



**Third Quarter 2012**

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

**November 8, 2012**

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## 1. HIGHLIGHTS

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

(Canadian dollars in millions, except where indicated)	Third Quarter			First Nine Months		
	2012	2011	Change \$	2012	2011	Change \$
<b>Financial Performance Metrics</b>						
Operating revenues	3,328	3,242	86	9,279	8,913	366
Operating income	421	270	151	391	277	114
Non-operating income (expense)	8	(394)	402	(212)	(467)	255
Income (loss) before income taxes	429	(124)	553	179	(190)	369
Net income (loss) from continuing operations	429	(124)	553	178	(189)	367
Net income (loss) from discontinued operations - Aveos	-	-	-	(55)	-	(55)
Net income (loss)	429	(124)	553	123	(189)	312
Adjusted net income <sup>(1)</sup>	230	193	37	59	45	14
Operating margin (%), excluding the impact of benefit plan amendments <sup>(2)</sup>	8.9%	8.3%	0.6 pp	2.9%	3.1%	(0.2) pp
Operating margin %	12.7%	8.3%	4.4 pp	4.2%	3.1%	1.1 pp
EBITDAR, excluding the impact of benefit plan amendments <sup>(2) (3)</sup>	554	535	19	1,043	1,080	(37)
EBITDAR <sup>(3)</sup>	678	535	143	1,167	1,080	87
EBITDAR margin (%), excluding the impact of benefit plan amendments <sup>(2) (3)</sup>	16.6%	16.5%	0.1 pp	11.2%	12.1%	(0.9) pp
EBITDAR margin % <sup>(3)</sup>	20.4%	16.5%	3.9 pp	12.6%	12.1%	0.5 pp
Cash, cash equivalents and short-term investments	2,196	2,179	17	2,196	2,179	17
Free cash flow <sup>(4)</sup>	(164)	4	(168)	204	435	(231)
Adjusted net debt <sup>(5)</sup>	4,268	4,645	(377)	4,268	4,645	(377)
Net income (loss) per share – diluted	\$1.54	(\$0.45)	\$1.99	\$0.63	(\$0.70)	\$1.33
Adjusted net income per share – diluted <sup>(1)</sup>	\$0.82	\$0.68	\$0.14	\$0.21	\$0.16	\$0.05
<b>Operating Statistics</b>						
			Change %			Change %
Revenue passenger miles (millions) (RPM)	16,258	16,126	0.8	43,072	42,158	2.2
Available seat miles (millions) (ASM)	18,835	18,799	0.2	51,785	51,170	1.2
Passenger load factor %	86.3%	85.8%	0.5 pp	83.2%	82.4%	0.8 pp
Passenger revenue per RPM ("Yield") (cents)	18.4	18.1	1.6	18.8	18.5	2.0
Passenger revenue per ASM ("RASM") (cents)	15.9	15.5	2.2	15.7	15.2	2.9
Operating revenue per ASM (cents)	17.7	17.2	2.4	17.9	17.4	2.9
Operating expense per ASM ("CASM") (cents)	15.4	15.8	(2.4)	17.2	16.9	1.7
Adjusted CASM (cents) <sup>(6)</sup>	10.7	10.6	1.6	11.6	11.4	2.0
Average number of full-time equivalent (FTE) employees (thousands) <sup>(7)</sup>	24.0	23.9	0.2	24.0	23.7	1.2
Aircraft in operating fleet at period end <sup>(8)</sup>	352	353	(0.3)	352	353	(0.3)
Average fleet utilization (hours per day) <sup>(9)</sup>	11.0	10.8	1.5	10.4	10.3	0.4
Revenue frequencies (thousands)	148	147	0.8	423	418	1.3
Average aircraft flight length (miles) <sup>(9)</sup>	925	931	(0.6)	899	903	(0.4)
Economic fuel cost per litre (cents) <sup>(10)</sup>	87.8	85.8	2.3	90.0	84.1	7.0
Fuel litres (millions) <sup>(9)</sup>	1,104	1,103	0.1	3,052	3,025	0.9
Revenue passengers carried (millions) <sup>(11)</sup>	9.8	9.5	2.5	26.7	26.0	2.8

- (1) *Adjusted net income (loss) and adjusted net income (loss) per share – diluted are non-GAAP financial measures. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.*
- (2) *In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$124 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.*
- (3) *EBITDAR (earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent), excluding the impact of benefit plan amendments, and EBITDAR are non-GAAP financial measures. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.*
- (4) *Free cash flow (cash flows from operating activities less additions to property, equipment and intangible assets) is a non-GAAP financial measure. Refer to section 7.5 of this MD&A for additional information.*
- (5) *Adjusted net debt (total debt less cash, cash equivalents and short-term investments plus capitalized operating leases) is a non-GAAP financial measure. Refer to section 7.3 of this MD&A for additional information.*
- (6) *Adjusted CASM is a non-GAAP financial measure. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.*
- (7) *Reflects FTE employees at Air Canada. Excludes FTE employees at third party carriers (such as at Jazz Aviation LP ("Jazz")) operating under capacity purchase agreements with Air Canada.*
- (8) *Includes Jazz aircraft covered under the capacity purchase agreement with Jazz ("Jazz CPA") and aircraft operated by third party carriers operating under capacity purchase agreements. Refer to section 6 of this MD&A for additional information on Air Canada's operating fleet.*
- (9) *Excludes charter operations. Also excludes third party carriers operating under capacity purchase arrangements, other than Jazz aircraft covered under the Jazz CPA.*
- (10) *Excludes third party carriers, other than Jazz, operating under capacity purchase agreements. Includes fuel handling expenses. Economic fuel price per litre is a non-GAAP financial measure. Refer to section 4 of this MD&A for additional information.*
- (11) *Consistent with the IATA definition of revenue passengers carried, revenue passengers are counted on a flight number basis.*

## 2. INTRODUCTION AND KEY ASSUMPTIONS

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers, as the context may require, to Air Canada and/or one or more of Air Canada's subsidiaries. This MD&A provides the reader with a review and analysis, from the perspective of management, of Air Canada's financial results for the third quarter of 2012. This MD&A should be read in conjunction with Air Canada's interim unaudited condensed consolidated financial statements and notes for the third quarter of 2012 and Air Canada's annual audited consolidated financial statements and notes and its annual MD&A for 2011 dated February 9, 2012. All financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), as set out in the Handbook of the Canadian Institute of Chartered Accountants – Part 1 ("CICA Handbook"), which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), except for any financial information specifically denoted otherwise.

Except as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 17 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of November 7, 2012. Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 18 "Risk Factors" of Air Canada's annual MD&A for 2011 dated February 9, 2012 and section 14 "Risk Factors" of this MD&A. Air Canada issued a news release dated November 8, 2012 reporting on its results for the third quarter of 2012. This news release is available on Air Canada's website at [aircanada.com](http://aircanada.com) and on SEDAR's website at [www.sedar.com](http://www.sedar.com). For further information on Air Canada's public disclosures, including Air Canada's Annual Information Form, consult SEDAR at [www.sedar.com](http://www.sedar.com).

### CAUTION REGARDING FORWARD-LOOKING INFORMATION

Air Canada's public communications may include written or oral forward-looking statements within the meaning of applicable securities laws. Such statements are included in this MD&A and may be included in other communications, including filings with regulatory authorities and securities regulators. Forward-looking statements may be based on forecasts of future results and estimates of amounts not yet determinable. These statements may involve, but are not limited to, comments relating to strategies, expectations, planned operations or future actions. Forward-looking statements are identified by the use of terms and phrases such as "anticipate", "believe", "could", "estimate", "expect", "intend", "may", "plan", "predict", "project", "will", "would", and similar terms and phrases, including references to assumptions.

Forward-looking statements, by their nature, are based on assumptions, including those described herein and are subject to important risks and uncertainties. Forward-looking statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, industry, market, credit and economic conditions, the ability to reduce operating costs and secure financing, pension issues, energy prices, employee and labour relations, currency exchange and interest rates, competition, war, terrorist acts, epidemic diseases, environmental factors (including weather systems and other natural phenomena and factors arising from man-made sources), insurance issues and costs, changes in demand due to the seasonal nature of the business, supply issues, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties as well as the factors identified throughout this MD&A and, in particular, those identified in section 18 "Risk Factors" of Air Canada's annual MD&A for 2011 dated February 9, 2012 and section 14 "Risk Factors" of this MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of November 7, 2012 (or as of the date they are otherwise stated to be made), and are subject to change after such date. However, Air Canada disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

### KEY ASSUMPTIONS

Assumptions were made by Air Canada in preparing and making forward-looking statements. Air Canada assumes Canadian GDP growth of between 1.5 to 2.0 per cent for 2012 and 2013. In addition, Air Canada expects that the Canadian dollar will trade, on average, at C\$0.99 per U.S. dollar in the fourth quarter of 2012 and C\$1.00 for the full year 2012 and that the price of jet fuel will average 88 cents per litre for the fourth quarter of 2012 and 89 cents per litre for the full year 2012.

### 3. OVERVIEW

In the third quarter of 2012, Air Canada reported revenue growth of 3%. On capacity growth of 0.2%, passenger revenues increased 3.1% on yield and traffic growth of 1.6% and 0.8%, respectively. RASM increased 2.2% on the yield improvement and a 0.5 percentage point increase in passenger load factor. In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$124 million related to certain benefit plan amendments. Excluding the impact of this operating expense reduction which had not been assumed in the airline's projected CASM guidance, CASM, excluding fuel expense and the cost of ground packages at Air Canada Vacations (herein referred to as "adjusted CASM"), increased 1.6%, in line with the 1.0% to 2.0% increase projected in its news release dated August 8, 2012. EBITDAR, excluding the impact of benefit plan amendments, amounted to \$554 million, an increase of \$19 million from the same quarter in 2011. Air Canada recorded adjusted net income of \$230 million or \$0.82 per diluted share in the third quarter of 2012 compared to adjusted net income of \$193 million or \$0.68 per diluted share in the third quarter of 2011. At September 30, 2012, cash and short-term investments amounted to \$2,196 million, or 18% of 12-month trailing operating revenues. Adjusted net debt of \$4,268 million at September 30, 2012 decreased \$308 million from December 31, 2011.

#### Collective Agreements

In the second and third quarters of 2012, new collective agreements were finalized with the International Association of Machinists and Aerospace Workers (IAMAW) and with the Air Canada Pilots Association (ACPA), respectively. Both agreements preserve the current defined benefit pension plans for current employees. IAMAW represented employees hired after June 17, 2012 will participate in a new IAMAW multi-employer pension plan, which will be accounted for as a defined contribution plan, and ACPA represented employees hired after July 30, 2012 will participate in a defined contribution plan.

Since July 2009, Air Canada has been subject to pension funding relief regulations further described in section 7.8 of this MD&A. As these special funding regulations expire in January 2014, Air Canada has, with the support of its four main Canadian labour groups, entered into discussions with the federal government with the purpose of requesting an extension of pension funding relief which would cap annual pension funding contributions at acceptable levels. There can be no assurances that extended or new pension funding relief will be available and any such relief would be subject to the passing of regulations by the federal government.

The ACPA collective agreement was amended to accommodate pilots working past age 60, which was the age of mandatory retirement in the previous collective agreement. As a result of these changes to retirement age, which are not subject to regulatory approval, Air Canada recorded an operating expense reduction of \$124 million in Benefit plan amendments in the third quarter of 2012 related to the impact of those amendments on pension and other employee benefit liabilities.

#### Low-cost Leisure Group Announced

On October 2, 2012, Air Canada unveiled plans to form an integrated leisure group, combining the activities of its tour operator business, Air Canada Vacations, with its new low-cost leisure airline to launch in 2013. Air Canada expects the new low-cost leisure carrier to commence service in July 2013 with two Boeing 767-300ER aircraft and two Airbus A319 aircraft that will be released from Air Canada's mainline fleet. This new leisure carrier will serve leisure destinations in Europe and the Caribbean, on behalf of Air Canada, that are either currently underserved, or that do not generate adequate profitability with Air Canada's existing cost structure. Air Canada's plans are subject to obtaining the necessary regulatory approvals and other conditions. Air Canada expects to progressively transfer narrowbody aircraft from the mainline fleet to the leisure carrier. The widebody fleet at the leisure carrier would be expected to increase as Air Canada starts to take delivery of new Boeing 787 Dreamliner aircraft in 2014, thereby freeing up additional widebody aircraft for transfer to the leisure carrier. As this occurs and subject to commercial demand and other conditions, the leisure carrier may operate up to 20 Boeing 767-300ER aircraft and 30 Airbus A319 aircraft, for a total of 50 aircraft.

#### Maintenance Update

Following Aveos' CCAA filing on March 19, 2012, Aveos and Air Canada entered into agreements pursuant to which all agreements by which Aveos was performing aircraft maintenance services for Air Canada were terminated. Air Canada also entered into a contract with a leading service provider to maintain engines on some of its narrowbody fleet of aircraft. Air Canada also has agreements with experienced service providers to perform airframe maintenance on its

fleet. With respect to the maintenance of Air Canada's aircraft components, Air Canada is sourcing experienced and cost competitive providers. The new maintenance agreements were concluded at market terms and rates.

### **Proposed Canada-U.S. Transborder Joint Venture**

In October 2010, Air Canada announced that it had concluded a memorandum of understanding with United Continental Holdings Inc., United Air Lines, Inc. and Continental Airlines Inc. (collectively "United Airlines") setting out the principles for a comprehensive revenue-sharing joint venture on Canada-U.S. flights. In June 2011, Canada's Commissioner of Competition filed a Notice of Application opposing the proposed joint venture as well as aspects of Air Canada's and United Airlines' existing transborder cooperation arrangements. On October 24, 2012, Air Canada announced that it, together with United Airlines, had reached an agreement with Canada's Commissioner of Competition which preserves, subject to agreed conditions, the airlines' existing commercial arrangements and provides the airlines with the flexibility of implementing a Canada-U.S. transborder joint venture.

### **Best International Airline in North America**

In July 2012, the airline was recognized for the skills and professionalism of its employees and its product offerings by being named the 'Best International Airline in North America' in a worldwide survey of air travelers for the Skytrax World Airline Awards. It is the third consecutive year Air Canada has ranked among the top global carriers in the awards. In 2012, Air Canada was also awarded "Best Flight Experience to Canada" for the 5th consecutive year in Executive Travel Magazine's 2012 Leading Edge Awards. These awards underscore Air Canada's progress and success toward achieving its strategic objective of engaging with customers with a focus on premium passengers and products.

