this imbalance, the Corporation has adopted the practice of converting excess revenues from offshore currencies into US dollars. In 2009, this conversion generated coverage of approximately 29% of the imbalance. The remaining 71% was covered through the use of a variety of foreign exchange derivatives, including spot transactions and U.S. dollar investments, 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, U.S. dollar net cash flows, as well as the amount attributed to aircraft and debt payments.

The following are the current derivatives employed in foreign exchange risk management activities and the adjustments recorded in 2009:

As at December 31, 2009, the Corporation had outstanding foreign currency option agreements converting U.S. dollars into Canadian dollars on $99 million (US$95 million) which mature in 2010 and ($632 million (US$516 million) in 2008) and $5 million (EUR 3) which mature in 2010 (2008 - $632 million (US$516 million) and $5 million (EUR 3)). The fair value of these foreign currency contracts as at December 31, 2009 was $4 million in favour of the counterparties ($64 million in 2008 in favour of the Corporation). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In 2009, a loss of $7 million was recorded in foreign exchange gain (loss) related to these derivatives ($327 million gain in 2008).

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. The Corporation uses derivative contracts on jet fuel and other crude oil-based commodities, heating oil and crude oil. Heating oil and crude oil commodities are used due to the relative limited liquidity of jet fuel derivative instruments on a medium to long-term horizon since jet fuel is not traded on an organized futures exchange. The Corporation's policy permits hedging of up to 75% of the projected jet fuel purchases for the next 12 months, 50% for the next 13 to 24 months and 25% for the next 25 to 36 months. These are maximum (but not mandated) limits. There is no minimum monthly hedging requirement. There are regular reviews to adjust the strategy in light of market conditions. The Corporation does not purchase or hold any derivative financial instrument for speculative purposes.

In 2009, the Corporation purchased crude oil call options. The premium related to these contracts was $6 million.

At January 31, 2010, approximately 21% of the Corporation's anticipated purchases of jet fuel for the remainder of 2010 is hedged at an average West Texas Intermediate ("WTI") capped price of USD$93 per barrel, and approximately 10% is subject to an average floor price of US$96 per barrel. The Corporation's contracts to hedge anticipated jet fuel purchases over the 2010 period is comprised of jet fuel and crude-oil based contracts.

The following table outlines the notional volumes per barrel outstanding at January 31, 2010, along with the WTI-weighted average floor and capped price for each year currently hedged by type of derivative instruments.

Outstanding at January 31, 2010				
Derivative Instruments	**Term**	**Volume (BBLs)**	**WTI-weighted Average Floor Price (US$ per barrel)**	**WTI-weighted Average Capped Price (US$ per barrel)**
Call Options (1)	2010	2,345,000	n/a	90
Swaps (1)	2010	975,000	99	99
Collars (1)	2010	1,055,000	93	95

(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.

In 2009, fuel derivative contracts cash settled with a fair value of $88 million in favour of the counterparties ($129 million in favour of the Corporation in 2008).

After considering the costs and benefits specific to the application of cash flow hedge accounting, the Corporation elected to discontinue hedge accounting for all fuel derivatives effective the third quarter of 2009. Therefore as of July 1, 2009, all fuel hedging contracts were considered "economic hedges" and the periodic change in their fair market value was recorded in other non-operating income under gain (loss) on financial instruments recorded at fair value. A fair value gain of $102 million was recognized in 2009 (a loss of $9 million in 2008).

While applying hedge accounting, the Corporation had recorded losses under Accumulated other comprehensive loss ("AOCL") which will be recognized under fuel expense in the period where the derivative is schedule to mature. Throughout 2009, $419 million has been recognized into fuel expense. As at December 31, 2009, the net amount of existing losses reporting in AOCL that is expected to be reclassified to operating income (loss) during the following 12 months is $183 million before tax (Q1: $58 million, Q2 $52 million, Q3: $42 million, Q4: $31 million). Due to the discontinuation of hedge accounting, the AOCL balance related to fuel hedging contracts will be completely depleted as of December 31, 2010.

In 2009, the Corporation modified its fuel hedge portfolio with the termination of swap and put option contracts for $192 million in favour of the counterparties. The collateral held by the counterparties covered the majority of the settlement amount, therefore minimal additional cash outflows resulted. Certain of these contracts were previously designated under hedge accounting. The value of the AOCL balance recognized in connection with these derivatives while designated under hedge accounting will be taken into fuel expense in the period where the derivative was scheduled to mature.

The types of derivative instruments used by the Corporation within its hedging program, such as swaps and put options within collar structures, expose the Corporation to the potential of providing collateral deposits to its counterparties. When fuel prices decrease causing the Corporation's derivative position to be in a liability position below the set credit thresholds with counterparties, the Corporation is responsible for extending collateral to the counterparties. As at December 31, 2009, the Corporation had extended $43 million of collateral to counterparties ($328 million as at December 31, 2008).

Below is a table summarizing the impact of fuel derivatives on the Corporation's consolidated statement of operations, consolidated statement of comprehensive loss and consolidated statement of financial position.

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(Canadian dollars in millions)		Fourth Quarter 2009	Fourth Quarter 2008	Full Year 2009	Full Year 2008
Consolidated Statement of Operations					
Operating expense					
Aircraft fuel	Realized effective gain (loss) – derivatives designated under hedge accounting	$ (85)	$ (111)	$ (419)	$ 79
Non-operating income (expense) Gain (loss) on financial instruments recorded at fair value	Ineffective gain (loss) – derivatives designated under hedge accounting	n/a	$ 59	$ -	$ 83
	Fair market value gain (loss) – economic hedges	$ 24	(40)	$ 102	$ (9)
Consolidated Statement of Comprehensive Income (Loss)					
	Effective gain (loss) – derivatives designated under hedge accounting	n/a	$ (678)	$ (1)	$ (605)
	Tax expense on effective gain	$ -	$ 44	$ -	$ -
	Reclassification of net realized (gain) loss on fuel derivatives designed under hedge accounting to aircraft fuel expense	$ 85	$ 111	$ 419	$ (79)
	Tax on reclassification	$ -	$ (39)	$ 4	$ 22

		December 31, 2009	December 31, 2008
Consolidated Statement of Financial Position			
Current assets	Collateral deposits for fuel derivatives	$ 43	$ 328
Current liabilities*	Fair market value of fuel derivatives designated under hedge accounting	n/a	$ (405)
	Fair market value of fuel derivatives – economic hedges	$ (31)	$ (15)
Shareholders' equity (AOCL)	Net loss from fuel derivatives designated under hedge accounting (net of tax in 2009 - $1 million and 2008 - $5 million)	$ (184)	$ (606)

