ANNUAL REPORT 2013

AIR CANADA

1. HIGHLIGHTS

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

(Canadian dollars in millions, except where indicated)	Fourth Quarter 2013	Fourth Quarter 2012	Fourth Quarter $ Change	Full Year 2013	Full Year 2012	Full Year $ Change
Financial Performance Metrics						
Operating revenues	2,894	2,839	55	12,382	12,114	268
Operating income	135	47	88	619	442	177
Non-operating expense (1)	(141)	(107)	(34)	(617)	(522)	(95)
Income (loss) before income taxes and discontinued operations	(6)	(60)	54	2	(80)	82
Net income (loss) from continuing operations	(6)	(60)	54	10	(81)	91
Net loss from discontinued operations – Aveos	-	-	-	-	(55)	55
Net income (loss)	(6)	(60)	54	10	(136)	146
Adjusted net income (loss) (2)	3	(5)	8	340	55	285
Operating margin, excluding the impact of benefit plan amendments % (3)	1.8%	1.7%	0.1 pp	4.3%	2.6%	1.7 pp
Operating margin %	4.7%	1.7%	3.0 pp	5.0%	3.6%	1.4 pp
EBITDAR, excluding the impact of benefit plan amendments (3) (4)	277	283	(6)	1,433	1,320	113
EBITDAR (4)	359	283	76	1,515	1,447	68
EBITDAR margin, excluding the impact of benefit plan amendments % (3) (4)	9.6%	10.0%	(0.4) pp	11.6%	10.9%	0.7 pp
EBITDAR margin % (4)	12.4%	10.0%	2.4 pp	12.2%	11.9%	0.3 pp
Unrestricted liquidity (5)	2,364	2,018	346	2,364	2,018	346
Free cash flow (6)	(276)	(21)	(255)	(231)	199	(430)
Adjusted net debt (7)	4,351	4,137	214	4,351	4,137	214
Return on invested capital ("ROIC") %(8)	11.0%	7.9%	3.1 pp	11.0%	7.9%	3.1 pp
Diluted earnings (loss) per share	($0.02)	($0.22)	$0.20	$0.02	($0.51)	$0.53
Adjusted net income (loss) per share – diluted (2)	$0.01	($0.02)	$0.03	$1.20	$0.20	$1.00
Operating Statistics (9)			% Change			% Change
Revenue passenger miles (millions) ("RPM")	12,882	12,574	2.5	56,788	55,646	2.1
Available seat miles (millions) ("ASM")	16,033	15,484	3.5	68,573	67,269	1.9
Passenger load factor %	80.3%	81.2%	(0.9) pp	82.8%	82.7%	0.1 pp
Passenger revenue per RPM ("Yield") (cents)	19.6	19.7	(0.6)	19.1	19.0	0.5
Passenger revenue per ASM ("RASM") (cents)	15.7	16.0	(1.7)	15.9	15.8	0.6
Operating revenue per ASM (cents)	18.1	18.3	(1.6)	18.1	18.0	0.3
Operating expense per ASM ("CASM") excluding the impact of benefit plan amendments (cents) (3)	17.7	18.0	(1.8)	17.3	17.5	(1.5)
Adjusted CASM (cents) (10)	12.1	12.4	(2.3)	11.6	11.8	(1.5)
Average number of full-time equivalent ("FTE") employees (thousands) (11)	24.1	24.1	0.2	24.5	24.0	2.0
Aircraft in operating fleet at period end	352	351	0.3	352	351	0.3
Average fleet utilization (hours per day)	9.4	9.4	(0.2)	10.0	10.0	0.2
Aircraft frequencies (thousands)	131	134	(1.8)	548	557	(1.7)
Average aircraft flight length (miles)	807	798	1.1	837	828	1.1
Economic fuel cost per litre (cents) (12)	88.4	88.2	0.3	89.0	89.6	(0.6)
Fuel litres (millions)	943	941	0.2	3,993	4,021	(0.7)
Revenue passengers carried (millions) (13)	8.5	8.3	3.0	35.8	34.9	2.3

(1) *In 2013, Air Canada recorded an interest charge of $95 million related to the purchase of its senior secured notes which were to become due in 2015 and 2016.*