### **Third Quarter Financial Summary**

- Operating revenue growth of \$86 million or 3% from the third quarter of 2011.
- Passenger revenue growth of \$92 million or 3.1% on a 1.6% improvement in yield and a 0.8% increase in system passenger traffic. Premium cabin revenues were unchanged from the third quarter of 2011 as a 1.1% improvement in yield was offset by a 1.1% decline in traffic.
- Capacity increase of 0.2%, reflecting ASM growth in the domestic, U.S. transborder and Other markets. The system capacity growth was in line with the 0% to 1.0% third quarter 2012 ASM capacity increase projected in Air Canada's news release dated August 8, 2012.
- RASM growth of 2.2%, on a system-basis, reflecting a yield improvement of 1.6% and a passenger load factor increase of 0.5 percentage points. RASM growth was reflected in the domestic, Atlantic and Pacific markets.
- Operating expense decrease of \$65 million or 2% from the third quarter of 2011. The ACPA collective agreement was amended to accommodate pilots working past age 60, which was the age of mandatory retirement in the previous collective agreement. As a result of these changes to retirement age, which are not subject to regulatory approval, Air Canada recorded an operating expense reduction of \$124 million in Benefit plan amendments in the third quarter of 2012 related to the impact of those amendments on pension and other employee benefit liabilities. Adjusted CASM increased 1.6% from the third quarter of 2011.
- Operating income of \$421 million compared to operating income of \$270 million in the third quarter of 2011, an increase of \$151 million.
- Net income of \$429 million or \$1.54 per diluted share compared to a net loss of \$124 million or \$0.45 per diluted share in the third quarter of 2011.
- EBITDAR (excluding the impact of benefit plan amendments) of \$554 million compared to EBITDAR of \$535 million in the third quarter of 2011, an increase of \$19 million. Refer to section 16 "Non-GAAP Financial Measures" for additional information.
- Adjusted net income of \$230 million or \$0.82 per diluted share compared to adjusted net income of \$193 million or \$0.68 per diluted share in the third quarter of 2011. Refer to section 16 "Non-GAAP Financial Measures" for additional information.



- Negative free cash flow of \$164 million, a deterioration of \$168 million from the third quarter of 2011 as the airline continues to fund ongoing purchase deposit payments on committed Boeing 777 and 787 aircraft.
- Adjusted net debt of \$4,268 million at September 30, 2012, a decrease of \$308 million from December 31, 2011. This reduction in adjusted net debt included the impact of lower debt balances.
- At September 30, 2012, cash and short-term investments amounted to \$2,196 million, or 18% of 12-month trailing operating revenues.



#### 4. RESULTS OF OPERATIONS – THIRD QUARTER 2012 VERSUS THIRD QUARTER 2011

The following table and discussion compares results of Air Canada for the third quarter of 2012 versus the third quarter of 2011.

(Canadian dollars in millions, except per share figures)	Third Quarter		Change	
	2012	2011	\$	%
<b>Operating revenues</b>				
Passenger	\$ 3,029	\$ 2,937	\$ 92	3
Cargo	118	121	(3)	(2)
Other	181	184	(3)	(2)
<b>Total revenues</b>	<b>3,328</b>	<b>3,242</b>	<b>86</b>	<b>3</b>
<b>Operating expenses</b>				
Aircraft fuel	963	943	20	2
Wages, salaries, and benefits	527	499	28	6
Benefit plan amendments <sup>(1)</sup>	(124)	-	(124)	-
Airport and navigation fees	271	284	(13)	(5)
Capacity purchase agreements	279	261	18	7
Depreciation, amortization and impairment	172	185	(13)	(7)
Aircraft maintenance	155	149	6	4
Sales and distribution costs	152	154	(2)	(1)
Food, beverages and supplies	81	82	(1)	(1)
Communications and information technology	45	48	(3)	(6)
Aircraft rent	85	80	5	6
Other	301	287	14	5
<b>Total operating expenses</b>	<b>2,907</b>	<b>2,972</b>	<b>(65)</b>	<b>(2)</b>
<b>Operating income</b>	<b>421</b>	<b>270</b>	<b>151</b>	
<b>Non-operating income (expense)</b>				
Foreign exchange gain (loss)	71	(281)	352	
Interest income	10	8	2	
Interest expense	(76)	(81)	5	
Interest capitalized	6	1	5	
Net financing expense relating to employee benefits	-	(4)	4	
Gain (loss) on financial instruments recorded at fair value	3	(33)	36	
Other	(6)	(4)	(2)	
<b>Total non-operating income (expense)</b>	<b>8</b>	<b>(394)</b>	<b>402</b>	
<b>Income (loss) before income taxes</b>	<b>429</b>	<b>(124)</b>	<b>553</b>	
Recovery of (provision for) income taxes	-	-	-	
<b>Net income (loss) for the period</b>	<b>\$ 429</b>	<b>\$ (124)</b>	<b>\$ 553</b>	
<b>Adjusted net income <sup>(2)</sup></b>	<b>\$ 230</b>	<b>\$ 193</b>	<b>\$ 37</b>	
<b>EBITDAR, excluding the impact of benefit plan amendments <sup>(1) (3)</sup></b>	<b>\$ 554</b>	<b>\$ 535</b>	<b>\$ 19</b>	
<b>EBITDAR <sup>(3)</sup></b>	<b>\$ 678</b>	<b>\$ 535</b>	<b>\$ 143</b>	
<b>Net income (loss) per share – basic</b>	<b>\$ 1.55</b>	<b>\$ (0.45)</b>	<b>\$ 2.00</b>	
<b>Net income (loss) per share – diluted</b>	<b>\$ 1.54</b>	<b>\$ (0.45)</b>	<b>\$ 1.99</b>	
<b>Adjusted net income per share – diluted <sup>(2)</sup></b>	<b>\$ 0.82</b>	<b>\$ 0.68</b>	<b>\$ 0.14</b>	

(1) In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$124 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(2) Adjusted net income (loss) and adjusted net income (loss) per share – diluted are non-GAAP financial measures. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.

(3) EBITDAR, excluding the impact of benefit plan amendments, and EBITDAR are non-GAAP financial measures. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.

### System passenger revenues increased 3.1% from the third quarter of 2011

2012 third quarter passenger revenues of \$3,029 million increased \$92 million or 3.1% from 2011 third quarter passenger revenues of \$2,937 million. This improvement was due to a 1.6% improvement in yield and a 0.8% growth in traffic.

Premium cabin revenues remained at third quarter 2011 levels as a 1.1% improvement in yield was offset by a 1.1% decline in traffic.

The table below provides passenger revenue by geographic region for the third quarter of 2012 and the third quarter of 2011.

Passenger Revenue	Third Quarter 2012	Third Quarter 2011	\$ Change	% Change
Canada	1,146	1,106	40	3.6
U.S. transborder	507	508	(1)	(0.2)
Atlantic	738	740	(2)	(0.4)
Pacific	425	373	52	13.9
Other	213	210	3	1.7
<b>System</b>	<b>3,029</b>	<b>2,937</b>	<b>92</b>	<b>3.1</b>

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the third quarter of 2012 versus the third quarter of 2011.

Third Quarter 2012 Versus Third Quarter 2011	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	3.6	0.9	2.3	1.2	1.1	2.6
U.S. transborder	(0.2)	1.3	1.5	0.2	(5.4)	(5.2)
Atlantic	(0.4)	(1.7)	(2.0)	(0.3)	1.9	1.6
Pacific	13.9	(0.5)	0.5	1.0	13.3	14.5
Other	1.7	3.9	5.2	1.1	(3.8)	(2.6)
<b>System</b>	<b>3.1</b>	<b>0.2</b>	<b>0.8</b>	<b>0.5</b>	<b>1.6</b>	<b>2.2</b>

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the third quarter 2012 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q3'11	Q4'11	Q1'12	Q2'12	Q3'12
Passenger revenues	7.9	5.2	9.2	3.3	3.1
Capacity (ASMs)	2.6	2.5	3.1	0.6	0.2
Traffic (RPMs)	3.8	2.6	4.8	1.4	0.8
Passenger load factor (pp change)	1.1	0.1	1.3	0.7	0.5
Yield	3.8	1.9	3.3	1.2	1.6
RASM	5.1	2.0	5.0	2.0	2.2

In the third quarter of 2012, Air Canada's overall capacity was 0.2% higher than the third quarter of 2011. Capacity growth was reflected in the North American and South American markets while the Atlantic and Pacific markets reflected capacity reductions.

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

- The traffic increase which reflected growth in the domestic, U.S. transborder, Pacific and Other markets.
- The system yield increase which reflected growth in the domestic, Atlantic and Pacific markets partly offset by yield declines in the U.S. transborder and Other markets. The yield decline in these markets was due to increased industry capacity and competitive pricing activities which negatively impacted yields in the quarter. A \$25 million favourable impact of a weaker Canadian dollar on foreign currency denominated passenger revenues also contributed to the yield growth year-over-year.

The system RASM improvement was due to the higher yield and passenger load factor. RASM improvements were recorded in the domestic, Atlantic, Pacific and South Pacific markets.

### Domestic passenger revenues increased 3.6% from the third quarter of 2011

In the third quarter of 2012, domestic passenger revenues of \$1,146 million increased \$40 million or 3.6% from the third quarter of 2011 due to traffic and yield growth.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the third quarter 2012 and each of the previous four quarters.

Canada	Year-over-Year by Quarter (% Change)				
	Q3'11	Q4'11	Q1'12	Q2'12	Q3'12
Passenger revenues	4.7	3.2	5.0	0.8	3.6
Capacity (ASMs)	0.3	2.1	2.0	1.1	0.9
Traffic (RPMs)	2.1	2.1	3.8	1.7	2.3
Passenger load factor (pp change)	1.5	-	1.4	0.5	1.2
Yield	2.4	0.4	0.7	(0.9)	1.1
RASM	4.3	0.4	2.6	(0.3)	2.6

The third quarter 2012 domestic capacity growth reflected capacity increases on regional routes to the Maritimes and within Ontario.

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

- The traffic increase which reflected growth on all major domestic services.
- The yield growth which reflected improvements on all major services with the exception of regional routes within Ontario where increased competitive pricing activities negatively impacted yields.

The domestic RASM growth was due to both the higher passenger load factor and the yield improvement.

**U.S. transborder passenger revenues decreased 0.2% from the third quarter of 2011**

In the third quarter of 2012, U.S. transborder passenger revenues of \$507 million decreased \$1 million or 0.2% from the third quarter of 2011. On October 27, 2011, Air Canada introduced a new baggage fee policy on U.S. transborder services. In the third quarter of 2012, a significant growth in baggage fees, which are not included in Air Canada's yield and RASM results, largely mitigated the impact of lower yields on U.S. transborder passenger revenues.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the third quarter 2012 and each of the previous four quarters.

U.S. Transborder	Year-over-Year by Quarter (% Change)				
	Q3'11	Q4'11	Q1'12	Q2'12	Q3'12
Passenger revenues	13.2	11.6	13.5	2.2	(0.2)
Capacity (ASMs)	4.7	3.2	6.2	0.8	1.3
Traffic (RPMs)	9.3	5.3	7.3	(0.8)	1.5
Passenger load factor (pp change)	3.4	1.4	0.8	(1.2)	0.2
Yield	3.4	5.4	3.9	(0.8)	(5.4)
RASM	8.0	7.4	4.9	(2.3)	(5.2)

In the third quarter of 2012, U.S. transborder capacity growth was largely driven by increases on eastern seaboard services and on services to California. Components of the year-over-year change in third quarter U.S. transborder passenger revenues included:

- The traffic growth which reflected increases on most major U.S. transborder services, including U.S. short-haul routes, and on routes to Florida and from Western Canada to California.
- The yield decline which reflected increased industry capacity and competitive pricing activities, particularly on U.S. short-haul routes such as Boston, New York and Washington, D.C.

The U.S. transborder RASM decrease was due to the lower yield.

**Atlantic passenger revenues decreased 0.4% from the third quarter of 2011**

In the third quarter of 2012, Atlantic passenger revenues of \$738 million decreased \$2 million or 0.4% from the third quarter of 2011.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the third quarter 2012 and each of the previous four quarters.

Atlantic	Year-over-Year by Quarter (% Change)				
	Q3'11	Q4'11	Q1'12	Q2'12	Q3'12
Passenger revenues	8.2	(1.0)	6.0	2.3	(0.4)
Capacity (ASMs)	3.6	2.2	3.3	(0.2)	(1.7)
Traffic (RPMs)	4.1	1.2	5.9	2.5	(2.0)
Passenger load factor (pp change)	0.5	(0.8)	1.8	2.2	(0.3)
Yield	3.8	(3.1)	(0.8)	0.1	1.9
RASM	4.3	(4.0)	1.7	2.8	1.6

In the third quarter of 2012, the Atlantic capacity reduction was largely driven by the use of smaller aircraft on Montreal – Brussels and Toronto – Munich, as well as a decrease in frequencies on Montreal to London, Paris, Athens, Barcelona and Rome. Components of the year-over-year change in third quarter Atlantic passenger revenues included:

- The traffic decline which reflected decreases on services to the U.K, Belgium, France, Germany and Greece. The effects of weak economic conditions were partially mitigated by traffic gains for passengers originating in North America. However, third quarter 2012 traffic to and from the U.K. was negatively impacted by the 2012 Summer Olympic Games as some Canadians avoided travelling to the U.K. due to higher hotel costs while some U.K.-originating passengers chose not to travel.
- The improvement in yield which was due to increased fares and fuel surcharges to partly offset higher fuel prices, as well as gains in premium cabin traffic.

The increase in Atlantic RASM was due to the higher yield.

### Pacific passenger revenues increased 13.9% from the third quarter of 2011

In the third quarter of 2012, Pacific passenger revenues of \$425 million increased \$52 million or 13.9% from the third quarter of 2011 primarily due to a yield improvement.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the third quarter 2012 and each of the previous four quarters.