** The balance is reflected within Current liabilities on the Consolidated Statement of Financial Position due to the counterparty's ability to terminate the derivatives at fair value at any time prior to maturity.*

Summary of gain on financial instruments recorded at fair value

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

	Fourth Quarter		Full Year	
(Canadian dollars in millions)	**2009**	**2008**	**2009**	**2008**
Ineffective portion of fuel hedges	$ -	$ 59	$ -	$ 83
Fuel derivatives not under hedge accounting	24	(40)	102	(9)
Cross-currency interest rate swaps	-	(2)	-	4
Other	(2)	15	(7)	14
Gain on financial instruments recorded at fair value	**$ 22**	**$ 32**	**$ 95**	**$ 92**

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. The Corporation 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. The Corporation's principal objective in managing liquidity risk is to maintain a minimum unrestricted cash balance in excess of a target liquidity level of 15% of annual operating revenues. As at December 31, 2009, Air Canada had cash, cash equivalents and short-term investments of $1,407 million which represented 14% of 2009 operating revenues.

Management believes that the significant events as described in section 6 of this MD&A improve the Corporation's current liquidity position. However, certain risks remain such as those related to the current economic environment, including risks related to market volatility in the price of fuel, foreign exchange and interest rates and increased competitive pressures as well as risks relating to restrictive terms under the Corporation's financing, credit card processing and other arrangements and other risks as identified below.

The H1N1 influenza virus may also continue to impact demand for air travel. The Corporation is continuing to monitor the H1N1 influenza virus risk. While the Corporation has developed contingency plans related to the H1N1 influenza virus risk, it is unable to predict the likelihood of this risk materializing or the impact on the Corporation to the extent this risk does materialize. The Corporation is also monitoring the impact on the demand for air travel of the new security measures imposed in December 2009 by Canadian and U.S. government authorities on flights from Canada to the U.S.

Pension funding obligations

Refer to section 10.6 of this MD&A for a discussion on Air Canada's pension funding obligations.

Covenants in credit card agreements

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

As at December 31, 2008, under the terms of certain credit card processing agreements with one of its principal credit card processors, the processor was entitled to withhold payment of funds to Air Canada upon the occurrence of certain events ("triggering events"), which included unrestricted cash (as defined per the agreements and generally based on the aggregate sums of Cash and cash equivalents and Short-term investments) being less than $900 million as at the end of any month and operating losses in excess of certain amounts. During 2009, the Corporation entered into amendments with this processor to amend certain credit card processing agreements under which the triggering events related to operating losses were removed, the levels of unrestricted cash required to be maintained by Air Canada were reduced to $800 million and Air Canada provides the processor with deposits, to be accumulated over time, and security. The agreements provide that should Air Canada maintain unrestricted cash of more than $1,200 million for two consecutive

months, the unrestricted cash requirement increases to $1,100 million at which time the processor will return to Air Canada all deposits and security previously provided by Air Canada. This occurred during the third quarter of 2009, and as a result, no deposit was provided under these processing agreements as at December 31, 2009. As long as unrestricted cash remains at or above $1,100 million at each month-end, Air Canada has no obligation to provide deposits or security to the processor. In addition, should the Corporation's unrestricted cash be less than $1,100 million at any month-end, its obligation to provide deposits to the processor would be capped at an amount not to exceed $75 million, provided unrestricted cash is not less than $800 million. The current agreements with this credit card processor expire in May 2010.

Cargo investigations and proceedings

The Corporation is exposed to potential liabilities related to the proceedings and investigations of alleged anti-competitive cargo pricing activities, as described in section 19 of this MD&A. The preliminary estimate recorded by the Corporation during 2008 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 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.

Credit Risk

Credit risk is the risk of loss due to a counterparty's inability to meet its obligations. As at December 31, 2009, the Corporation's credit risk exposure consists mainly of the carrying amounts of Cash and cash equivalents, Short-term investments and accounts receivable as well as collateral deposits for fuel derivatives extended to counterparties. Cash and cash equivalents 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. 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.

At January 31, 2010, the Corporation has $55 million in collateral deposits extended to fuel hedge counterparties. Credit risk related to these deposits is offset against the related liability to the counterparty under the fuel derivative.

Refer to the "Asset Backed Commercial Paper" section below for information on credit risks.

Market Risks

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, 2009 is based on a number of assumptions as to the fair value of the investments including factors such as estimated cash flow scenarios and risk adjusted discount rates. The assumptions used in estimating the fair value of the investments are subject to change, which may result in further adjustments to non-operating results in the future. No adjustments to the carrying value were recorded during 2009.

14. 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 (the "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 Accounting Guideline 15 – Consolidated of Variable Interest Entities ("AcG-15") was approximately $162 million as at December 31, 2009 ($127 million as at December 31, 2008), 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.

15. Related Party Transactions

At December 31, 2009, ACE Aviation Holdings Inc. ("ACE") held a 27% ownership interest in Air Canada. Air Canada has various related party transactions with Aveos Fleet Performance Inc. ("Aveos") and ACE.

Summary of Significant Related Party Agreements

The Relationship between the Corporation and Aveos

Refer to the "Aveos Restructuring Plan" section below for a description of a restructuring plan announced by Aveos on January 26, 2010. Closing of Aveos' restructuring transactions is expected to occur during the first quarter of 2010 and is dependant on completion of formal documentation and certain conditions. This restructuring would modify the terms of certain commercial agreements between Air Canada and Aveos, including terms of the Pension and Benefits Agreement and the Agreement with Aveos on Revised payment terms described below.

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) in 2007). 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 Memorandum of Agreement ("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 by Air Canada 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. Refer to the "Aveos Restructuring Plan" section below for a description of amendments which would be made to this agreement pursuant to the restructuring.

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 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. On March 5, 2009, the Corporation received the decision of the arbitrator seized with resolving five issues which remained outstanding following the execution of the Transition MOA. The Corporation and the IAMAW subsequently amended the Transition MOA, by establishing timelines for the steps for the transition and by providing for a date on which the employees who will transition to Aveos will become employees of Aveos, namely, April 1, 2011.

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.

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 cancelled. The cancellation of the letters of credit provided cash to Air Canada of approximately $40 million and was 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 were originally scheduled to begin reducing in May 2009 with a corresponding return of the letters of credit to Aveos.