(2) *Adjusted net income (loss) and adjusted net income (loss) per share – diluted are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of the MD&A for additional information.*

(3) *In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans. In the third quarter of 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age. Refer to section 20 "Non-GAAP Financial Measures" of the MD&A for additional information.*

(4) *EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of the MD&A for additional information.*

(5) *Unrestricted liquidity refers to the sum of cash, cash equivalents, short-term investments and the amount of available credit under Air Canada's revolving credit facilities. At December 31, 2013, unrestricted liquidity was comprised of cash and short-term investments of $2,208 million and undrawn lines of credit of $156 million. At December 31, 2012, unrestricted liquidity was comprised of cash and short-term investments of $1,973 million and undrawn lines of credit of $45 million.*

(6) *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 9.5 of the MD&A for additional information.*

(7) *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 9.3 of the MD&A for additional information.*

(8) *Return on invested capital (ROIC) is a non-GAAP financial measure. Refer to section 20 of the MD&A for additional information*

(9) *Operating statistics (except for average number of FTE employees) include third party carriers (such as Jazz Aviation LP ("Jazz")) operating under capacity purchase agreements with Air Canada.*

(10) *Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of the MD&A for additional information.*

(11) *Reflects FTE employees at Air Canada. Excludes FTE employees at third party carriers (such as Jazz) operating under capacity purchase agreements with Air Canada.*

(12) *Includes fuel handling expenses. Economic fuel price per litre is a non-GAAP financial measure. Refer to sections 6 and 7 of the MD&A for additional information.*

(13) *Revenue passengers are counted on a flight number basis which is consistent with the IATA definition of revenue passengers carried.*

TABLE OF CONTENTS

1. Highlights 2
Message from the President and Chief Executive Officer 4
Management's Discussion and Analysis 6
2. Introduction and Key Assumptions 6
3. About Air Canada 7
4. Strategy 8
5. Overview 17
6. Results of Operations – Full Year 2013 versus Full Year 2012 20
7. Results of Operations – Fourth Quarter 2013 versus Fourth Quarter 2012 29
8. Fleet 40
9. Financial and Capital Management 43
    9.1. Liquidity 43
    9.2. Financial Position 43
    9.3. Adjusted Net Debt 44
    9.4. Working Capital 45
    9.5. Consolidated Cash Flow Movements 45
    9.6. Capital Expenditures and Related Financing Arrangements 46
    9.7. Pension Funding Obligations 47
    9.8. Contractual Obligations 49
    9.9. Share Information 52
10. Quarterly Financial Data 53
11. Selected Annual Information 55
12. Financial Instruments and Risk Management 56
13. Critical Accounting Estimates 59
14. Accounting Policies 62
15. Off-Balance Sheet Arrangements 63
16. Related Party Transactions 65
17. Sensitivity of Results 66
18. Risk Factors 67
19. Controls and Procedures 77
20. Non-GAAP Financial Measures 78
21. Glossary 82
Statement of Management's Responsibility for Financial Reporting 84
Independent Auditor's Report 85
Consolidated Financial Statements and Notes 86
Officers and Directors 146
Investor and Shareholder Information 147
Official Languages at Air Canada 147
Corporate Profile 148

MESSAGE FROM THE PRESIDENT AND CHIEF EXECUTIVE OFFICER

In 2013, we crossed a watershed in the transformation underway at Air Canada. During the year, we produced some of the strongest financial and operational results in our history, bringing us closer to our objective of sustainable profitability over the long term. Our present task is to secure and consolidate these accomplishments by focusing on the corporate priorities that have guided our renewal and positioned Air Canada to look confidently toward the future.

The company reported a record $340 million in adjusted net income for 2013 ($1.20 per diluted share), an improvement of $285 million ($1.00 per diluted share) from the previous year. On a GAAP basis, annual net income was $10 million or 2 cents per diluted share, versus a net loss of $136 million or 51 cents per diluted share in the prior year. Annual EBITDAR, excluding the impact of benefit plan amendments, was $1.43 billion, which marked an 8.6 per cent improvement over 2012.