Pacific	Year-over-Year by Quarter (% Change)				
	Q3'11	Q4'11	Q1'12	Q2'12	Q3'12
Passenger revenues	5.8	6.9	17.8	18.5	13.9
Capacity (ASMs)	2.0	1.4	2.3	3.0	(0.5)
Traffic (RPMs)	1.5	1.6	3.5	4.0	0.5
Passenger load factor (pp change)	(0.5)	0.1	1.0	0.8	1.0
Yield	4.2	4.7	12.8	14.0	13.3
RASM	3.6	4.9	14.1	15.1	14.5

In the third quarter of 2012, the Pacific capacity reduction was mainly attributable to a capacity decrease on services to China. This capacity reduction was partly offset by capacity growth on services to Japan. Air Canada estimated that the impact of the March 11<sup>th</sup>, 2011 earthquake in Japan and its aftermath reduced passenger revenues by \$5 million in the third quarter of 2011.

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

- The traffic increase which reflected capacity growth on services to Japan and Korea, partly offset by a decrease on services to China.
- The yield increase which reflected growth on all major Pacific services. The yield improvement was due to higher fuel surcharges to partly offset higher fuel prices, fare increases, and the introduction of Tango fares on China and Hong Kong flights, as well as changes to the airline's fare structure. A significant yield increase in the premium cabin, as well as a \$12 million favourable currency impact were also factors in the overall yield improvement year-over-year.

The Pacific RASM improvement was due to the yield growth and, to a lesser extent, the higher passenger load factor.

### Other passenger revenues increased 1.7% from the third quarter of 2011

In the third quarter of 2012, Other passenger revenues (comprised of routes to Australia, the Caribbean, Mexico, Central and South America) of \$213 million increased \$3 million or 1.7% from the third quarter of 2011 due to traffic growth.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the third quarter 2012 and each of the previous four quarters.

Other	Year-over-Year by Quarter (% Change)				
	Q3'11	Q4'11	Q1'12	Q2'12	Q3'12
Passenger revenues	16.9	11.1	11.1	0.4	1.7
Capacity (ASMs)	5.3	4.6	1.7	(3.2)	3.9
Traffic (RPMs)	5.8	4.9	3.7	(3.5)	5.2
Passenger load factor (pp change)	0.4	0.2	1.6	(0.2)	1.1
Yield	10.4	5.7	6.3	3.6	(3.8)
RASM	11.0	5.9	8.4	3.3	(2.6)

In the third quarter of 2012, the capacity growth was driven by additional frequencies on services to South America, including Bogota, Buenos Aires, Santiago and Caracas. Components of the year-over-year change in third quarter Other passenger revenues included:

- The overall traffic growth which reflected increases on all major services.
- The overall yield decline which was due to increased industry capacity and competitive pricing activities on routes to South America and on routes to traditional leisure destinations.

The overall RASM decline was due to the lower yield.

### Cargo revenues decreased 2.0% from the third quarter of 2011

In the third quarter of 2012, cargo revenues of \$118 million decreased \$3 million or 2.0% from the third quarter of 2011 due to a lower yield.

The table below provides cargo revenue by geographic region for the third quarter of 2012 and the third quarter of 2011.

Cargo revenue	Third Quarter 2012 \$ Million	Third Quarter 2011 \$ Million	\$ Change	% Change
Canada	18	18	-	(0.6)
U.S. transborder	4	4	-	0.1
Atlantic	43	50	(7)	(12.6)
Pacific	41	37	4	7.7
Other	12	12	-	0.9
<b>System</b>	<b>118</b>	<b>121</b>	<b>(3)</b>	<b>(2.0)</b>

The table below provides year-over-year percentage changes in system cargo revenues and operating statistics for the third quarter 2012 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q3'11	Q4'11	Q1'12	Q2'12	Q3'12
Cargo revenues	(1.7)	1.2	5.0	3.0	(2.0)
Capacity (ETMs)	1.9	2.5	3.1	(0.1)	(1.1)
Revenue per ETM	(3.5)	(1.3)	2.8	2.4	(1.7)
Traffic (RTMs)	(7.7)	(0.4)	5.0	5.3	4.5
Yield per RTM	6.5	1.6	1.3	(2.9)	(6.9)

The table below provides year-over-year percentage changes in cargo revenues and operating statistics for the third quarter of 2012 versus the third quarter of 2011.

Third Quarter 2012 Versus Third Quarter 2011	Cargo Revenue % Change	Capacity (ETMs) % Change	Rev / ETM % Change	Traffic (RTMs) % Change	Yield / RTM % Change
Canada	(0.6)	0.5	(1.1)	6.7	(6.8)
U.S. transborder	0.1	(13.2)	15.3	(3.4)	3.6
Atlantic	(12.6)	(1.6)	(11.2)	(0.3)	(12.4)
Pacific	7.7	(0.6)	8.4	9.7	(1.9)
Other	0.9	4.0	(2.9)	5.3	(4.2)
<b>System</b>	<b>(2.0)</b>	<b>(1.1)</b>	<b>(1.7)</b>	<b>4.5</b>	<b>(6.9)</b>

Components of the year-over-year change in third quarter cargo revenues included:

- The traffic increase which reflected growth in the domestic, Pacific and Other markets.
- The overall yield decline which was due to increased competitive pricing activities, particularly in the Atlantic market.

#### Other revenues decreased 2% from the third quarter of 2011

In the third quarter of 2012, other revenues of \$181 million decreased \$3 million or 2% from the third quarter of 2011. An increase in ground package revenues at Air Canada Vacations and growth in cancellation and change fees was more than offset by a decrease in property rent lease revenues from Aveos, as well as a decrease in aircraft lease revenues year-over-year. The decrease in aircraft lease revenues was due to fewer aircraft leased to Jazz when compared to the third quarter of 2011.



**CASM decreased 2.4% from the third quarter of 2011. Adjusted CASM increased 1.6% from the third quarter of 2011**

The following table compares Air Canada's CASM for the third quarter of 2012 to Air Canada's CASM for the corresponding period in 2011.

(cents per ASM)	Third Quarter		Change	
	2012	2011	cents	%
Wages and salaries	2.16	2.08	0.08	3.8
Benefits	0.64	0.57	0.07	12.3
Benefit plan amendments <sup>(1)</sup>	(0.66)	-	(0.66)	-
Aircraft fuel	5.12	5.02	0.10	2.0
Airport and navigation fees	1.44	1.51	(0.07)	(4.6)
Capacity purchase agreements	1.48	1.39	0.09	6.5
Ownership (DAR) <sup>(2)</sup>	1.36	1.41	(0.05)	(3.5)
Aircraft maintenance	0.82	0.79	0.03	3.8
Sales and distribution costs	0.81	0.82	(0.01)	(1.2)
Food, beverages and supplies	0.43	0.44	(0.01)	(2.3)
Communications and information technology	0.24	0.26	(0.02)	(7.7)
Other	1.59	1.52	0.07	4.6
<b>CASM</b>	<b>15.43</b>	<b>15.81</b>	<b>(0.38)</b>	<b>(2.4)</b>
<b>Remove:</b>				
Benefit plan amendments <sup>(1)</sup>	0.66	-	0.66	-
Fuel expense and the cost of ground packages at Air Canada Vacations	(5.37)	(5.26)	(0.11)	2.1
<b>Adjusted CASM <sup>(1) (3)</sup></b>	<b>10.72</b>	<b>10.55</b>	<b>0.17</b>	<b>1.6</b>

(1) In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$124 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(2) DAR refers to the combination of depreciation, amortization and impairment, and aircraft rent expenses.

(3) Adjusted CASM is a non-GAAP financial measure. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.

### Operating expenses decreased 2% from the third quarter of 2011

In the third quarter of 2012, operating expenses of \$2,907 million decreased \$65 million or 2% from operating expenses of \$2,972 million recorded in the third quarter of 2011.

As a result of changes to the terms of the ACPA collective agreement related to retirement age, which are not subject to regulatory approval, Air Canada recorded an operating expense reduction of \$124 million in Benefit plan amendments in the third quarter of 2012 related to the impact of those amendments on pension and other employee benefit liabilities.

In the third quarter of 2012, the unfavourable impact of a weaker Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars) when compared to the third quarter of 2011 increased operating expenses by \$49 million.

### Fuel expense increased 2% from the third quarter of 2011

In the third quarter of 2012, fuel expense of \$963 million increased \$20 million or 2% from the third quarter of 2011. This increase was mainly due to the unfavourable impact of a weaker Canadian dollar in the third quarter of 2012 when compared to the third quarter of 2011, which accounted for an increase of \$36 million. Partially offsetting this increase was the impact of lower base fuel prices year-over-year, which accounted for a decrease of \$17 million.

The table below provides Air Canada's fuel cost per litre and economic fuel cost per litre for the periods indicated.

(Canadian dollars in millions, except where indicated)	Third Quarter		Change	
	2012	2011	\$	%
Aircraft fuel expense – GAAP <sup>(1)</sup>	\$ 956	\$ 935	\$ 21	2
<b>Add:</b> Net cash payments on fuel derivatives <sup>(2)</sup>	13	11	2	18
<b>Economic cost of fuel – Non-GAAP <sup>(3)</sup></b>	<b>\$ 969</b>	<b>\$ 946</b>	<b>\$ 23</b>	<b>2</b>
Fuel consumption (thousands of litres) <sup>(1)</sup>	1,104,106	1,102,478	1,628	-
Fuel cost per litre (cents) – GAAP	86.6	84.8	1.8	2
Economic fuel cost per litre (cents) – Non-GAAP <sup>(3)</sup>	87.8	85.8	2.0	2

(1) Excludes fuel expense and fuel litres related to third party carriers, other than Jazz, operating under capacity purchase agreements.

(2) Includes net cash settlements on maturing fuel derivatives and premium costs associated with those derivatives.

(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 its cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period and premium costs associated with those derivatives.

### Wages, salaries and benefits expense amounted to \$527 million in the third quarter of 2012, an increase of \$28 million or 6% from the third quarter of 2011

In the third quarter of 2012, wages and salaries expense of \$408 million increased \$18 million or 5% from the third quarter of 2011, which included the impact of higher average salaries year-over-year and the impact of a higher Air Canada share price on stock-based compensation programs.

In the third quarter of 2012, employee benefits expense of \$119 million increased \$10 million or 9% from the third quarter of 2011, largely as a result of lower discount rates which increase the service cost of pension and other employee future benefits expense.

### Capacity purchase costs increased 7% from the third quarter of 2011

In the third quarter of 2012, capacity purchase costs of \$279 million increased \$18 million or 7% from the third quarter of 2011, mainly due to higher Jazz CPA rates, increased flying by Jazz, as well as an unfavourable impact of foreign exchange on U.S. currency denominated Jazz CPA expenses paid by Air Canada.

### Ownership costs decreased 3% from the third quarter of 2011

In the third quarter of 2012, ownership costs (which are comprised of depreciation, amortization and impairment, and aircraft rent expenses) of \$257 million decreased \$8 million or 3% from the third quarter of 2011, mainly due to a decrease in depreciation expense related to the airline's interior refurbishment programs.

### Aircraft maintenance expense increased 4% from the third quarter of 2011

In the third quarter of 2012, aircraft maintenance expense of \$155 million increased \$6 million or 4% from the third quarter of 2011. This increase was mainly driven by growth in scheduled engine maintenance activity and higher maintenance rates related to Air Canada's Boeing 777 aircraft which were previously negotiated. These increases were partly offset by a decrease in airframe maintenance activity, the impact of lower rates for airframe maintenance year-over-year, as well as a decrease of \$4 million pertaining to end of lease maintenance return provisions.

### Sales and distribution costs decreased 1% from the third quarter of 2011

In the third quarter of 2012, sales and distribution costs of \$152 million decreased \$2 million or 1% from the third quarter of 2011 on passenger revenue growth of 3.1%. Growth in credit card fees, which was in line with sales and revenue growth, and an increase in transaction fees paid to global distribution services ("GDS") providers were more than offset by lower commission expense at Air Canada, in part due to program changes, and by a decrease in sales and distribution costs at Air Canada Vacations.

### Other operating expenses increased 5% from the third quarter of 2011

In the third quarter of 2012, other operating expenses of \$301 million increased \$14 million or 5% from the third quarter of 2011.

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

(Canadian dollars in millions)	Third Quarter		Change	
	2012	2011	\$	%
Air Canada Vacations' land costs	\$ 48	\$ 46	\$ 2	4
Terminal handling	48	54	(6)	(11)
Building rent and maintenance	30	34	(4)	(12)
Crew cycle	30	28	2	7
Miscellaneous fees and services	34	26	8	31
Remaining other expenses	111	99	12	12
<b>Other operating expenses</b>	<b>\$ 301</b>	<b>\$ 287</b>	<b>\$ 14</b>	<b>5</b>

Factors contributing to the year-over-year change in the third quarter Other expenses included:

- An increase of \$8 million or 31% in miscellaneous fees and services which included fees incurred in relation to the pursuit of various corporate initiatives.
- An increase in "remaining other expenses" of \$12 million or 12% which was largely driven by expenses incurred, such as engine and rotatable equipment rentals, as a result of the Aveos closure.

### Non-operating income amounted to \$8 million in the third quarter of 2012 compared to non-operating expense of \$394 million in the third quarter of 2011

The following table provides a breakdown of non-operating income (expense) for the periods indicated:

(Canadian dollars in millions)	Third Quarter		Change
	2012	2011	\$
Foreign exchange gain (loss)	\$ 71	\$ (281)	\$ 352
Interest income	10	8	2
Interest expense	(76)	(81)	5
Interest capitalized	6	1	5
Net financing expense relating to employee benefits	-	(4)	4
Gain (loss) on financial instruments recorded at fair value	3	(33)	36
Other	(6)	(4)	(2)
<b>Total non-operating income (expense)</b>	<b>\$ 8</b>	<b>\$ (394)</b>	<b>\$ 402</b>

Factors contributing to the year-over-year change in third quarter non-operating income (expense) included:

- Gains on foreign exchange (mainly related to U.S. currency denominated long-term debt) which amounted to \$71 million in the third quarter of 2012 compared to losses of \$281 million in the third quarter of 2011. The gains in the third quarter of 2012 were mainly attributable to a stronger Canadian dollar at September 30, 2012 when compared to June 30, 2012. The September 30, 2012 closing exchange rate was US\$1 = C\$0.9832 while the June 30, 2012 closing exchange rate was US\$1 = C\$1.0181.
- Gains related to fair value adjustments on derivative instruments which amounted to \$3 million in the third quarter of 2012 versus losses of \$33 million in the third quarter of 2011. Refer to section 9 of this MD&A for additional information.