As a result of amendments, the payment terms were extended. The extended payment terms to Aveos will be reduced starting in February 2010, with the expiration of the extended terms to be completed over the following six months. By July 2010, following expiration of the extended payment terms, the letters of credit would be reinstated to the levels then required under the Pension and Benefits Agreement between the two parties. Refer to the "Aveos Restructuring Plan" section below for a description of amendments which would be made to this agreement pursuant to the restructuring.

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) and component maintenance. 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. 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. 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 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

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.

Aveos Restructuring Plan

On January 26, 2010, Aveos reached an agreement with its lenders and equity holders on the terms of a consensual restructuring plan to recapitalize the company. As part of this recapitalization, Air Canada and Aveos entered into a preliminary agreement to settle certain issues and modify the terms of certain contractual arrangements in exchange for Air Canada receiving a minority equity interest in Aveos. The modified terms relating to the maintenance agreements are not expected to have a material impact on maintenance expense over their terms.

Closing of Aveos' recapitalization, including the related transactions between Air Canada and Aveos, is subject to completion of formal documentation and other conditions and is expected to occur during the first quarter of 2010. As part of these agreements, the Corporation would also agree to extend repayment terms on $22 million of receivables (described above under "Agreement with Aveos on Revised Payment Terms"), due in 2010, over six years with annual repayments on a non-interest bearing basis, with such payments subject to satisfaction of certain conditions.

The terms of the Pension and Benefits Agreement (described above) would also be modified to defer the determination of pension assets and related solvency deficiencies of transferring unionized employees performing airframe maintenance services to April 2011. This would have the result of Air Canada assuming changes in the solvency deficiency for those affected employees from the date of the Pension and Benefits Agreement to the date of their transfer to Aveos, scheduled for April 2011. As part of the amendment, all letters of credit issued under the Pension and Benefits Agreement would be cancelled and a new letter of credit in a maximum amount of $20 million would be issued by Air Canada in favour of Aveos to secure the payment of all compensation payments owing by Air Canada to Aveos in respect of pension, disability, and retiree liabilities for which Air Canada is liable under the Pension and Benefits Agreement. This modification would result in a reduction to the outstanding deposit under Air Canada's letter of credit facility of approximately $20 million in the first quarter of 2010.

The accounting for the above agreements will be determined upon closing.

The Relationship between the Corporation and ACE

Credit Facility

ACE is a participant lender in the Credit Facility as described in section 6 of this MD&A. ACE's participation in the Credit Facility represents $150 million of the outstanding loan of $600 million as at December 31, 2009. The participant lenders participate on a pro-rata basis with respect to any warrants and principal and interest payments. ACE's pro-rata share of interest expense reported in 2009 amounted to $8 million and its pro-rata share of the warrants as reported in contributed surplus is approximately $2 million.

Master Services Agreement

Air Canada provides certain accounting and administrative services to ACE in return for a fee. ACE terminated the majority of these service agreements in 2009.

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, 2009	December 31, 2008
Accounts receivable		
ACE	$ -	$ 2
Aveos	135	120
	$ 135	**$ 122**
Prepaid Maintenance		
Aveos	$ 9	$ 5
	$ 9	**$ 5**
Accounts payable and accrued liabilities		
ACE	$ 3	$ -
Aveos	92	99
	$ 95	**$ 99**
Long-term debt including current portion and value of warrants		
ACE	$ 150	$ -
	$ 150	**$ -**

Revenues and expenses with related parties are summarized as follows:

	Full Year	
(Canadian dollars in millions)	2009	2008
Revenues		
Property rental revenues from ACE and Aveos	$ 31	$ 29
Revenues from information technology services to Aveos	6	15
Revenues from corporate services and other to ACE and Aveos	9	15
	$ 46	**$ 59**
Expenses		
Maintenance expense for services from Aveos	$ 514	$ 478
Recovery of wages, salary and benefit expense for employees assigned to ACE and Aveos	(228)	(277)
Interest expense for ACE's participation in the Credit Facility	8	
Other Expenses	-	1
	$ 294	**$ 202**

16. 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 corporation that provides loyalty program services to the Corporation and purchases seats from Air Canada pursuant to the Aeroplan Commercial Participation and Services Agreement between Aeroplan and Air Canada (the "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.

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 Corporation employees perform work for ACE and Aveos and are members of Corporation-sponsored defined benefit pension plans and also participate in Corporation-sponsored health, life and disability benefit plans. Other Corporation employees performed work for Aeroplan until the date of transition to employment at Aeroplan and then ceased to accrue benefits under the Corporation-sponsored defined benefit pension plans and under the Corporation-sponsored health, life and disability benefit plans. The Corporation's audited consolidated financial statements for 2009 include all of the assets and liabilities of all the sponsored plans of the Corporation. Employee benefits expense includes the expenses for all employees participating in the plans less a cost recovery which is charged to ACE, Aveos, and Aeroplan for those employees contractually assigned. The cost recovery includes current service costs for pensions, past service costs to Aeroplan for pensions and a portion of post-employment and post-retirement benefits to ACE and Aveos, based on the actuarial calculation for their specific employee group. The cost recovery amounted to $32 million for the year ended December 31, 2009 ($40 million for the year ended December 31, 2008).

In May 2009, Air Canada and Aeroplan reached an agreement with the Canadian Auto Workers (CAW) Local 2002 providing for a process for the approximately 750 Air Canada employees then assigned to and working in the Aeroplan contact centres to choose to transition to employment at Aeroplan, effective June 1, 2009, or to remain employees of Air Canada. Employees at Air Canada work locations who became surplus to Air Canada's needs due to employees who were senior to them and then working at Aeroplan contact centres choosing to remain employees of Air Canada were given the option to transition to employment at Aeroplan. Effective October 4, 2009, all affected employees had completed the transition to Aeroplan. For those employees who transferred to Aeroplan, their service, which largely determines benefit levels under the Air Canada pension and other employee benefit plans, ceased to accrue as of the date of employment with Aeroplan. Air Canada and Aeroplan continue to discuss the terms surrounding the transfer of pension benefits and certain implications relating to same remain to be resolved. Air Canada continues to retain plan assets and report liabilities for services accrued for the transferred Aeroplan employees as at December 31, 2009, pending final determination of this matter. Aeroplan is now contributing current service costs in their pension plan for service accruing with Aeroplan.