These results reflected both a strong revenue and cost performance by our company. For the fifth consecutive year, operating revenue grew year-over-year, reaching a record $12.4 billion. System passenger revenue increased 2.6 per cent on capacity growth of 1.9 per cent due to positive traffic growth of 2.1 per cent and yield growth of 0.5 per cent, while adjusted unit costs decreased 1.5 per cent. Passenger revenue grew in most major markets, including domestic, transborder and on both the Atlantic and Pacific.

We reported a full year record load factor of 82.8 per cent, meaning our aircraft flew fuller than ever. At year-end, we had unrestricted liquidity of $2.4 billion. Adjusted net debt, having declined by $1.3 billion over the four previous years, increased by $214 million during the year to $4.3 billion, largely due to the purchase of four high density Boeing 777-300ER aircraft. However, Air Canada's financial leverage improved slightly year-over-year as the adjusted net debt to EBITDAR ratio decreased to 3.0 versus 3.1 a year earlier. Air Canada uses this ratio to manage financial leverage risk and aims to maintain it below 3.5.

For investors, of course, the ultimate measure is share price performance. In 2013, Air Canada shares were returned to the S&P/TSX Composite Index where they were the top performing stock for 2013, returning 323 per cent.

Air Canada also performed impressively on non-financial measures during the year, which began with the airline receiving a coveted 4-Star designation from Skytrax, making us the only international network carrier in North America to achieve this rating. We were recognized in virtually every important industry award competition throughout the year including, for the fourth consecutive year, "Best Airline in North America" in a worldwide survey of more than 18 million air travelers for Skytrax's 2013 World Airline Awards. Air Canada was also named "Canada's Favourite Airline for Business Travel" in the 2013 Ipsos Reid Business Traveler Survey – we were preferred by 81 per cent of frequent business travelers, an improvement of 12 percentage points over five years.

Finally, our workplace health and safety record was recognized by *Canadian Occupational Safety* magazine in its annual Canada's Safest Employer Awards for 2013. Among other things, eligibility for the award requires that in the previous five years a company has neither fatalities nor serious injuries nor occupational health and safety act charges.

Such success, on so many fronts, does not occur by happenstance but is instead the result of careful planning, hard work, determination and consistent execution. It also requires an understanding that in our dynamic and intensely competitive industry, one can never relent and settle for average but must instead strive to continuously improve. We will continue to do this by retaining our focus on our four corporate priorities that have brought us this far and that every employee in the company understands.

Our first priority is Cost Transformation, designed to transform our legacy full service cost structure so we may better withstand the periodic reversals endemic to our industry. In this regard, the foremost achievement of 2013 was the elimination of our Canadian pension plan solvency deficit. Based on preliminary estimates, these plans, which began 2013 with an aggregate deficit of $3.7 billion, are estimated to be in a small surplus position on a solvency basis as at January 1, 2014.

It is difficult to overstate the significance of this development. It provides reassurance to our employees and retirees that their pensions are secure. Moreover, it provides encouragement to the investment community, which tended to regard the solvency deficit as some form of overhanging corporate debt which diminished Air Canada's market value. They can now revisit their valuations of Air Canada and hopefully value us based on a higher multiple, closer to that applied to U.S. carriers.

Other important steps Air Canada took in 2013 to transform costs were a $1.4 billion refinancing of its 2010 high yield notes, the lowering of debt costs and extension of the debt's maturity by four years, a strengthening of our balance sheet by increasing cash balances, and improving our credit profile. Additionally, we were the first airline outside the U.S. to avail itself of the *full* benefits of a financing mechanism known as Enhanced Equipment Trust Certificates, which we used to finance the five new high density Boeing 777s on very favourable terms.

Complementing these steps were numerous cost reduction initiatives resulting from changes to our fleet. The most high-profile was the launch mid-year of Air Canada *rouge*™, a lower cost leisure carrier designed to enhance profits in leisure markets and to give us a means to continue to participate in these lower-margin markets.

We also introduced four new Boeing 777 aircraft with a higher seat density, reducing unit costs, and a Premium Economy cabin that creates additional revenue opportunities. Additionally, fleet rationalization continued as we transferred our EMBRAER 175 aircraft to a lower-cost regional carrier as part of a broader strategy to diversify regional flying. Further fleet changes are to continue in 2014 when we are due to start accepting delivery of Boeing 787 Dreamliners that will operate routes currently flown by less-efficient Boeing 767s.