## 5. RESULTS OF OPERATIONS – FIRST NINE MONTHS 2012 VERSUS FIRST NINE MONTHS 2011

The following table and discussion compares results of Air Canada for the first nine months of 2012 versus the first nine months of 2011.

(Canadian dollars in millions, except per share figures)	First Nine Months		Change	
	2012	2011	\$	%
<b>Operating revenues</b>				
Passenger	\$ 8,224	\$ 7,834	\$ 390	5
Cargo	362	356	6	2
Other	693	723	(30)	(4)
<b>Total revenues</b>	<b>9,279</b>	<b>8,913</b>	<b>366</b>	<b>4</b>
<b>Operating expenses</b>				
Aircraft fuel	2,740	2,567	173	7
Wages, salaries, and benefits	1,580	1,490	90	6
Benefit plan amendments <sup>(1)</sup>	(124)	-	(124)	-
Airport and navigation fees	761	770	(9)	(1)
Capacity purchase agreements	809	752	57	8
Depreciation, amortization and impairment	521	554	(33)	(6)
Aircraft maintenance	511	469	42	9
Sales and distribution costs	470	472	(2)	-
Food, beverages and supplies	223	225	(2)	(1)
Communications and information technology	141	145	(4)	(3)
Aircraft rent	255	249	6	2
Other	1,001	943	58	6
<b>Total operating expenses</b>	<b>8,888</b>	<b>8,636</b>	<b>252</b>	<b>3</b>
<b>Operating income</b>	<b>391</b>	<b>277</b>	<b>114</b>	
<b>Non-operating income (expense)</b>				
Foreign exchange gain (loss)	97	(168)	265	
Interest income	28	26	2	
Interest expense	(236)	(244)	8	
Interest capitalized	11	2	9	
Net financing expense relating to employee benefits	(13)	(12)	(1)	
Loss on financial instruments recorded at fair value	(27)	(58)	31	
Loss on investments in Aveos	(65)	-	(65)	
Other	(7)	(13)	6	
<b>Total non-operating expense</b>	<b>(212)</b>	<b>(467)</b>	<b>255</b>	
<b>Income (loss) before income taxes</b>	<b>179</b>	<b>(190)</b>	<b>369</b>	
Recovery of (provision for) income taxes	(1)	1	(2)	
<b>Net income (loss) for the period from continuing operations</b>	<b>\$ 178</b>	<b>\$ (189)</b>	<b>\$ 367</b>	
<b>Net income (loss) for the period from discontinued operations - Aveos</b>	<b>\$ (55)</b>	<b>\$ -</b>	<b>\$ (55)</b>	
<b>Net income (loss) for the period</b>	<b>\$ 123</b>	<b>\$ (189)</b>	<b>\$ 312</b>	
<b>Adjusted net income <sup>(2)</sup></b>	<b>\$ 59</b>	<b>\$ 45</b>	<b>\$ 14</b>	
<b>EBITDAR, excluding the impact of benefit plan amendments <sup>(1) (3)</sup></b>	<b>\$ 1,043</b>	<b>\$ 1,080</b>	<b>\$ (37)</b>	
<b>EBITDAR <sup>(3)</sup></b>	<b>\$ 1,167</b>	<b>\$ 1,080</b>	<b>\$ 87</b>	
<b>Net income (loss) per share – basic and diluted</b>	<b>\$ 0.63</b>	<b>\$ (0.70)</b>	<b>\$ 1.33</b>	
<b>Adjusted net income per share – diluted <sup>(2)</sup></b>	<b>\$ 0.21</b>	<b>\$ 0.16</b>	<b>\$ 0.05</b>	

(1) In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$124 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(2) Adjusted net income (loss) and adjusted net income (loss) per share – Diluted are non-GAAP financial measures. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.

(3) EBITDAR, excluding the impact of benefit plan amendments, and EBITDAR are non-GAAP financial measures. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.

### System passenger revenues increased 5.0% from the first nine months of 2011

2012 first nine months system passenger revenues of \$8,224 million increased \$390 million or 5.0% from 2011 first nine months passenger revenues of \$7,834 million. This improvement was due to a 2.2% growth in traffic and a 2.0% improvement in yield.

Air Canada's operations were impacted by job actions in March and April of 2012 which, in the immediate aftermath, caused a decline in bookings for travel originating in Canada. This decline in bookings affected second quarter 2012 passenger demand, particularly within Air Canada's North American network and for leisure travel packages offered by Air Canada Vacations. Higher-yielding business market demand was also adversely affected. In addition, second quarter 2012 system capacity and, as a result, passenger revenues were negatively affected by aircraft scheduling changes due to the closure by Aveos of its maintenance facilities in Canada. Booking trends returned to normal levels by the end of the second quarter of 2012. Management estimated that the combined impact of the labour disruptions and the slight reduction in capacity stemming from the Aveos closure adversely impacted passenger revenues by \$60 million in the second quarter of 2012.

Management estimated that the March 11<sup>th</sup>, 2011 earthquake in Japan and its aftermath reduced passenger revenues by \$28 million in the first nine months of 2011.

Premium cabin revenues increased \$75 million or 4.6% from the first nine months of 2011 due to traffic growth of 3.8% and a yield improvement of 0.8%.

The table below provides passenger revenue by geographic region for the first nine months of 2012 and the first nine months of 2011.

Passenger Revenue	First Nine Months 2012 \$ Million	First Nine Months 2011 \$ Million	\$ Change	% Change
Canada	3,127	3,034	93	3.1
U.S. transborder	1,646	1,564	82	5.3
Atlantic	1,664	1,633	31	1.9
Pacific	1,045	898	147	16.4
Other	742	705	37	5.2
<b>System</b>	<b>8,224</b>	<b>7,834</b>	<b>390</b>	<b>5.0</b>

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the first nine months of 2012 versus the first nine months of 2011.

First Nine Months 2012 Versus First Nine Months 2011	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	3.1	1.3	2.5	1.0	0.3	1.6
U.S. transborder	5.3	2.9	2.8	(0.1)	(0.7)	(0.8)
Atlantic	1.9	-	1.1	0.9	0.7	1.9
Pacific	16.4	1.5	2.6	0.9	13.2	14.4
Other	5.2	0.9	2.0	1.0	2.5	3.7
<b>System</b>	<b>5.0</b>	<b>1.2</b>	<b>2.2</b>	<b>0.8</b>	<b>2.0</b>	<b>2.9</b>

In the first nine months of 2012, Air Canada's overall capacity was 1.2% higher than the first nine months of 2011, with capacity growth reflected in all markets with the exception of the Atlantic market where capacity remained at third quarter 2011 levels.

Components of the year-over-year change in first nine months system passenger revenues included:

- The system traffic increase which reflected growth in all markets.
- The system yield improvement which reflected growth in all markets with the exception of the U.S. short-haul services market where U.S. short-haul routes continued to be impacted by increased industry capacity and aggressive competitive pricing activities. The overall yield improvement was due to increased fares and higher fuel surcharges to partly offset higher fuel prices, a \$46 million favourable currency impact, as well as gains in premium cabin traffic.

The RASM improvement was due to the higher yield and passenger load factor.

### Cargo revenues increased 2.0% from the first nine months of 2011

Cargo revenues of \$362 million in the first nine months of 2012 increased \$6 million or 2.0% from the first nine months of 2011 due to traffic growth.

The table below provides cargo revenue by geographic region for the first nine months of 2012 and the first nine months of 2011.

Cargo revenue	First Nine Months 2012 \$ Million	First Nine Months 2011 \$ Million	\$ Change	% Change
Canada	51	50	1	1.9
U.S. transborder	13	12	1	5.1
Atlantic	133	147	(14)	(9.4)
Pacific	123	106	17	15.4
Other	42	41	1	4.9
<b>System</b>	<b>362</b>	<b>356</b>	<b>6</b>	<b>2.0</b>

The table below provides year-over-year percentage changes in cargo revenues and operating statistics for the first nine months of 2012 versus the first nine months of 2011.

First Nine Months 2012 Versus First Nine Months 2011	Cargo Revenue % Change	Capacity (ETMs) % Change	Rev / ETM % Change	Traffic (RTMs) % Change	Yield / RTM % Change
Canada	1.9	0.4	1.5	6.9	(5.5)
U.S. transborder	5.1	(1.9)	7.2	5.3	(0.2)
Atlantic	(9.4)	(0.3)	(9.1)	(6.0)	(3.6)
Pacific	15.4	1.6	13.6	17.6	(1.9)
Other	4.9	1.8	3.1	5.3	(0.3)
<b>System</b>	<b>2.0</b>	<b>0.5</b>	<b>1.3</b>	<b>4.8</b>	<b>(2.9)</b>

Components of the year-over-year change in first nine months cargo revenues included:

- The traffic increase which reflected growth in all markets with the exception of the Atlantic market. The Pacific market experienced strong demand in spite of increased industry cargo capacity while the Atlantic market continued to be negatively impacted by weak economic conditions in Europe.
- The overall yield decline which was mainly due to the impact of increased competitive pricing activities, particularly in the domestic and Atlantic markets.



### Other revenues decreased 4% from the first nine months of 2011

In the first nine months of 2012, other revenues of \$693 million decreased \$30 million or 4% from the first nine months of 2011. This decrease was due to a \$12 million decrease in ground package revenues at Air Canada Vacations, reductions in property rent revenues from Aveos, as well as lower aircraft lease revenues as a result of fewer aircraft leased to Jazz when compared to the first nine months of 2011. The decrease in ground package revenues at Air Canada Vacations was due to lower passenger volumes driven by increased industry capacity. The effect of passenger uncertainty in booking with Air Canada as a result of the labour disruptions experienced in March and April 2012 also negatively impacted revenues at Air Canada Vacations.

### CASM and Adjusted CASM respectively increased 1.7% and 2.0% from the first nine months of 2011

The following table compares Air Canada's CASM for the first nine months of 2012 to Air Canada's CASM for the corresponding period in 2011.

(cents per ASM)	First Nine Months		Change	
	2012	2011	cents	%
Wages and salaries	2.33	2.23	0.10	4.5
Benefits	0.73	0.68	0.05	7.4
Benefit plan amendments <sup>(1)</sup>	(0.24)	-	(0.24)	-
Aircraft fuel	5.29	5.02	0.27	5.4
Airport and navigation fees	1.47	1.50	(0.03)	(2.0)
Capacity purchase agreements	1.56	1.47	0.09	6.1
Ownership (DAR) <sup>(2)</sup>	1.50	1.57	(0.07)	(4.5)
Aircraft maintenance	0.99	0.92	0.07	7.6
Sales and distribution costs	0.91	0.92	(0.01)	(1.1)
Food, beverages and supplies	0.43	0.44	(0.01)	(2.3)
Communications and information technology	0.27	0.28	(0.01)	(3.6)
Other	1.92	1.85	0.07	3.8
<b>CASM</b>	<b>17.16</b>	<b>16.88</b>	<b>0.28</b>	<b>1.7</b>
<b>Remove:</b>				
Benefit plan amendments <sup>(1)</sup>	0.24	-	0.24	-
Fuel expense and the cost of ground packages at Air Canada Vacations	(5.80)	(5.51)	(0.29)	5.3
<b>Adjusted CASM <sup>(1) (3)</sup></b>	<b>11.60</b>	<b>11.37</b>	<b>0.23</b>	<b>2.0</b>

(1) In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$124 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(2) DAR refers to the combination of depreciation, amortization and impairment, and aircraft rent expenses.

(3) Adjusted CASM is a non-GAAP financial measure. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.

### Operating expenses increased 3% from the first nine months of 2011

In the first nine months of 2012, operating expenses of \$8,888 million increased \$252 million or 3% from operating expenses of \$8,636 million recorded in the first nine months of 2011.

As a result of changes to the terms of the ACPA collective agreement related to retirement age, which are not subject to regulatory approval, Air Canada recorded an operating expense reduction of \$124 million in Benefit plan amendments in the third quarter of 2012 related to the impact of those amendments on pension and other employee benefit liabilities.

In the first nine months of 2012, the unfavourable impact of a weaker Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars) when compared to the first nine months of 2011 increased operating expenses by \$106 million.

### Fuel expense increased 7% from the first nine months of 2011

In the first nine months of 2012, fuel expense of \$2,740 million increased \$173 million or 7% from the first nine months of 2011. This increase was mainly due to higher base fuel prices year-over-year, which accounted for an increase of \$75 million, the unfavourable impact of a weaker Canadian dollar in the first nine months of 2012 when compared to the first nine months of 2011, which accounted for an increase of \$74 million, and a greater volume of fuel litres consumed, which accounted for an increase of \$24 million.

The table below provides Air Canada's fuel cost per litre and economic fuel cost per litre for the periods indicated.

(Canadian dollars in millions, except where indicated)	First Nine Months		Change	
	2012	2011	\$	%
Aircraft fuel expense – GAAP <sup>(1)</sup>	\$ 2,716	\$ 2,548	\$ 168	7
<b>Add:</b> Net cash (receipts) payments on fuel derivatives <sup>(2)</sup>	31	(3)	34	
<b>Economic cost of fuel – Non-GAAP <sup>(3)</sup></b>	<b>\$ 2,747</b>	<b>\$ 2,545</b>	<b>\$ 202</b>	<b>8</b>
Fuel consumption (thousands of litres) <sup>(1)</sup>	3,052,548	3,024,679	27,869	1
Fuel cost per litre (cents) – GAAP	89.0	84.2	4.8	6
Economic fuel cost per litre (cents) – Non-GAAP <sup>(3)</sup>	90.0	84.1	5.9	7

(1) Excludes fuel expense and fuel litres related to third party carriers, other than Jazz, operating under capacity purchase agreements.

(2) Includes net cash settlements on maturing fuel derivatives and premium costs associated with those derivatives.

(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 its cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period and premium costs associated with those derivatives.

### Wages, salaries and benefits expense amounted to \$1,580 million in the first nine months of 2012, an increase of \$90 million or 6% from the first nine months of 2011

In the first nine months of 2012, wages and salaries expense of \$1,205 million increased \$64 million or 6% from the first nine months of 2011, which included the impact of higher average salaries year-over-year and a 1.2% increase in the average number of full-time equivalent ("FTE") employees. In addition, in the first nine months of 2012, Air Canada recorded a liability of \$18 million related to employee profit sharing payments. This liability is an estimate based on a number of assumptions and may be subject to adjustment in the future.