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

	December 31, 2009	December 31, 2008
Weighted average assumptions used to determine the accrued benefit liability		
Discount rate	6.40%	7.35%
Rate of compensation increase [1]	2.50%	2.50%
Weighted average assumptions used to determine the accrued benefit cost		
Discount rate	7.35%	5.75%
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 0% plus merit was used for years 2009 and 2010 in determining the net benefit obligation for the pension plan and 2.50% plus merit for the remaining years.
(2) A rate of compensation increase of 0% plus merit was used in 2009 and in 2010 in determining the net benefit pension expense and 2.50% plus merit 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 in the discount rate of 0.25% results in a decrease of $346 million to the pension obligation and $28 million to the pension expense. A decrease in the discount rate of 0.25% results in an increase of $346 million to the pension obligation and $25 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 the partial recovery in 2009, and historical returns, to the extent that the past is indicative of the expected long-term, prospective rate. There can be no assurance that any of the plans will earn the expected rate of return. A sensitivity analysis on pension expense assuming a change in the expected return on plan assets is provided below.

Composition of Pension Plan Assets

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

	2009	2008	Target allocation [1]
Non-matched assets (mainly equities)	55.9%	52.9%	54.4%
Matched assets (mainly Canadian bonds)	43.4%	43.5%	45.6%
Cash and temporary investments	0.7%	3.6%	0.0%
Total	**100.0%**	**0.0%**	**100.0%**

(1) Weighted average of the Master Trust Fund target allocation (99% of Domestic Registered Plan assets) and the Bond Fund target allocation. The Bond Fund serves the purpose of altering the asset mix of some of the participating plans. These plans exhibit characteristics that differ from the majority of the participating plans, which are solely invested in the Master Trust.

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) as amended during 2008. The investment return objective of the Fund is to achieve a total annualized rate of return that exceeds by a minimum of 1.0% before investment fees on average over the long term (i.e.10 years) the total annualized return that could have been earned by passively managing the Liability Benchmark. The Liability Benchmark, which is referenced to

widely used Canadian fixed income performance benchmarks (DEX), is composed of a mix of the DEX Universe Provincial Bond Index, DEX Long Term Provincial Bond Index and DEX Real Return Bond Index that closely matches the characteristics of the pension liabilities.

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

- Non-matched assets are mainly equities, and are required to be diversified among industries and economic sectors. Foreign equities can comprise 31% to 37% of the total market value of the Master Trust Fund. Limitations are placed on the overall allocation to any individual security at both cost and market value. Investments in non-publicly traded securities and in non-traditional asset classes are allowed up to 10% of the total market value of the Master Trust Fund.

- Matched assets are mainly Canadian bonds, oriented toward long term investment grade securities rated "BBB" or higher. With the exception of Government of Canada securities or a province thereof, in which the plan may invest the entire fixed income allocation, these investments are required to be diversified among individual securities and sectors.

Derivatives are permitted provided that they are used for hedging a particular risk (including interest rate risk related to pension liabilities) or to create exposures to given markets and currencies and that counterparties have a minimum credit rating of A. As of December 31, 2009, an additional 5% derivatives exposure to matched assets is in place to hedge interest rate risk related to pension liabilities.

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 2009 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 2009 pension expense in $ millions	**Decrease**	**Increase**
Discount rate on obligation assumption	$ 25	$ (28)
Long-term rate of return on plan assets assumption	$ 30	$ (29)

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 2009 (8.25% was assumed for 2008). 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 $18 million. A one percentage point decrease in assumed health care trend rates would have decreased the service and interest costs by $2 million and the obligation by $23 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, 2009, Air Canada has substantial tax attributes largely in the form of loss carry forwards and other tax attributes to shelter future taxable income. 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. 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 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.

17. Accounting Policies

17.1 Changes in Accounting Policies

Stock-based compensation plans

The Corporation changed its accounting policy for awards of stock-based compensation granted to Corporation employees with a graded vesting schedule. Prior to January 1, 2009, the fair value of stock options with a graded vesting schedule was recognized as compensation expense and a credit to contributed surplus on a straight-line basis over the applicable vesting period. Effective January 1, 2009, the fair value of stock options with a graded vesting schedule is determined based on different expected lives for the options that vest each year, as it would be if the award were viewed as several separate awards, each with a different vesting date, and it is accounted for on that basis. The new accounting policy provides more reliable and relevant information about the effects of the transactions.

The impact of the change in accounting policy for awards granted to Corporation employees with a graded vesting schedule was immaterial to any prior period and therefore no adjustments were made to such prior periods.

Goodwill and intangible assets

Effective January 1, 2009, the Corporation adopted new Canadian Institute of Chartered Accountants ("CICA") accounting standard 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 Corporation's accounting policy for intangible assets is consistent with the new standard and, as a result, no adjustment was recorded on transition.

Credit risk and the fair value of financial assets and financial liabilities

Effective January 1, 2009, the Corporation adopted the recommendations of the Emerging Issues Committee ("EIC") of the CICA relating to Abstract EIC-173 *Credit Risk and the Fair Value of Financial Assets and Financial Liabilities.* Under this Abstract, the Corporation's own credit risk and the credit risk of the counterparty are taken into consideration in determining the fair value of financial assets and liabilities, including derivative instruments. The adoption of this guidance had no significant impact on the Corporation's consolidated financial statements as collateral deposits with fuel derivative counterparties and master netting arrangements are considered in determining whether a credit risk adjustment is required on the valuation of the derivatives.

Financial Instruments – Disclosures

Effective January 1, 2009, the Corporation has adopted the enhanced disclosure requirements of amended CICA section 3862 Financial Instruments – Disclosures. Under these requirements, a classification of fair value measurements recognized in Air Canada's Consolidated Statement of Financial Position is presented using a fair value hierarchy that reflects the significance of the inputs used in making the measurements.

17.2 Future Accounting Standard Changes

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 these 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, Finance and Risk Committee on a quarterly basis.

The Corporation has identified the following major differences between its current accounting policies and those required or expected to apply in preparing IFRS financial statements.

Passenger and Cargo Revenues

Current accounting policy

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 corporation that provides loyalty program services to Air Canada and purchases seats from Air Canada under the 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. The Corporation has formed alliances with other airlines encompassing loyalty program participation, code sharing and coordination of services including reservations, baggage handling and flight schedules. Revenues are allocated based upon formulas specified in the agreements and are recognized as transportation is provided.

The Corporation performs regular evaluations on the deferred revenue liability which may result in adjustments being recognized as revenue. Due to the complex pricing structures; the complex nature of interline and other commercial agreements used throughout the industry; historical experience over a period of many years; and other factors including refunds, exchanges and unused tickets, certain relatively small amounts are recognized as revenue based on estimates. Events and circumstances may result in actual results that are different from estimates.