In the first nine months of 2012, employee benefits expense of \$375 million increased \$26 million or 7% from the first nine months of 2011, largely as a result of lower discount rates which increase the service cost of pension and other employee future benefits expense, and the impact of higher health care rates.

### Capacity purchase costs increased 8% from the first nine months of 2011

In the first nine months of 2012, capacity purchase costs of \$809 million increased \$57 million or 8% from the first nine months of 2011, mainly due to higher Jazz CPA rates, increased flying by Jazz, and an unfavourable impact of foreign exchange on U.S. currency denominated Jazz CPA expenses paid by Air Canada. Sky Regional's commencement, on May 1, 2011, of services on behalf of Air Canada between Billy Bishop Toronto City Airport and Montreal Trudeau Airport was also a contributing factor to the increase in capacity purchase costs year-over-year.

### Ownership costs decreased 3% from the first nine months of 2011

In the first nine months of 2012, ownership costs (which are comprised of depreciation, amortization and impairment, and aircraft rent expenses) of \$776 million decreased \$27 million or 3% from the first nine months of 2011, mainly due to a decrease in depreciation expense related to the airline's interior refurbishment programs.

### Aircraft maintenance expense increased 9% from the first nine months of 2011

In the first nine months of 2012, aircraft maintenance expense of \$511 million increased \$42 million or 9% from the first nine months of 2011. This increase was mainly driven by growth in scheduled engine maintenance activity, higher maintenance rates related to Air Canada's Boeing 777 aircraft which were previously negotiated, as well as an increase of \$7 million pertaining to end of lease maintenance return provisions. These increases were partly offset by a decrease in airframe maintenance expenses.

### Sales and distribution costs decreased \$2 million from the first nine months of 2011

In the first nine months of 2012, sales and distribution costs of \$470 million decreased \$2 million from the first nine months of 2011 on passenger revenue growth of 5.0%. An increase in transaction fees paid to global distribution services ("GDS") providers and growth in credit card fees were more than offset by lower commission expense at Air Canada, in part due to program changes, and by a decrease in sales and distribution costs at Air Canada Vacations.

### Other operating expenses increased 6% from the first nine months of 2011

In the first nine months of 2012, other operating expenses of \$1,001 million increased \$58 million or 6% from the first nine months of 2011.

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

(Canadian dollars in millions)	First Nine Months		Change	
	2012	2011	\$	%
Air Canada Vacations' land costs	\$ 262	\$ 250	\$ 12	5
Terminal handling	142	150	(8)	(5)
Building rent and maintenance	92	98	(6)	(6)
Crew cycle	87	85	2	2
Miscellaneous fees and services	105	76	29	38
Remaining other expenses	313	284	29	10
<b>Other operating expenses</b>	<b>\$ 1,001</b>	<b>\$ 943</b>	<b>\$ 58</b>	<b>6</b>

Factors contributing to the year-over-year change in first nine months Other expenses included:

- An increase of \$29 million or 38% in miscellaneous fees and services which included fees incurred in relation to the pursuit of various corporate initiatives.
- An increase in "remaining other expenses" of \$29 million or 10% which was largely driven by expenses, such as engine and rotatable equipment rentals, as a result of the Aveos closure.
- An increase of \$12 million or 5% in expenses related to ground packages at Air Canada Vacations which was mainly due to a higher cost of ground packages.

### Non-operating expense amounted to \$212 million in the first nine months of 2012 compared to non-operating expense of \$467 million in the first nine months of 2011

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

(Canadian dollars in millions)	First Nine Months		Change
	2012	2011	\$
Foreign exchange gain (loss)	\$ 97	\$ (168)	\$ 265
Interest income	28	26	2
Interest expense	(236)	(244)	8
Interest capitalized	11	2	9
Net financing expense relating to employee benefits	(13)	(12)	(1)
Loss on financial instruments recorded at fair value	(27)	(58)	31
Loss on investment in Aveos	(65)	-	(65)
Other	(7)	(13)	6
<b>Total non-operating expense</b>	<b>\$ (212)</b>	<b>\$ (467)</b>	<b>\$ 255</b>

Factors contributing to the year-over-year change in first nine months non-operating expense included:

- Gains on foreign exchange, which were related to U.S. denominated long-term debt, amounted to \$97 million in the first nine months of 2012 compared to losses of \$168 million in the first nine months of 2011.
- Losses related to fair value adjustments on derivative instruments which amounted to \$27 million in the first nine months of 2012 versus losses of \$58 million in the first nine months of 2011. Refer to section 9 of this MD&A for additional information.
- In the first quarter of 2012, Air Canada recorded a loss on its investments in Aveos' parent holding company as a result of Aveos' filing for court protection pursuant to the Companies' Creditors Arrangements Act ("CCAA") and ceasing operations in March 2012. As a result, Air Canada reduced the carrying value of its investment in Aveos Holding Company, Aveos' parent company as well as the carrying value of a long term note receivable from Aveos to nil, and recorded an aggregate loss on investments of \$65 million. In addition, in the first quarter of 2012, Air Canada recorded a liability of \$55 million, which was charged to Discontinued Operations, related to Air Canada's commitment under an employee separation program. There was no impact to cash flows relating to Discontinued Operations in the first nine months of 2012. It is expected that payments to settle Air Canada's commitment will be finalized in 2013.

## 6. FLEET

The following table provides the number of aircraft in Air Canada's operating fleet as at September 30, 2012, and December 31, 2011, as well as Air Canada's expected operating fleet as at December 31, 2012 and as at December 31, 2013 (excluding aircraft which are leased or subleased to third parties and excluding aircraft operated by Jazz under the Jazz CPA and by other regional airlines operating flights on behalf of Air Canada under the Air Canada Express banner pursuant to commercial agreements with Air Canada). There have been no changes to the number of aircraft in Air Canada's operating fleet in the first nine months of 2012.

	Actual (As at September 30, 2012)			Planned (As at September 30, 2012)		
	December 31, 2011	First Nine Months Fleet Changes	September 30, 2012	Remainder of 2012 Fleet Changes	December 31, 2012	2013 Fleet Changes
Boeing 777-300	12	-	12	-	12	2
Boeing 777-200	6	-	6	-	6	-
Boeing 767-300	30	-	30	-	30	(3)
Airbus A330-300	8	-	8	-	8	-
Airbus A321	10	-	10	-	10	-
Airbus A320	41	-	41	-	41	-
Airbus A319	38	-	38	-	38	(2)
EMBRAER 190	45	-	45	-	45	-
EMBRAER 175	15	-	15	-	15	(15)
<b>Total</b>	<b>205</b>	<b>-</b>	<b>205</b>	<b>-</b>	<b>205</b>	<b>(18)</b>

On October 1, 2012 Air Canada announced the planned addition of two new Boeing 777-300ER aircraft, scheduled to be delivered in June and August 2013, to the mainline widebody fleet in order to pursue strategic growth opportunities for its international network. The addition of these two aircraft to the mainline fleet is reflected in the table above. Air Canada also has outstanding purchase commitments for three additional Boeing 777 aircraft with scheduled deliveries in late 2013 and the first half of 2014. As Air Canada is reviewing operating alternatives for these three aircraft, they have not been reflected in the table provided above.

Air Canada also announced that it had entered into agreement for the transfer of 15 Embraer 175 aircraft from Air Canada to Sky Regional Airlines, Inc. (Sky Regional). Subject to certain conditions, including the conclusion of an amended capacity purchase agreement, Sky Regional will operate these aircraft on behalf of Air Canada. The aircraft will continue to be operated on short-haul regional routes, primarily from Toronto and Montreal to destinations in the northeast United States, under the Air Canada Express banner. The transfer of these 15 regional aircraft is expected to be made between February and June 2013. The removal of these aircraft from the mainline fleet is reflected in the table above.

On October 2, 2012, Air Canada announced its plans to form an integrated leisure group, combining the activities of its tour operator business, Air Canada Vacations, with a new low-cost leisure airline to launch in 2013. Air Canada expects the new low-cost leisure carrier to commence service in July 2013 with two Boeing 767-300ER aircraft and two Airbus A319 aircraft that will be released from Air Canada's mainline fleet. Air Canada's plans are subject to obtaining the necessary regulatory approvals and other conditions. The removal of these aircraft from the mainline fleet is reflected in the table above. Air Canada expects to progressively transfer narrowbody aircraft from the mainline fleet to the leisure carrier. The widebody fleet at the leisure carrier would be expected to increase as Air Canada starts to take delivery of new Boeing 787 Dreamliner aircraft in 2014, thereby freeing up additional widebody aircraft for transfer to the leisure carrier. As this occurs and subject to commercial demand and other conditions, the leisure carrier may operate up to 20 Boeing 767-300ER aircraft and 30 Airbus A319 aircraft, for a total of 50 aircraft.

The following table provides the planned number of aircraft, as at December 31, 2013, which will be operated by the new low-cost airline.

	Planned fleet as at December 31, 2013
Airbus A319	2
Boeing 767-300	2
<b>Total</b>	<b>4</b>

The following table provides, as at September 30, 2012, the number of aircraft operated by Jazz and by other airlines operating flights on behalf of Air Canada under the Air Canada Express banner pursuant to commercial agreements with Air Canada.

	As at September 30, 2012			
	Jazz	Sky Regional	Other	Total
CRJ-100	9	–	–	9
CRJ-200	25	–	–	25
CRJ-705	16	–	–	16
Dash 8-100	34	–	–	34
Dash 8-300	26	–	–	26
Dash 8-400	15	5	–	20
Beech 1900	–	–	17	17
<b>Total</b>	<b>125</b>	<b>5</b>	<b>17</b>	<b>147</b>

On July 12, 2012, Chorus Aviation Inc. ("Chorus") announced that it had exercised six of 15 options it holds to acquire additional Dash 8-400 ("Q400") aircraft to be operated by its subsidiary, Jazz, under the Air Canada Express banner. Chorus announced that the six optioned 74-seat Q400 aircraft are contracted to be delivered at a rate of two per month in February, March and April 2013, and will be placed in operation the subsequent month. Chorus also announced that a total of nine 50-seat CRJ-100 aircraft will be removed from the Jazz fleet between December 2012 and April 2013. As a result, the covered fleet under the Jazz CPA would be reduced from 125 to 122 aircraft, with the overall seating capacity, operated under the Jazz CPA, being held relatively constant.

As disclosed above, Air Canada plans to transfer 15 Embraer 175 regional aircraft to Sky Regional between February and June 2013.

The following table provides the planned number of aircraft, as at December 31, 2013, which will be operated by Jazz and by other airlines operating flights on behalf of Air Canada under the Air Canada Express banner pursuant to commercial agreements with Air Canada.

	Planned Fleet As at December 31, 2013			
	Jazz	Sky Regional	Other	Total
EMBRAER 175	-	15	-	15
CRJ-200	25	-	-	25
CRJ-705	16	-	-	16
Dash 8-100	34	-	-	34
Dash 8-300	26	-	-	26
Dash 8-400	21	5	-	26
Beech 1900	-	-	17	17
<b>Total</b>	<b>122</b>	<b>20</b>	<b>17</b>	<b>159</b>



## 7. FINANCIAL AND CAPITAL MANAGEMENT

### 7.1. Liquidity

Air Canada manages its liquidity needs through a variety of strategies which include seeking to achieve positive cash from operations, sourcing committed financing for new and existing aircraft, and through other financing activities.

Liquidity needs are primarily related to meeting obligations associated with financial liabilities, capital commitments, ongoing operations, contractual and other obligations (including pension funding obligations), and covenants in credit card and other agreements. Refer to sections 7.6, 7.7 and 7.8 of this MD&A for information on Air Canada's contractual obligations, capital commitments and pension funding obligations. Air Canada monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as well as those assets being used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. Air Canada's principal objective in managing liquidity risk is to maintain a minimum unrestricted cash balance in excess of 15% of 12-month trailing operating revenues. At September 30, 2012, cash, cash equivalents and short-term investments amounted to \$2,196 million, or 18% of 12-month trailing operating revenues (September 30, 2011 – \$2,179 million, or 19% of 12-month trailing operating revenues).

### 7.2. Financial Position

The following table provides a condensed statement of financial position of Air Canada as at September 30, 2012 and as at December 31, 2011.

(Canadian dollars in millions)	September 30, 2012	December 31, 2011	Change \$
<b>Assets</b>			
Cash, cash equivalents and short-term investments	\$ 2,196	\$ 2,099	\$ 97
Other current assets	1,138	1,228	(90)
Current assets	3,334	3,327	7
Property and equipment	4,924	5,088	(164)
Intangible assets	317	312	5
Goodwill	311	311	-
Deposits and other assets	494	595	(101)
<b>Total assets</b>	<b>\$ 9,380</b>	<b>\$ 9,633</b>	<b>\$ (253)</b>
<b>Liabilities</b>			
Current liabilities	\$ 3,353	\$ 3,153	\$ 200
Long-term debt and finance leases	3,603	3,906	(303)
Pension and other benefit liabilities	5,296	5,563	(267)
Maintenance provisions	585	548	37
Other long-term liabilities	437	469	(32)
<b>Total liabilities</b>	<b>13,274</b>	<b>13,639</b>	<b>(365)</b>
<b>Total equity</b>	<b>(3,894)</b>	<b>(4,006)</b>	<b>112</b>
<b>Total liabilities and equity</b>	<b>\$ 9,380</b>	<b>\$ 9,633</b>	<b>\$ (253)</b>

Movements in current assets and current liabilities are described in section 7.4 of this MD&A. Long-term debt and finance leases are discussed in sections 7.3 and 7.5 of this MD&A.

At September 30, 2012, Deposits and other assets declined by \$101 million from December 31, 2011 reflecting, in part, the write-off of Air Canada's investments in Aveos' parent company in the first quarter of 2012. Property and equipment amounted to \$4,924 million at September 30, 2012, a reduction of \$164 million from December 31, 2011. This reduction in Property and equipment was mainly due to the impact of depreciation expense of \$491 million in the first nine months of 2012, partly offset by additions to property and equipment of \$332 million. The additions to property and equipment included deposits and progress payments on future aircraft deliveries of \$158 million, flight equipment (including capitalized maintenance costs) of \$81 million, and facility purchases of \$57 million.

Pension and other benefit liabilities decreased \$267 million from December 31, 2011, mainly due to Air Canada having made pension funding payments of \$320 million in the first nine months of 2012. The decrease also relates to the impact of the benefit plan amendments of \$124 million, as further described in section 7.8 of this MD&A.

### 7.3. Adjusted Net Debt

The following table reflects Air Canada's adjusted net debt balances as at September 30, 2012 and as at December 31, 2011.

(Canadian dollars in millions)	September 30, 2012	December 31, 2011	Change \$
Total long-term debt and finance leases	\$ 3,603	\$ 3,906	\$ (303)
Current portion of long-term debt and finance leases	474	424	50
Total long-term debt and finance leases, including current portion	4,077	4,330	(253)
Less cash, cash equivalents and short-term investments	(2,196)	(2,099)	(97)
<b>Net debt</b>	<b>\$ 1,881</b>	<b>\$ 2,231</b>	<b>\$ (350)</b>
Capitalized operating leases <sup>(1)</sup>	2,387	2,345	42
<b>Adjusted net debt</b>	<b>\$ 4,268</b>	<b>\$ 4,576</b>	<b>\$ (308)</b>

(1) Adjusted net debt is a non-GAAP financial measure used by Air Canada and may not be comparable to measures presented by other public companies. Adjusted net debt is a key component of the capital managed by Air Canada and provides a measure of its net indebtedness. Air Canada includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7.0. This definition of capitalized operating leases is used by Air Canada and may not be comparable to similar measures presented by other public companies. Aircraft rent was \$341 million for the twelve months ended September 30, 2012 and \$335 million for the twelve months ended December 31, 2011.

Total long-term debt and finance leases, including current portion, amounted to \$4,077 million at September 30, 2012, a decrease of \$253 million from December 31, 2011. The reduction in long-term debt and finance leases from December 31, 2011 was mainly due to debt repayments of \$317 million, as well as the favourable impact of a stronger Canadian dollar at September 30, 2012 compared to December 31, 2011 on Air Canada's foreign currency denominated debt (mainly U.S. dollars), which accounted for a decrease of \$124 million. These decreases were partly offset by proceeds from borrowings of \$163 million.

At September 30, 2012, adjusted net debt of \$4,268 million decreased \$308 million from December 31, 2011. This reduction in adjusted net debt included the impact of lower debt balances, as described above.

## Credit Ratings

On April 24, 2012, Standard & Poor's Ratings Services ("Standard & Poor's") affirmed its ratings on Air Canada, including Air Canada's "B-" long-term corporate credit rating. At the same time, Standard & Poor's removed all ratings from CreditWatch with negative implications, where they had been placed on March 23, 2012. The outlook is negative, reflecting Standard & Poor's stated expectations of weak cash flow generation in 2012 due to operational disruptions caused by labour disputes, which Standard & Poor's has stated could lead to a leverage ratio of 9 times EBITDA (earnings before interest, taxes, depreciation and amortization) in 2012.

On April 3, 2012, Moody's Investors Service, Inc. ("Moody's") lowered Air Canada's corporate family rating and probability of default ratings to Caa1 from B3, its 1st lien senior secured rating to B2 from B1 and its 2nd lien senior secured rating to Caa2 from Caa1. Moody's affirmed Air Canada's speculative grade liquidity rating at SGL-2, stating that this was indicative of good liquidity. Moody's stated that Air Canada's rating outlook was stable. Moody's also stated that it had lowered Air Canada's ratings because of its expectation that Air Canada's adjusted leverage will remain in excess of eight times EBITDA through at least 2012, higher than Moody's had previously expected. Moody's also stated its concern with Air Canada's ability to absorb higher capital expenditures for new aircraft and additional funding requirements for pension shortfalls beginning in 2014.

On November 17, 2011, DBRS Limited ("DBRS") assigned an Issuer Rating of "B" to Air Canada; the trend is Stable. DBRS stated that the rating reflects its view of Air Canada's high business risk, operating in the very competitive and volatile global airline industry; its leveraged balance sheet; its high cost structure; and its relatively weak debt coverage ratios. DBRS stated it believes Air Canada's overall business risk profile is near the industry average. DBRS also stated that it views Air Canada as having a strong position in the markets where it competes and is the largest airline in Canada.

## 7.4. Working Capital

The following table provides information on Air Canada's working capital balances at September 30, 2012 and at December 31, 2011.

(Canadian dollars in millions)	September 30, 2012	December 31, 2011	Change \$
Cash and short-term investments	\$ 2,196	\$ 2,099	\$ 97
Accounts receivable	702	712	(10)
Other current assets	436	516	(80)
Accounts payable and accrued liabilities	(1,231)	(1,175)	(56)
Advance ticket sales	(1,648)	(1,554)	(94)
Current portion of long-term debt and finance leases	(474)	(424)	(50)
<b>Net working capital</b>	<b>\$ (19)</b>	<b>\$ 174</b>	<b>\$ (193)</b>

The net negative working capital of \$19 million at September 30, 2012 represented a deterioration of \$193 million from December 31, 2011. This decline in net working capital was largely due to the impact of capital expenditures of \$368 million, pension funding payments of \$320 million, and a liability of \$55 million recorded in Accounts payable and accrued liabilities in the first quarter of 2012 related to the separation program for former Air Canada employees having transferred to Aveos. Largely offsetting these items was the impact of positive cash flows from operating activities and the proceeds from long-term borrowings of \$163 million. The decrease in Other current assets of \$80 million was largely due to the seasonal decline in restricted cash and prepaid vacation deposits in the Air Canada Vacations' business.

## 7.5. Consolidated Cash Flow Movements

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

(Canadian dollars in millions)	Third Quarter				First Nine Months		
	2012	2011	Change \$		2012	2011	Change \$
Net cash flows from operating activities, before the undernoted items	\$ 503	\$ 416	\$ 87		\$ 545	\$ 614	\$ (69)
Net cash flows from (used for) fuel hedge settlements and premiums	(10)	(1)	(9)		(38)	8	(46)
Excess of employee benefit funding over expense	(63)	(38)	(25)		(139)	(96)	(43)
Benefit plan amendments	(124)	-	(124)		(124)	-	(124)
Loss on investments in Aveos	-	-	-		65	-	65
Discontinued operations - Aveos	-	-	-		55	-	55
Change in maintenance provisions	10	10	-		13	42	(29)
Provision for cargo investigations	-	-	-		(8)	(29)	21
Changes in non-cash working capital balances	(365)	(323)	(42)		203	60	143
Net cash flows from (used for) operating activities	(49)	64	(113)		572	599	(27)
Additions to property, equipment and intangible assets	(115)	(60)	(55)		(368)	(164)	(204)
<b>Free cash flow <sup>(1)</sup></b>	<b>(164)</b>	<b>4</b>	<b>(168)</b>		<b>204</b>	<b>435</b>	<b>(231)</b>
Short-term investments	161	86	75		(104)	(103)	(1)
Other	43	(11)	54		63	(37)	100
<b>Net cash flows from (used for) investing activities (excluding additions to property, equipment and intangible assets)</b>	<b>204</b>	<b>75</b>	<b>129</b>		<b>(41)</b>	<b>(140)</b>	<b>99</b>
Proceeds from borrowings	13	-	13		163	125	38
Reduction of long-term debt and finance lease obligations	(79)	(73)	(6)		(317)	(484)	167
Distributions related to aircraft special purpose leasing entities	-	-	-		(16)	(52)	36
<b>Net cash flows used for financing activities</b>	<b>(66)</b>	<b>(73)</b>	<b>7</b>		<b>(170)</b>	<b>(411)</b>	<b>241</b>
Net increase (decrease) in cash and cash equivalents	(26)	6	(32)		(7)	(116)	109
Net increase (decrease) in short-term investments	(161)	(86)	(75)		104	103	1
<b>Net increase (decrease) in cash, cash equivalents and short-term investments</b>	<b>\$ (187)</b>	<b>\$ (80)</b>	<b>\$ (107)</b>		<b>\$ 97</b>	<b>\$ (13)</b>	<b>\$ 110</b>

(1) Free cash flow is a non-GAAP financial measure used by Air Canada 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, including repaying debt, meeting ongoing financial obligations and reinvesting in Air Canada.

Free cash flow was negative \$164 million in the third quarter of 2012 compared to free cash flow of \$4 million in the third quarter of 2011, a deterioration of \$168 million. This deterioration in free cash flow was due to an increase in capital expenditures of \$55 million, which was related to ongoing purchase deposit payments on committed Boeing 777 and 787 aircraft, as well as unfavourable changes in non-cash working capital balances due to the timing of certain operating expense payments.

In the first nine months of 2012, free cash flow amounted to \$204 million, a decrease of \$231 million from the first nine months of 2011. This decrease in free cash flow was due principally to an increase in capital expenditures of \$204 million, which was primarily related to the ongoing purchase deposit payments on committed Boeing 777 and 787 aircraft, partly offset by favourable changes in non-cash working capital balances.

In the first nine months of 2012, proceeds from borrowings amounted to \$163 million, which included net financing proceeds of \$41 million under a credit agreement to refinance amounts related to four Airbus A319 aircraft, with refinanced terms of five years, as well as additional draws of \$119 million under a revolving loan facility.

In the first nine months of 2012, debt repayments amounted to \$317 million and included payments of \$48 million for the refinancing of amounts related to the four Airbus A319 aircraft referred to above.

## 7.6. Contractual Obligations

Information on Air Canada's contractual obligations is described in section 9.7 of Air Canada's 2011 MD&A dated February 9, 2012. Except for changes in projected capital expenditures (disclosed in section 7.7 "Capital Expenditures and Related Financing Arrangements" of this MD&A) and the extension of the maturity of a term loan from 2013 to 2015, there have been no significant changes to Air Canada's contractual obligations from those disclosed at that time.

Air Canada also provides an update, in the following paragraph, on section 9.7 of Air Canada's annual MD&A for 2011 dated February 9, 2012 entitled "Covenants in Credit Card Agreements".

### Covenants in Credit Card Agreements

As described in section 9.7 of Air Canada's 2011 MD&A dated February 9, 2012, Air Canada retains the services of third parties to process customer credit card transactions. In the second quarter of 2012, Air Canada transitioned its principal credit card processing agreements for credit card processing services in North America to a new service provider. The terms of the new agreements are for five years each and the agreements contain triggering events upon which Air Canada would be required to provide the credit card processor with cash deposits. The obligation to provide cash deposits and the required amount of such deposits are each based upon a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio and the unrestricted cash and short-term investments of Air Canada.

## 7.7. Capital Expenditures and Related Financing Arrangements

### Boeing

Air Canada has outstanding purchase commitments with The Boeing Company ("Boeing") for the acquisition of 37 Boeing 787 aircraft. The first seven deliveries are scheduled for 2014 and the remaining 30 between 2015 and 2019.

In addition, following the exercise of purchase rights in the fourth quarter of 2011 and the first quarter of 2012, Air Canada has outstanding purchase commitments for the acquisition of five Boeing 777 aircraft, two of which will be added to Air Canada's mainline fleet in the second half of 2013. Air Canada is currently reviewing operating alternatives for the remaining three aircraft which have scheduled deliveries in late 2013 and the first half of 2014. Air Canada is also evaluating financing alternatives in the approximate range of \$500 million to \$600 million, covering all five aircraft. Such financing, which would decrease Air Canada's capital commitments, is not reflected in the table below.

### Capital Commitments

The estimated aggregate cost of the future firm Boeing aircraft deliveries and other capital purchase commitments, as at September 30, 2012, approximates \$4,996 million (of which \$3,007 million is subject to committed financing, subject to the fulfillment of certain terms and conditions).

The table below provides updated information on Air Canada's current projected, planned and committed capital expenditures for the remainder of 2012, for the next four years and after 2016.

(Canadian dollars in millions)	Remainder of 2012	2013	2014	2015	2016	Thereafter	Total
Projected committed expenditures	\$ 59	\$ 549	\$ 830	\$ 548	\$ 969	\$ 2,041	\$ 4,996
Projected planned but uncommitted expenditures	3	210	200	149	146	not available	not available
Projected planned but uncommitted capitalized maintenance <sup>(1)</sup>	10	46	97	56	56	not available	not available
<b>Total projected expenditures <sup>(2)</sup></b>	<b>72</b>	<b>805</b>	<b>1,127</b>	<b>753</b>	<b>1,171</b>	<b>not available</b>	<b>not available</b>
Projected financing on committed expenditures	-	-	(584)	(446)	(788)	(1,189)	(3,007)
<b>Total projected expenditures, net of financing</b>	<b>\$ 72</b>	<b>\$ 805</b>	<b>\$ 543</b>	<b>\$ 307</b>	<b>\$ 383</b>	<b>not available</b>	<b>not available</b>

(1) The table above includes certain maintenance events which are capitalized under IFRS. Future capitalized maintenance amounts for 2016 and beyond are not yet determinable however an estimate of \$56 million has been made for 2016.

(2) U.S. dollar amounts are converted using the September 30, 2012 closing exchange rate of US\$1 = C\$0.9832. The estimated aggregate cost of aircraft is based on delivery prices that include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day U.S. LIBOR rate at September 30, 2012.

## 7.8. Pension Funding Obligations

Air Canada maintains several pension plans, including defined benefit and defined contribution pension plans and plans providing other retirement and post-employment benefits to its employees. Based on actuarial valuations completed in the second quarter of 2012, the aggregate solvency deficit in Air Canada's domestic registered pension plans as at January 1, 2012 was \$4.2 billion. This increase to the aggregate solvency deficit of \$2.0 billion versus the valuation as of January 1, 2011 was mainly due to a decrease in the solvency discount rate partly offset by a 6.8% return on plan assets. As described in section 9.8 of Air Canada's 2011 MD&A dated February 9, 2012, valuations will not increase pension past service cost funding obligations required prior to 2014. Pension funding obligations for 2014 would be determined based on January 1, 2014 actuarial valuations which are expected to be completed in mid-2014. For illustrative purposes only, based on the actuarial valuations dated January 1, 2012, an increase in the discount rate of 1% results in a decrease of \$1,840 million to the pension solvency liability. A decrease in the discount rate of 1% results in an increase of \$2,348 million to the pension solvency liability.