Expected IFRS accounting policy

No significant changes have been identified from the Corporation's current accounting policy.

Employee Future Benefits

Current accounting policy

The cost of pensions, other post-retirement and post-employment benefits earned by employees is actuarially determined annually as at December 31. The cost is determined using the projected benefit method prorated on service, market interest rates, and management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees and health care costs.

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

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

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

Expected IFRS accounting policy

Defined benefit plans

Actuarial gains and losses

Under IAS 19 *Employee benefits* ("IAS19"), actuarial gains and losses may either be:

- Deferred up to a maximum, with any excess amortised in profit or loss (the 'corridor approach'),
- Recognised immediately in profit or loss, or
- Recognised immediately in other comprehensive income without subsequent recycling to income.

Under the corridor approach under IAS 19, cumulative actuarial gains and losses in excess of 10% of the greater of the obligation and the fair value of plan assets at the beginning of the period are amortized in profit or loss over the average remaining working lives of the employees. Under current Canadian GAAP, the corridor approach is used and cumulative actuarial gains and losses in excess of 10% of the greater of the obligation and market-related value of plan assets at the beginning of the period is amortized in profit or loss.

The Corporation has not finalized its decision with respect to the accounting for actuarial gains and losses.

Fair value of plan assets vs market-related value of plan assets

Under IAS 19, a market-related valuation method can not be used to value plan assets. Under current Canadian GAAP, a market-related value of assets whereby the difference between actual and expected return is gradually recognized over four years is used.

The Corporation will use the fair value of plan assets under IAS 19.

The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction

In July 2007, the IASB issued IFRIC 14 *IAS 19 – The Limit of a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* ("IFRIC 14"). The Interpretation addresses the application of paragraph 58 of IAS 19 which limits the measurement of a defined benefit asset to "the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan" plus cumulative unrecognised net losses and past service cost. Questions have arisen about when refunds or reductions in future contributions should be regarded as available, particularly when a minimum funding requirement exists. Further, minimum funding requirements may give rise to a liability if the required contributions will not be available to the entity once they have been paid.

IFRIC 14 provides guidance regarding (a) when refunds or reductions in future contributions should be regarded as available in accordance with paragraph 58 of IAS 19, (b) how a minimum funding requirement might affect the availability of reductions in future contributions and (c) when a minimum funding requirement might give rise to a liability. This is a detailed piece of guidance for which there is no Canadian-specific equivalent. In addition, there is some lack of clarity around how the requirements of the IFRIC are to be interpreted in a Canadian environment.

The Corporation has not finalized the impact of IFRIC 14 with respect to the accounting for the limits of any defined benefit assets.

Other long-term employee benefits

Under Canadian GAAP, there is no separate category for other long-term employee benefits. IFRS takes the approach that the introduction of, or changes to, other long-term employee benefits rarely causes a material amount of past service cost. For these reasons, IAS 19 requires a simplified method of accounting for other long-term employee benefits. This method differs from the accounting required for post-employment benefits as follows:

- actuarial gains and losses are recognised immediately and no 'corridor' is applied; and
- all past service cost is recognised immediately.

The Corporation will adopt this revised accounting policy on transition to IFRS for other long-term employee benefits.

Income Taxes

Current accounting policy

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.

Expected IFRS accounting policy

The Corporation has not finalized analyzing the impact of IAS 12 *Income taxes* with respect to the accounting for income taxes.

Impairment of Long-Lived Assets

Current accounting policy

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

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

Expected IFRS accounting policy

Impairment testing of long-term assets is based on a two-step approach under current Canadian GAAP, while it is based on comparing the carrying amount to the recoverable amount under IAS 36 *Impairment of Assets* ("IAS 36"). In addition, IAS 36 requires, under certain circumstances, the reversal of impairment losses, which is not allowed under current Canadian GAAP.

The Corporation will adopt this revised accounting policy on transition to IFRS.

Property and Equipment

Current accounting policy

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

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

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

Expected IFRS accounting policy

Componentization

IAS 16 *Property, plant and equipment* ("IAS 16") reinforces the requirement under Canadian GAAP that requires that each part of property, plant and equipment that has a cost that is significant in relation to the overall cost of the item should be depreciated separately.

The Corporation will adopt this revised accounting policy with respect to componentization of property, plant and equipment on transition to IFRS.

Capitalization of major engine and airframe overhaul

In addition, IAS 16 provides guidance that would require major engine and airframe overhaul be treated as separate components of an aircraft with the overhaul cost capitalised and depreciated over the period to the next major overhaul.

The Corporation will adopt this revised accounting policy with respect to capitalization of major maintenance on transition to IFRS.

Leases

Under IAS 17 *Leases*, a lease is classified as either a finance lease or an operating lease. Lease classification depends on whether substantially all of the risks and rewards incidental to ownership of a leased asset have been transferred from the lessor to the lessee, and is made at inception of the lease. A number of indicators are used to assist in lease classification however, quantitative thresholds are not offered as an indicator as under current Canadian GAAP.

The Corporation has developed internal indicators to assist in lease classification under IFRS.

Intangible Assets

Current accounting policy

Intangible assets are initially recorded at cost. Indefinite life assets are not amortized while assets with finite lives are amortized on a straight-line basis to nil over their estimated useful lives.

Expected IFRS accounting policy

No significant changes have been identified from the Corporation's current accounting policy.

IFRS transition

With regards to IFRS transition, the Corporation has thoroughly analyzed the optional exemptions available under IFRS 1 First-time Adoption of International Financial Reporting Standards ("IFRS 1"). The decisions about the optional exemptions available under IFRS 1 are preliminary at this time. The decisions about accounting policy choices available under IFRS 1 and other individual IFRS standards will be disclosed throughout 2010 as they are reviewed by the Audit, Finance and Risk Committee and finalized. The Audit, Finance and Risk Committee Audit, Finance and Risk Committee will consider the appropriateness of the accounting policies applied under IFRS both at the time of transition and following transition.

Summary of the IFRS changeover plan

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:

	Key activities	Status
Accounting policies and implementation decisions	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.	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 continue to progress towards the quantification of the identified differences and choices throughout 2010.
Infrastructure Financial reporting expertise	Development of IFRS expertise.	The Corporation has provided training for key employees and stakeholders. Additional training will be ongoing until full adoption in 2011.
Infrastructure Information technology and data systems	Development of systems solution for transition period and post-convergence period.	The Corporation has determined system requirements and solutions. The impact with respect to Information technology and data systems is due to the change in accounting for property, plant and equipment. These changes have largely been implemented at nominal cost.