As described in section 9.8 of Air Canada's 2011 MD&A dated February 9, 2012, the collective agreements concluded with the CAW and CUPE include amendments to the defined benefit pension plans for CAW and CUPE represented plan members. As described below, collective agreements concluded with the International Association of Machinists and Aerospace Workers ("IAMAW") and the Air Canada Pilots Association ("ACPA") also include amendments to the defined benefit pension plans for IAMAW and ACPA represented plan members. Based on the actuarial valuations of January 1, 2012, Air Canada has estimated that these changes in the aggregate would result in a decline of approximately \$1.1 billion to the solvency deficit in its domestic registered pension plans, had these amendments been implemented on January 1, 2012. Such amendments remain subject to regulatory approval by the Office of the Superintendent of Financial Institutions ("OSFI") and will be accounted for at the time these approvals have been received.

In June 2012, Air Canada and IAMAW received the decision of the arbitrator in the final offer selection arbitration conducted in accordance with the process legislated by the federal government in the *Protecting Air Service Act*. The arbitrator's final offer selection concludes a new five-year collective agreement with the IAMAW which is in effect until March 31, 2016. The new collective agreement preserves the defined benefit pension plans for current employees and introduces a new IAMAW multi-employer pension plan for new employees hired after the date of the decision, which will be accounted for as a defined contribution plan.

On July 30, 2012, Air Canada and ACPA received the decision of the arbitrator in the final offer selection arbitration conducted in accordance with the *Protecting Air Service Act*. The arbitrator's final offer selection concludes a new five-year collective agreement with ACPA which is in effect until April 1, 2016. This new collective agreement preserves defined benefit pension plans for current employees and introduces a defined contribution pension plan for new employees hired after July 30, 2012. The collective agreement also includes amendments to the defined benefit pension plans of current ACPA members which are subject to regulatory approval by OSFI and will be accounted for at the time this approval has been received. In addition, the new ACPA collective agreement contemplates pilots working past age 60, which was the age of mandatory retirement in the previous collective agreement. As a result of these changes to retirement age, which are not subject to regulatory approval, Air Canada recorded an operating expense reduction of \$124 million in Benefit plan amendments in the third quarter of 2012 related to the impact of those amendments on pension and other employee benefit liabilities. By virtue of its size and incidence, this item is separately disclosed on Air Canada's consolidated statement of operations.

Also in June 2012, Air Canada concluded an agreement with Aimia Canada Inc. (formerly Aeroplan) through which Air Canada will transfer to the Aeroplan defined benefit pension plan all the pension plan assets and obligations related to pension benefits accrued by CAW-represented employees who were Air Canada employees and who chose to transition to employment at Aeroplan in 2009. The transfer is subject to the approval of OSFI but the 2012 actuarial valuations assume that the transfer has been made. Based on the most recent actuarial valuation report, the solvency deficit and related compensation for transferred employees is not material.

### Pension and Benefits Agreement with Aveos

On June 22, 2007, Air Canada and Aveos entered into a Pension and Benefits Agreement covering the transfer of certain pension and benefit assets and obligations to Aveos. On July 14, 2011 (the "Certification Date"), certain unionized employees of Air Canada elected to become employees of Aveos. The Pension and Benefits Agreement provided that, subject to regulatory approval by OSFI, where required, the assets and obligations under the pension, other post-retirement and post-employment benefits plans pertaining to the transferred unionized employees would be transferred to Aveos, with Air Canada providing compensation payments to be paid quarterly to Aveos over a period not exceeding five years once determined after the transfer. In the second quarter of 2012, OSFI ordered the termination of Aveos' defined benefit pension plans and, as a result, the assets and liabilities, accruing prior to the Certification Date in respect of transferred employees will remain under Air Canada's pension plans. In addition, obligations under the other post-retirement and post-employment benefits plans pertaining to the transferred unionized employees, for accounting purposes, continue to be included in Air Canada's consolidated financial statements but their final determination may be subject to Aveos' CCAA proceedings.

## 7.9. Share Information

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

	Number of Shares at	
	October 31, 2012	December 31, 2011
<b>Issued and outstanding shares</b>		
Class A variable voting shares	35,555,755	42,204,645
Class B voting shares	241,378,268	235,166,848
<b>Total issued and outstanding shares</b>	<b>276,934,023</b>	<b>277,371,493</b>
<b>Class A variable voting and Class B voting shares potentially issuable</b>		
Warrants	10,000,000	89,430,300
Shares held in trust	1,474,462	1,536,992
Stock options	8,505,403	6,581,242
<b>Total shares potentially issuable</b>	<b>19,979,865</b>	<b>97,548,534</b>
<b>Total outstanding and potentially issuable shares</b>	<b>296,913,888</b>	<b>374,920,027</b>



**Warrants**

Warrants outstanding as at September 30, 2012 are as follows:

Grant date	Number of Warrants Outstanding	Exercise Prices	Expiry Dates
July 30, 2009	5,000,000	\$1.51	July 30, 2013
October 19, 2009	5,000,000	\$1.44	October 19, 2013
October 27, 2009	79,430,300	\$2.20	October 27, 2012
	<b>89,430,300</b>		

On October 27, 2012, 79,430,300 warrants expired.

## 8. QUARTERLY FINANCIAL DATA

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

(Canadian dollars in millions)	2010	2011				2012		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
<b>Operating revenues</b>	\$ 2,616	\$ 2,753	\$ 2,918	\$ 3,242	\$ 2,699	\$ 2,962	\$ 2,989	\$ 3,328
Aircraft fuel	640	742	882	943	808	889	888	963
Ownership (DAR) <sup>(1)</sup>	313	273	265	265	260	268	251	257
Other operating expenses <sup>(2)</sup>	1,648	1,804	1,698	1,764	1,729	1,898	1,787	1,687
<b>Operating expenses</b>	<b>2,601</b>	<b>2,819</b>	<b>2,845</b>	<b>2,972</b>	<b>2,797</b>	<b>3,055</b>	<b>2,926</b>	<b>2,907</b>
<b>Operating income (loss), before provision adjustment for cargo investigations</b>	<b>15</b>	<b>(66)</b>	<b>73</b>	<b>270</b>	<b>(98)</b>	<b>(93)</b>	<b>63</b>	<b>421</b>
Provision adjustment for cargo investigations <sup>(3)</sup>	46	-	-	-	-	-	-	-
<b>Operating income (loss)</b>	<b>61</b>	<b>(66)</b>	<b>73</b>	<b>270</b>	<b>(98)</b>	<b>(93)</b>	<b>63</b>	<b>421</b>
<b>Total non-operating income (expense)</b>	<b>28</b>	<b>47</b>	<b>(120)</b>	<b>(394)</b>	<b>38</b>	<b>(62)</b>	<b>(158)</b>	<b>8</b>
Recovery of (provision for) income taxes	-	-	1	-	-	-	(1)	-
Discontinued operations - Aveos	-	-	-	-	-	(55)	-	-
<b>Net income (loss)</b>	<b>\$ 89</b>	<b>\$ (19)</b>	<b>\$ (46)</b>	<b>\$ (124)</b>	<b>\$ (60)</b>	<b>\$ (210)</b>	<b>\$ (96)</b>	<b>\$ 429</b>

(1) DAR refers to the combination of depreciation, amortization and impairment, and aircraft rent expense.

(2) In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$124 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(3) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of \$125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of \$46 million to this provision.

(Canadian dollars in millions, except where indicated)	2010	2011				2012		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Revenue passenger miles (millions)	11,756	12,355	13,677	16,126	12,065	12,946	13,868	16,258
Available seat miles (millions)	14,918	15,859	16,512	18,799	15,290	16,344	16,606	18,835
Passenger load factor (%)	78.8	77.9	82.8	85.8	78.9	79.2	83.5	86.3
RASM (cents) <sup>(1)</sup>	15.1	14.5	15.6	15.5	15.4	15.2	15.9	15.9
CASM (cents)	17.4	17.8	17.2	15.8	18.3	18.7	17.6	15.4
Adjusted CASM (cents) <sup>(2)</sup>	12.8	12.2	11.5	10.6	12.6	12.3	11.9	10.7
Economic fuel price per litre (cents) <sup>(3)</sup>	67.5	78.2	87.9	85.8	88.6	91.6	90.8	87.8
<b>EBITDAR before the provision adjustment for cargo investigations and before the impact of benefit plan amendments <sup>(4)(5)(6)</sup></b>	<b>\$ 328</b>	<b>\$ 207</b>	<b>\$ 338</b>	<b>\$ 535</b>	<b>\$ 162</b>	<b>\$ 175</b>	<b>\$ 314</b>	<b>\$ 554</b>
<b>EBITDAR <sup>(6)</sup></b>	<b>\$ 374</b>	<b>\$ 207</b>	<b>\$ 338</b>	<b>\$ 535</b>	<b>\$ 162</b>	<b>\$ 175</b>	<b>\$ 314</b>	<b>\$ 678</b>
<b>Adjusted net income (loss) <sup>(7)</sup></b>	<b>\$ (36)</b>	<b>\$ (148)</b>	<b>\$ -</b>	<b>\$ 193</b>	<b>\$ (167)</b>	<b>\$ (164)</b>	<b>\$ (7)</b>	<b>\$ 230</b>
<b>Net income (loss) per share</b>								
- Basic	\$ 0.31	\$ (0.07)	\$ (0.17)	\$ (0.45)	\$ (0.22)	\$ (0.76)	\$ (0.35)	\$ 1.55
- Diluted	\$ 0.27	\$ (0.07)	\$ (0.17)	\$ (0.45)	\$ (0.22)	\$ (0.76)	\$ (0.35)	\$ 1.54

(1) System RASM excludes the impact of a \$40 million favourable adjustment recorded in the fourth quarter of 2010.

(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.

(3) Excludes third party carriers, other than Jazz, operating under capacity purchase agreements. Includes fuel handling expenses. Economic fuel price per litre is a non-GAAP financial measure. Refer to section 4 of this MD&A for additional information.

(4) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of \$125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of \$46 million to this provision.

(5) In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$124 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(6) EBITDAR, excluding the impact of benefit plan amendments, and EBITDAR are non-GAAP financial measures. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.

(7) Adjusted net income (loss) is a non-GAAP financial measure. Refer to section 16 "Non-GAAP Financial Measures" of this MD&A for additional information.

## 9. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

### Summary of "Gain (Loss) on Financial Instruments Recorded at Fair Value"

The following is a summary of "gain (loss) 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:

(Canadian dollars in millions)	Third Quarter		First Nine Months	
	2012	2011	2012	2011
Fuel derivatives	\$ 2	\$ (18)	\$ (29)	\$ (27)
Interest rate swaps	(1)	(11)	(1)	(21)
Share forward contracts	2	(4)	2	(7)
Other	-	-	1	(3)
<b>Gain (loss) on financial instruments recorded at fair value</b>	<b>\$ 3</b>	<b>\$ (33)</b>	<b>\$ (27)</b>	<b>\$ (58)</b>

### Fuel Price Risk Management

Fuel price risk is the risk that future cash flows relating to jet fuel purchases will fluctuate because of changes in jet fuel prices. In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, Air Canada enters into derivative contracts with financial intermediaries.

In the third quarter of 2012, Air Canada recorded a gain of \$2 million in "Gain (loss) on financial instruments recorded at fair value" related to fuel derivatives (loss of \$29 million in the first nine months of 2012). In the third quarter of 2012, Air Canada purchased crude-oil and refined products-based call options covering a portion of 2012 and 2013 fuel exposure. The cash premium related to these contracts was \$10 million (\$38 million in the first nine months of 2012).

As of September 30, 2012, approximately 40% of Air Canada's anticipated purchases of jet fuel for the remainder of 2012 was hedged at an average West Texas Intermediate ("WTI") equivalent capped price of US\$104 per barrel. Air Canada's contracts to hedge anticipated jet fuel purchases over the 2012 period are comprised of call options. Air Canada has also hedged approximately 13% of its 2013 anticipated jet fuel purchases at an average capped price of US\$102 per barrel. The fair value of the fuel derivatives portfolio at September 30, 2012 was \$20 million in favour of Air Canada (\$11 million in favour of Air Canada as at December 31, 2011).

The following table outlines the notional volumes per barrel along with the WTI-equivalent weighted average capped price for each year currently hedged by type of derivative instruments as at September 30, 2012. Air Canada is expected to generate fuel hedging gains if oil prices increase above the average capped price.

Derivative Instruments	Term	Volume (bbls)	WTI-Equivalent Weighted Average Capped Price (US\$/bbl)
Call options	2012	2,335,768	\$104
Call options	2013	3,311,499	\$102

## 10. CRITICAL ACCOUNTING ESTIMATES

Information on Air Canada's critical accounting estimates is disclosed in section 13 "Critical Accounting Estimates" of Air Canada's 2011 MD&A dated February 9, 2012. There have not been any significant changes to Air Canada's critical accounting estimates from those disclosed at that time.

## 11. ACCOUNTING POLICIES

An overview of the accounting standard changes which Air Canada will be required to adopt in future years is disclosed in section 14 "Accounting Policies" of Air Canada's 2011 MD&A dated February 9, 2012. Accounting policies remain consistent with those disclosed at that time with the exception of the following:

### **Carbon Emissions Accounting Policy**

The European Union passed legislation for an Emissions Trading System ("ETS") which includes carbon emissions from aviation commencing January 2012, including for flights operated between Canada and countries within the European Union. The legislation requires aircraft operators to monitor and report on fuel use and emissions data. Air Canada began accounting for the terms of the ETS in January 2012. A cost of settlement accounting model is adopted whereby emission allowances granted by the European Union are recorded in Intangible assets on Air Canada's consolidated statement of financial position and are measured at fair value at the date of initial recognition with an offset to deferred income as a government grant. Purchased emission allowances are recorded at cost and also recognized in Intangible assets. The intangible assets are subsequently measured using the cost model in IAS 38, Intangible assets and will be de-recognized at the end of each emission compliance period as an offset to Air Canada's provision for emissions obligations. The intangible assets are subject to Air Canada's impairment of long-lived assets accounting policy. The government grant, measured based on the fair value of emission allowances at the date of initial recognition, is amortized as an offset to Other operating expenses over the emission compliance period based on volume of emissions generated during the period compared to the expected volume of emissions during the emission compliance period. A provision to deliver emission allowances is recognized, with an offset to Other operating expense, as carbon emissions are made using a weighted average cost model per unit of emission expected to be incurred for the emission compliance period as a whole. The emission allowances, net of the provision to deliver emission allowances, at September 30, 2012, was \$5 million and was recorded within Intangible assets on Air Canada's consolidated statement of financial position. The deferred credit related to the government grant was \$5 million and was recorded within Accounts payable and accrued liabilities on Air Canada's consolidated statement of financial position.