Business activities Financial covenants	Identification of impact on financial covenants and business practices; Completion of any required renegotiations/changes by the third quarter of 2010.	The Corporation is in the process of analyzing the contractual implications of IFRS on any financing relationships and other arrangements.
Business activities Compensation arrangements	Identification of impact on compensation arrangements; Assessment of required changes by the third quarter of 2010.	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	For all accounting policy changes identified, assessment of Internal Controls over Financial Reporting ("ICFR") design and effectiveness implications; Implementation of appropriate changes by the second quarter of 2010.	The Corporation is in the process of analyzing any issues with respect to ICFR.
Control activities Disclosure controls and procedures	For all accounting policy changes identified, assessment of Disclosure Controls and Procedures ("DC&P") design and effectiveness implications; Implementation of appropriate changes by the second quarter of 2010.	The Corporation is in the process of analyzing any issues with respect to DC&P.

18. 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 2009 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		2009 Measure	Sensitivity Factor	Favourable/(Unfavourable) Estimated Operating Income Impact
Revenue Measures				
Passenger yield (cents)	System	17.7	1% increase in yield	$ 80
	Canada	23.0		$ 34
Traffic (RPMs) (millions)	System	47,884	1% increase in traffic	$ 76
	Canada	15,544		$ 32
Passenger load factor	System	80.7	1 percentage point increase	$ 94
RASM (cents)	System	14.3	1% increase in RASM	$ 78
Cost Measures				
Labour and benefits expenses ($ millions)		1,751	1% increase	$ (18)
Fuel – WTI price (US$/barrel) (1)		59.2	US$1/barrel increase to WTI	$ (25)
Fuel – jet fuel price (CAD cents/litre) (1)		57.2	1% increase	$ (20)
Cost per ASM (cents)		16.9	1% increase in CASM	$ (101)
Currency Exchange				
Cdn$ to US$		1US$ = Cdn$1.09	1 cent increase (e.g. $1.09 to $1.08)	$ 23

(1) Excludes the impact of fuel surcharges and fuel hedging. Refer to section 13 of this MD&A for information on Air Canada's fuel derivative instruments.

($ millions) Key Variable	2009 Measure	Sensitivity Factor	Favourable/(Unfavourable) Estimated Pre-Tax Income Impact (1)
Currency Exchange			
Cdn$ to US$	1US$ = Cdn$1.09	1 cent increase (e.g. $1.09 to $1.08)	$ 57

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

19. Risk Factors

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

Risks Relating to Air Canada

Operating Results

Prior to emergence from its restructuring under the Companies Creditors Arrangement Act, as amended ("CCAA") on September 30, 2004, Air Canada had sustained significant losses and Air Canada may sustain significant losses in the future. In 2008, Air Canada recorded an operating loss before a provision for cargo investigations and proceedings of $39 million. During 2009, Air Canada recorded an operating loss of $316 million. Current economic conditions may result in significant losses for Air Canada. Despite ongoing business initiatives and efforts at securing cost reductions, revenue improvements and additional sources of financing, Air Canada 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 improve yield or offset or mitigate risks facing Air Canada, including those relating to economic conditions, liquidity, pension funding, unexpected volatility in fuel costs and other expenses.

Leverage

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

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

Need for Additional Capital and Liquidity

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

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

Air Canada's credit ratings influence its ability to access capital markets and its liquidity. There can be no assurance that Air Canada's credit ratings will not be downgraded, which would add to Air Canada's borrowing 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 Air Canada, its business, results from operations and financial condition.

Economic and Geopolitical Conditions

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

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

Pension Plans

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

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

Refer to section 10.6 of this MD&A for additional information relating to Air Canada's pension funding obligations. In particular, as of 2014, the Air Canada 2009 Pension Regulations will cease to have effect and Air Canada's pension funding obligations may vary significantly based on several factors, including regulatory developments, assumptions and methods used and changes in the economic conditions (mainly the return on fund assets and changes in interest rates). Underfunded pension plans or a failure or inability by Air Canada to make required cash contributions to its registered pension plans could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Fuel Costs

Fuel costs constituted the largest percentage of the total operating costs of Air Canada in 2009. Fuel prices fluctuate widely depending on many factors including international market conditions, geopolitical events and the Canada/U.S. 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 Air Canada, its business, results from operations and financial condition. Due to the competitive nature of the airline industry, Air Canada may not be able to pass on increases in fuel prices to its customers by increasing its fares. Based on 2009 volumes, management estimates that a US$1 per barrel movement in the average price of WTI crude oil would have resulted in an approximate $25 million change in 2009 fuel expense for Air Canada (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

Air Canada's financial results are sensitive to the fluctuating value of the Canadian dollar. In particular, Air Canada has a significant annual net outflow of U.S. dollars and is affected by fluctuations in the Canada/U.S. dollar exchange rate. Management estimates that during 2009, a $0.01 increase in the Cdn/U.S. dollar

exchange rate (i.e., $1.09 to $1.08 per U.S. dollar) would have had an estimated $23 million favourable impact on operating income and a $57 million favourable impact on pre-tax income. Conversely, an opposite change in the exchange rate would have had the opposite effect. Air Canada incurs significant expenses in U.S. dollars for such items as fuel, aircraft rental and maintenance charges, interest payments, debt servicing and computerized reservations system fees, while a substantial portion of its revenues are generated in Canadian dollars. A significant deterioration of the Canadian dollar relative to the U.S. dollar would increase the costs of Air Canada relative to its U.S. competitors and could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, Air Canada may be unable to appropriately hedge the risks associated with fluctuations in exchange rates.

Labour Costs and Labour Relations

Labour costs constitute one of Air Canada's largest operating cost items. There can be no assurance that Air Canada will be able to maintain such costs at levels 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 Air Canada's expectations or comparable to agreements entered into by Air Canada'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 Air Canada, its business, results from operations and financial condition.

Most of Air Canada's employees are unionized. The collective agreements representing the majority of the unionized workforce were renewed or extended in 2009 and will now expire in 2011. 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 further renewed without labour conflict or action or that there will not be a labour conflict that could lead to a dispute or to an interruption or stoppage in Air Canada's service or otherwise adversely affect the ability of Air Canada to conduct its operations, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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

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

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

Competition

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

Canadian low-cost and other carriers have entered and/or expanded or announced their intention to compete in many of Air Canada's key domestic markets and, along with some U.S. carriers have also entered and/or expanded their operations in the U.S. transborder and leisure-oriented markets. Carriers against which Air Canada may compete, including U.S. 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 Air Canada. Air Canada is also facing increasing competition in international markets as carriers increase their

international capacity, both by expansion and by shifting existing domestic capacity to international operations to avoid low-cost domestic competition.