### **Accounting Standards and Amendments Issued But Not Yet Adopted**

Refer to Air Canada's 2011 Consolidated Financial Statement and Notes dated February 9, 2012 for information on new accounting standards and amendments not yet effective. Air Canada expects the most significant of these changes to apply to Air Canada to be related to IFRS 10 Consolidated Financial Statements and Amendments to IAS 19 Employee Benefits. A summary of the anticipated impact on Air Canada's consolidated financial statements is provided below.

### **IFRS 10 – Consolidated Financial Statements**

IFRS 10 requires an entity to consolidate an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC-12 Consolidation—Special Purpose Entities and parts of IAS 27 Consolidated and Separate Financial Statements. IFRS 10 is effective for annual periods beginning on or after January 1, 2013, with earlier application permitted.

Air Canada will adopt this standard effective January 1, 2013. The standard will be applied retrospectively with adjustment to the opening consolidated statement of financial position as at January 1, 2012. On adoption of IFRS 10, Air Canada expects the three Fuel Facility Corporations that are consolidated under SIC-12 to no longer be consolidated. No significant impact to the consolidated statement of operations is expected. The anticipated impact on the consolidated statement of financial position as at January 1, 2012 is summarized as follows:

	Increase (decrease)
Cash and cash equivalents	\$ (71)
Property and equipment	(150)
Current portion of long-term debt	(5)
Long-term debt	(199)
Other long-term liabilities	(6)
Deficit	(6)
Non-controlling interests	\$ (5)

### Amendments to IAS 19 - Employee Benefits

IAS 19 has been amended for annual periods beginning January 1, 2013 with retrospective application. The amendments to IAS 19 make significant changes to the recognition and measurement of defined benefit pension expense and termination benefits, and enhance the disclosures for employee benefits. Actuarial gains and losses are renamed 'remeasurements' and will be recognized immediately in OCI. Remeasurements recognized in Other Comprehensive Income ("OCI") will not be recycled through profit or loss in subsequent periods. The amendments also accelerate the recognition of past service costs whereby they are recognized in the period of a plan amendment, irrespective of whether the benefits have vested. The annual expense for a funded benefit plan will be computed based on the application of the discount rate to the net defined benefit asset or liability.

A number of other amendments to IAS 19 have been made to recognition, measurement and classification including those re-defining short-term and other long-term benefits guidance on the treatment of taxes related to benefit plans, guidance on risk/cost sharing factors and expanded disclosures.

Air Canada's current accounting policy for employee benefits for the immediate recognition of actuarial gains and losses in OCI is consistent with the requirements in the new standard, however, additional disclosures and the computation of annual expense based on the application of the discount rate to the net defined benefit asset or liability will be required in relation to the revised standard.

Upon retrospective application of the new standard on January 1, 2013, Air Canada expects restated net income for 2012 to be lower than originally reported under the current accounting standard. The decrease is expected to arise from net financing expense relating to the pension benefit liability which will be calculated using the discount rate used to value the benefit obligation. As the discount rate is expected to be lower than the expected rate of return on plan assets, consistent with Air Canada's current view and long-term historical experience, net financing expense will increase as the net interest attributable to plan assets will decline. The difference, if any, between the actual rate of return on plan assets and the discount rate, would be included in OCI as a remeasurement. The amended standard will not impact Air Canada's consolidated statement of financial position, or Air Canada's consolidated statement of cash flows.

The expected impact of the amended standard on the consolidated statement of operations is an increase to net financing expense relating to employee benefits of \$41 million for the three months ended September 30, 2012 and \$122 million for the nine months ended September 30, 2012, and an increase to Salary, wages and benefits of \$2 million for the three months ended September 30, 2012 and \$5 million for the nine months ended September 30, 2012, with an offset to OCI. The net result of these combine to produce no net impact to total comprehensive income.

## 12. OFF-BALANCE SHEET ARRANGEMENTS

Information on Air Canada's off-balance sheet arrangements is disclosed in section 15 "Off-Balance Sheet Arrangements" of Air Canada's 2011 MD&A dated February 9, 2012. There have been no material changes to Air Canada's off-balance sheet arrangements from what was disclosed at that time.

## 13. RELATED PARTY TRANSACTIONS

At September 30, 2012, Air Canada had no transactions with related parties as defined in the CICA Handbook – Part 1, except those pertaining to transactions with key management personnel in the ordinary course of their employment or directorship agreements.

## 14. RISK FACTORS

For a detailed description of risk factors associated with Air Canada, refer to section 18 "Risk Factors" of Air Canada's 2011 MD&A dated February 9, 2012. Air Canada is not aware of any significant changes to its risk factors from those disclosed at that time. Air Canada, however, provides the following updates:

The risk factors in Air Canada's 2011 MD&A dated February 9, 2012 related to Investigations by Competition Authorities relating to Cargo under *Current Legal Proceedings* are updated to account for the fact that, in the first quarter of 2012, Air Canada entered into a settlement agreement relating to class action proceedings in the United States concerning alleged anti-competitive cargo pricing activities. This settlement, for which final court approval was obtained during the third quarter of 2012, was made without any admission of liability. As a result of the settlement agreement, a payment of \$8 million was made in the first quarter of 2012 to settle the class action proceedings in the United States.

The status of matters relating to Air Canada's collective agreements with its principal union groups and discussed in the risk factors relating to Labour Costs and Labour Relations is updated as follows:

In 2011, tentative collective agreements with the CAW, the union representing Air Canada's customer service employees at airports and call centres, as well as with CUPE, the union representing its flight attendants, were concluded and, respectively, ratified or conclusively settled through arbitration. Also in 2011, Air Canada entered into a collective agreement with UNITE, the union representing the airline's London Heathrow-based employees. In the first quarter of 2012, Air Canada concluded agreements with the CAW, in relation to in-flight crew schedulers and flight operations crew schedulers, and with CALDA, in relation to flight dispatchers.

In June 2012, the decision of the arbitrator was issued in respect of the IAMAW final offer selection arbitration conducted in accordance with the process legislated by the federal government in the *Protecting Air Service Act*. The arbitrator's final offer selection concluded a new five-year collective agreement between Air Canada and the IAMAW which is in effect until March 31, 2016.

In July 2012, the decision of the arbitrator was issued in respect of the ACPA final offer selection arbitration conducted in accordance with the process legislated by the federal government in the *Protecting Air Service Act*. The arbitrator's final offer selection concluded a new five-year collective agreement between Air Canada and the ACPA which is in effect until April 1, 2016.

ACPA and the IAMAW have, each, independently, instituted proceedings to contest the constitutional validity of the legislation which referred to arbitration the resolution of the issues that had not been resolved in bargaining. Air Canada expects that in both cases the legislation (and therefore the collective agreements concluded through the arbitration process) will be upheld. ACPA is also contesting the award of the arbitrator appointed pursuant to the legislation to have it set aside. Air Canada is confident that it will prevail in upholding the award of the arbitrator.

## 15. CONTROLS AND PROCEDURES

### **Disclosure Controls and Procedures and Internal Controls over Financial Reporting**

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

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

In the Corporation's 2011 filings, the Corporation's CEO and CFO certified, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design and effectiveness of the Corporation's disclosure controls and procedures and the design and effectiveness of internal controls over financial reporting.

In the Corporation's third quarter 2012 filings, the Corporation's CEO and CFO certify, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design of the Corporation's disclosure controls and procedures and the design of internal controls over financial reporting.

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

### **Changes in Internal Controls over Financial Reporting**

There have been no changes to Air Canada's internal controls over financial reporting during the third quarter of 2012 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.



## 16. NON-GAAP FINANCIAL MEASURES

### EBITDAR

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

EBITDAR, excluding the impact of benefit plan amendments, and EBITDAR are reconciled to operating income (loss) as follows:

(Canadian dollars in millions)	Third Quarter			First Nine Months		
	2012	2011	Change \$	2012	2011	Change \$
<b>GAAP operating income (loss)</b>	\$ 421	\$ 270	\$ 151	\$ 391	\$ 277	\$ 114
<b>Add back:</b>						
Aircraft rent	85	80	5	255	249	6
Depreciation, amortization and impairment	172	185	(13)	521	554	(33)
<b>EBITDAR</b>	<b>\$ 678</b>	<b>\$ 535</b>	<b>\$ 143</b>	<b>\$ 1,167</b>	<b>\$ 1,080</b>	<b>\$ 87</b>
<b>Add back:</b>						
Benefit plan amendments	(124)	-	(124)	(124)	-	(124)
<b>EBITDAR, excluding the impact of benefit plan amendments</b>	<b>\$ 554</b>	<b>\$ 535</b>	<b>\$ 19</b>	<b>\$ 1,043</b>	<b>\$ 1,080</b>	<b>\$ (37)</b>

### Adjusted CASM

Air Canada uses Adjusted CASM to assess the operating performance of its ongoing airline business without the effects of fuel expense, the cost of ground packages at Air Canada Vacations and unusual items as such expenses may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$124 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age. Other airlines may not record such a credit. In addition, fuel expense fluctuates widely depending on many factors, including international market conditions, geopolitical events, jet fuel refining costs and Canada/U.S. currency exchange rates.

Air Canada also incurs expenses related to ground packages at Air Canada Vacations, which some airlines without comparable tour operator businesses may not incur. Therefore, excluding the impact of benefit plan amendments, fuel expense and the cost of ground packages at Air Canada Vacations from operating expenses generally allows for more meaningful comparisons of Air Canada's operating expense performance to those of other airlines. In addition, these costs do not generate ASMs and therefore excluding these costs from operating expense results, provides for a more meaningful comparison across periods when such costs may vary.

Operating expense, excluding the impact of benefit plan amendments, fuel expense and the cost of ground packages at Air Canada Vacations, is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning and may not be comparable to similar measures presented by other public companies.

Adjusted CASM is reconciled to GAAP operating expense as follows:

(Canadian dollars in millions, except where indicated)	Third Quarter			First Nine Months		
	2012	2011	Change	2012	2011	Change
<b>GAAP operating expense</b>	\$ 2,907	\$ 2,972	\$ (65)	\$ 8,888	\$ 8,636	\$ 252
<b>Remove:</b>						
Aircraft fuel	(963)	(943)	(20)	(2,740)	(2,567)	(173)
Cost of ground packages at Air Canada Vacations	(48)	(46)	(2)	(262)	(250)	(12)
Unusual item - Benefit plan amendments	124	-	124	124	-	124
<b>Operating expense, excluding the above-noted items</b>	\$ 2,020	\$ 1,983	\$ 37	\$ 6,010	\$ 5,819	\$ 191
<b>ASMs (millions)</b>	18,835	18,799	0.2%	51,785	51,170	1.2%
<b>Adjusted CASM</b>	¢ 10.7	¢ 10.6	1.6%	¢ 11.6	¢ 11.4	2.0%

### Adjusted Net Income (Loss) and Adjusted Net Income (Loss) Per Share – Diluted

Air Canada uses adjusted net income (loss) and adjusted net income (loss) per share – diluted to assess the performance of its business without the effects of foreign exchange, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value and unusual items. These measures are not recognized measures for financial statement presentation under GAAP, do not have a standardized meaning and may not be comparable to similar measures presented by other public companies.

(Canadian dollars in millions, except per share values)	Third Quarter			First Nine Months		
	2012	2011	Change \$	2012	2011	Change \$
<b>Net income (loss) for the period attributable to shareholders</b>	\$ 428	\$ (125)	\$ 553	\$ 120	\$ (193)	\$ 313
<b>Remove:</b>						
Benefit plan amendments	(124)	-	(124)	(124)	-	(124)
Foreign exchange (gain) loss	(71)	281	(352)	(97)	168	(265)
Net financing expense (income) relating to employee benefits	-	4	(4)	13	12	1
(Gain) loss on financial instruments recorded at fair value	(3)	33	(36)	27	58	(31)
Loss on investment in Aveos	-	-	-	65	-	65
Discontinued operations – Aveos	-	-	-	55	-	55
<b>Adjusted net income</b>	\$ 230	\$ 193	\$ 37	\$ 59	\$ 45	\$ 14
Weighted average number of outstanding shares used in computing diluted income per share (in millions)	279	282	(3)	279	284	(5)
<b>Adjusted net income per share – diluted</b>	\$ 0.82	\$ 0.68	\$ 0.14	\$ 0.21	\$ 0.16	\$ 0.05

## 17. GLOSSARY

**ACPA** – Refers to the Air Canada Pilots Association

**Atlantic passenger and cargo revenues** – Refers to revenues from flights that cross the Atlantic Ocean with origins and destinations principally in Europe

**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

**CALDA** – Refers to the Canadian Airline Dispatchers Association

**CASM** – Operating expense per ASM

**CAW** – Refers to the Canadian Auto Workers

**CUPE** – Refers to the Canadian Union of Public Employees

**EBITDAR** – EBITDAR is earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent and is a non-GAAP financial measure commonly used in the airline industry to view operating results before depreciation, amortization and impairment, and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Refer to section 16 of this MD&A for additional information

**Effective Ton Miles or ETMs** – Refers to the mathematical product of tonnage capacity times distance hauled

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

**IATA** – Refers to the International Air Transport Association

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

**Pacific passenger and cargo revenues** – Refers to revenues from flights that cross the Pacific Ocean with origins and destinations principally in Asia

**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 (baggage fees, which are included in passenger revenue, are removed for the purposes of calculating RASM)

**Percentage point (pp)** – A measure for the arithmetic difference of two percentages

**Revenue Passenger Carried** – Refers to IATA's definition of passenger carried whereby passengers are counted on a flight no. basis rather than by journey/itinerary or by leg

**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

**Revenue Ton Miles or RTMs** – Refers to the mathematical product of weight in tons of a shipment being transported by the number of miles that it is transported

**Yield** – Average passenger revenue per RPM (baggage fees, which are included in passenger revenue, are removed for the purposes of calculating yield)