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

Air Canada 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 Air Canada'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 Air Canada, its business, results from operations and financial condition. Furthermore, Air Canada's ability to reduce its fares in order to effectively compete with other carriers is dependent on Air Canada's ability to achieve acceptable operating margins and may also be limited by government policies to encourage competition. Likewise, competitors continue to pursue commission/incentive actions and, in many cases, increase these payments. The decision to modify Air Canada's current programs in order to remain competitive and maintain passenger traffic could result in increased costs to Air Canada's business.

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 Air Canada which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Limitations Due to Restrictive Covenants

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

A failure by Air Canada to comply with its contractual obligations (including restrictive, financial and other covenants), or to pay its indebtedness and fixed costs could result in a variety of material adverse consequences, including the acceleration of its indebtedness, the withholding of credit card proceeds by the credit card service providers and the exercise of remedies by its creditors and lessors, and such defaults could trigger additional defaults under other indebtedness or agreements. In such a situation, it is unlikely that Air Canada 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 Air Canada which secure Air Canada's obligations.

Refer to section 13 of this MD&A for a description of restrictive covenants relating to one of Air Canada's credit card processing agreements.

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. Though certain authorities have implemented some fee reductions, if authorities in Canada or elsewhere were to increase their fees Air Canada, its 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, Air Canada 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, business process initiatives, information technology 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 Air Canada's control. Such factors include the performance of third parties, including suppliers, the implementation and integration of such initiatives into Air Canada's other activities and processes as well as the adoption and acceptance of initiatives by Air Canada'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 Air Canada's ability to operate its business, achieve its goals and remain competitive and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

For instance, a key component of Air Canada's business plan is the completion of Air Canada's fleet restructuring program through the acquisition of new and more efficient Boeing 787 aircraft. A delay or failure in the completion of Air Canada's fleet restructuring, including further 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 Air Canada's business plan which may, in turn, have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Dependence on Technology

Air Canada relies heavily on technology, including computer and telecommunications equipment and software and Internet-based systems, to operate its business, increase its revenues and reduce its costs. These systems include those relating to Air Canada's telecommunications, websites, computerized airline reservations and airport customer services and flight operations.

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 Air Canada continues to invest in initiatives, including security initiatives and disaster recovery plans, these measures may not be adequate or implemented properly. Any such technology systems failure, interruption or misuse could materially and adversely affect Air Canada's operations and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key Supplies and Suppliers

Air Canada is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and services in a timely manner, including those available at airports or from airport authorities or otherwise required for Air Canada's operations such as fuel, aircraft and related parts and aircraft maintenance services (including maintenance services obtained from Aveos). In certain cases, Air Canada may only be able to access goods and services from a limited number of suppliers and transition to new suppliers may take 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 Air Canada's control. In addition, in the context of the current economic climate, there can be no assurance as to the continued viability of any of Air Canada's suppliers. Any failure or inability of Air Canada to successfully source goods and services, including by reason of a failure, refusal or inability of a supplier, or to source goods and services on terms and pricing and within the timeframes acceptable to Air Canada, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Aeroplan

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

Jazz

Under the CPA, Jazz provides Air Canada's customers service in lower density markets and higher density markets at off-peak times throughout Canada and to and from certain destinations in the United States and also provides valuable traffic feed to Air Canada's mainline routes. Pursuant to the terms of the Jazz CPA, Air Canada pays Jazz a number of fees which are determined based upon certain costs incurred by Jazz. Air Canada 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 Air Canada under the Jazz CPA, or other unexpected interruptions or cessation of Jazz's services which are beyond Air Canada's control could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, the Jazz CPA requires that Jazz maintain a minimum fleet size and contains a minimum average daily utilization

guarantee which requires that Air Canada make certain minimum payments to Jazz regardless of the amount of flying done on its behalf by Jazz.

Star Alliance®

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

Interruptions or Disruptions in Service

Air Canada's business is significantly dependent upon its ability to operate without interruption at a number of hub airports, including Toronto Pearson 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 Air Canada or other causes beyond the control of Air Canada could have a material adverse impact on Air Canada, its business, results from operations and financial condition.

Current Legal Proceedings

The European Commission, the United States Department of Justice and the Competition Bureau in Canada are investigating alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including Air Canada. Competition authorities have sought or requested information from Air Canada as part of their investigations. Air Canada is cooperating with these investigations, which are likely to lead, or have led, to proceedings against Air Canada and a number of airlines and other cargo operators in certain jurisdictions including in the European Union where all formal procedural steps preceding a decision have been completed. Air Canada 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, Air Canada recorded a provision of $125 million as a preliminary estimate. This is only an estimate 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 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 and such provisions could have a material adverse effect on Air Canada's financial position.

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. On October 16, 2009, Jazz discontinued its suit in the Ontario Superior Court against Porter. However, Jazz is continuing its proceedings in the Federal Court of Canada against the TPA, to which Porter intervened. The counterclaim filed by Porter in the Ontario Court against Jazz and Air Canada has been stayed pending the outcome of the mirror counterclaim in the Federal Court. Management views Porter's counterclaims in both jurisdictions as being without merit.

The Canadian Union of Public Employees ("CUPE"), which represents Air Canada's flight attendants, has filed 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 Air Canada for investigation. Air

Canada 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.

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

Future Legal proceedings

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

Key Personnel

Air Canada is dependent on the experience and industry knowledge of its executive officers and other key employees to execute its business plan. If Air Canada were to experience a substantial turnover in its leadership or other key employees, Air Canada'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, Europe and the U.S., causes uncertainty in the minds of the traveling public. The occurrence of a terrorist attack (or attempted attacks) (whether domestic or international and whether involving Air Canada or another carrier or no carrier at all) and increasingly restrictive security measures, such as current restrictions on the content of carry-on baggage, current or proposed passenger identification document requirements, and passenger screening procedures could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on Air Canada's flights. It could also lead to a substantial increase in insurance, airport security and other costs. Any resulting reduction in passenger revenues and/or increases in insurance, security or other costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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

The international outbreaks of Severe Acute Respiratory Syndrome (SARS) in 2003 and the resulting actions tabled by the World Health Organization (the "WHO"), including a travel advisory against non-essential travel to Toronto, Canada, had a significant adverse effect on passenger demand for air travel in Air Canada's markets and resulted in a major negative impact on traffic on the entire network. Air Canada is continuing to monitor the H1N1 influenza virus risk. While Air Canada has developed contingency plans related to the H1N1 influenza virus risk, it is unable to predict the likelihood of this risk materializing or the impact on its operations to the extent this risk does materialize. An outbreak of influenza, SARS, H1N1 influenza virus or of another epidemic disease (whether domestic or international) or any WHO travel advisories (whether relating to Canadian cities or regions or other cities, regions or countries) could have a material adverse effect on passenger demand for air travel. Any resulting reduction in traffic in the markets served by Air Canada could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Casualty Losses

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

Canada's reputation for safety, which would have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Seasonal Nature of the Business, Other Factors and Prior Performance

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

As described elsewhere, demand for and cost of air travel is also affected by factors such as geopolitical and economic conditions, war or the threat of war or terrorist attacks, fare levels and weather conditions. Due to these and other factors, operating results for an interim period are not necessarily indicative of operating results for an entire year, and operating results for 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, privacy, licensing, competition, environment (including noise levels and carbon emissions) and, in some measure, pricing.

For example, new and proposed legislation have been considered or adopted concerning carbon emissions emanating from the aviation industry; such legislative initiatives include, for example, market-based mechanisms called emissions trading systems which are being proposed and implemented to reduce the amount of carbon emissions through the setting of emissions allowances and charging aircraft operators for a certain percentage of these allowances. 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 Air Canada, its business, results from operations and financial condition.

The European Union passed legislation for an Emissions Trading System which will include carbon emissions from aviation commencing in January 2012, including for flights operated between Canada and countries within the European Union. The legislation would require aircraft operators to monitor and report on fuel use and emissions data. While this legislation would be expected to result in increased costs relating to the purchase of emissions allowances, the net financial impact would, in part, depend upon how much of such cost, if any, would be recoverable in the form of higher passenger and cargo fares.

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

Air Canada 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 Air Canada 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 Air Canada, its business, results from operations and financial condition.

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

Increased Insurance Costs

Since September 11, 2001 the aviation insurance industry has been continually re-evaluating the terrorism risks that it covers, and this activity may adversely affect some of Air Canada's existing insurance carriers or Air Canada's ability to obtain future insurance coverage. To the extent that Air Canada's existing insurance carriers are unable or unwilling to provide it with insurance coverage, and in the absence of measures by the Government of Canada to provide the required coverage, Air Canada's insurance costs may increase further and may result in Air Canada being in breach of regulatory requirements or contractual arrangements requiring that specific insurance be maintained, which may have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Third Party War Risk Insurance

There is a risk that the Government of Canada may not continue to provide an indemnity for third party war risk liability coverage, which it currently provides to Air Canada 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, Air Canada and other industry participants would have to turn to the commercial insurance market to seek such coverage. Air Canada estimates that such coverage would cost Air Canada approximately $5 million per year. Alternative solutions, such as those envisioned by the International Civil Aviation Organization ("ICAO") and the International Air Transport Association ("IATA"), have not developed as planned, due to actions taken by other countries and the recent availability of supplemental insurance products. ICAO and IATA are continuing their efforts in this area, however, the achievement of a global solution is not likely in the immediate or near future. The U.S. federal government has set up its own facility to provide war risk coverage to U.S. carriers, thus removing itself as a key component of any global plan.

Risks Related to Air Canada's Relationship with ACE

Control of Air Canada and Related Party Relationship

As at September 30, 2009, ACE owned Class B voting shares representing 75% of the shares issued and outstanding. This voting control enabled ACE to determine substantially all matters requiring security holder approval as a result of its voting interest in Air Canada. Accordingly, ACE would have been able to exercise control over corporate transactions that must be submitted to Air Canada's security holders for approval and effectively has sufficient voting power to effect or prevent a change in control of Air Canada. Following completion of the offering, as described in section 6 of this MD&A, and the issuance of shares under the Pension MOUs, ACE's ownership is reported to represent 27% of the shares issued and outstanding, however, ACE remains the largest shareholder of Air Canada. The extent of ACE's shareholdings in Air Canada 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. The exercise, if any, by lenders other than ACE of the initial warrants and additional warrants under the Credit Agreement would further dilute ACE's shareholdings in Air Canada.

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 significant 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, subject to compliance with applicable securities laws. 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 perception or possibility of those sales by ACE, could adversely affect the market price of the shares and/or impede Air Canada's ability to raise capital through the issuance of equity securities.

ACE has no contractual obligation to retain any of its Air Canada shares. The Registration Rights Agreement that Air Canada entered into with ACE concurrently with its initial public offering 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.

20. 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 President and Chief Executive Officer ("CEO") and the Executive Vice President and Chief Financial Officer ("CFO"), to provide reasonable assurance regarding the reliability of the Corporation's financial reporting and its preparation of financial statements for external purposes in accordance with GAAP.

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

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

Management's report on disclosure controls and procedures

Management, 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, 2009, 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 legislation was recorded, processed, summarized and reported within the time periods specified in securities legislation.

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, 2009, 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, 2009 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

21. Non-GAAP Financial Measures

EBITDAR

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

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2009**	**2008**	**Change $**	**2009**	**2008**	**$ Change**
GAAP operating loss before the provision for cargo investigations	$ (83)	$ (146)	$ 63	$ (316)	$ (39)	$ (277)
Add back:						
Aircraft rent	85	80	5	335	279	56
Depreciation and amortization	165	174	(9)	660	694	(34)
EBITDAR before the provision for cargo investigations	**$ 167**	**$ 108**	**$ 59**	**$ 679**	**$ 934**	**$ (255)**
Add back:						
Provision for cargo investigations	-	-	-	-	(125)	125
EBITDAR	**$ 167**	**$ 108**	**$ 59**	**$ 679**	**$ 809**	**$ (130)**

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 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/U.S. exchange rate, and excluding this expense from GAAP results analysis 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 is reconciled to operating expense as follows:

	Fourth Quarter			Year		
(Canadian dollars in millions)	**2009**	**2008**	**Change $**	**2009**	**2008**	**$ Change**
GAAP operating expense	$ 2,431	$ 2,644	$ (213)	$ 10,055	$ 11,121	$ (1,066)
Remove:						
Aircraft fuel	(601)	(792)	191	(2,448)	(3,419)	971
Operating expense, excluding fuel expense	**$ 1,830**	**$ 1,852**	**$ (22)**	**$ 7,607**	**$ 7,702**	**$ (95)**

22. 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 depreciation and amortization, and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Refer to section 21 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.