These measures are the key drivers to an expected 15 per cent reduction in unit costs when compared to 2012, assuming that all other cost drivers remain at 2012 levels. Air Canada aims to realize this 15 per cent reduction in unit costs over the next five years.

Our second priority is Customer Engagement. While Air Canada regularly wins numerous awards for its service and again reported improved satisfaction levels in monthly customer surveys in 2013, we remain very focused on excelling in this area. This is not only necessary to maintain engagement, but also to anticipate and respond to changing customer expectations and increasing competition.

Among other initiatives during the year was the introduction of Premium Economy class on select Boeing 777 aircraft that will become more widely available with the arrival of our Dreamliners. We also reformulated our loyalty program and rebranded it as Air Canada Altitude™ to better align rewards with travel. Operational programs were implemented as well to improve the travel experience for customers, such as the creation of a cross-functional team dedicated to increasing on-time-performance that yielded double-digit improvements.

We anticipate customer satisfaction levels will be further bolstered with the arrival of Dreamliners into the fleet as these aircraft deliver a superior travel experience. In a similar vein, Air Canada also placed an order in 2013 for 61 Boeing 737 MAX aircraft, which, subject to completion of final documentation and other conditions, will replace our existing fleet of narrow body aircraft, with deliveries scheduled to begin in 2017, giving us one of the youngest fleets in North America. Looking ahead, Air Canada is introducing a customer-centric relationship management system to gather customer feedback that will help guide future engagement activities.

Recognizing that an engaged workforce is essential to the sustainability of any company where high standards of customer service are essential, our third priority, Culture Change, is aimed at ensuring our people have the right mindset, training and tools. We are fostering an environment that embraces leadership, accountability and entrepreneurship. Moreover, we continue to build on our existing programs and rewards to attract, engage, and retain the right talent.

In 2013, we started or expanded a number of training programs including a new on-board service program, a special Disney customer-service course for Air Canada *rouge*™ flight attendants, leadership training, additional French language training, online courses and a very extensive suite of new programs throughout all operational branches in preparation for the Dreamliner's arrival. Such programs have the beneficial effect of enhancing the skills of our employees, which also fosters employee engagement by demonstrating our commitment to invest in their future. Moreover, employees take pride in new aircraft types entering the fleet and the launch of new routes.

Commitment can also be expressed in other forms, such as being active through the company in one's community, which Air Canada Foundation encourages with an active employee component. And it is not only local communities that are benefitting. For example, through a matching donation program with the Air Canada Foundation and the Government of Canada, more than $200,000 was donated to the Canadian Red Cross on behalf of Air Canada employees and retirees to assist victims of Typhoon Haiyan in the Philippines.

The progress we are making on Culture Change is being recognized outside the company. In 2013, Air Canada was named one of Canada's Top 100 Employers from an initial list of 75,000 potential candidates. Each month, we receive 110,000 hits on our career page, and for every Air Canada job we fill, more than 100 people apply.

Our fourth priority is building an International Powerhouse. In addition to launching service to Istanbul and Seoul from Toronto in 2013, we announced an impressive list of new and expanded international routes and destinations to start in 2014. Among these is service between Toronto and Milan, Toronto and Tokyo-Haneda as well as enhanced service between Calgary and Tokyo-Narita to offer daily departures.

We also announced our intention to introduce seasonal, non-stop flights by Air Canada *rouge*™ from Toronto to Lisbon and Manchester and from Montreal to Barcelona and Nice in 2014. We also plan to offer a year-round service from Toronto to Dublin on Air Canada *rouge*™. Moreover, we have implemented capacity increases to existing destinations operated by Air Canada mainline from other Canadian hubs.

Key to our strategy is capturing global traffic flows by promoting our award-winning products and services to entice international travelers to fly Air Canada and connect through Canadian hubs, particularly Toronto. In 2013, we concluded an enhanced cooperation agreement with the Greater Toronto Airports Authority to grow global connecting traffic at Toronto. During the year sixth freedom revenue (international-to-international connections, including U.S.) at Toronto Pearson rose almost 3 per cent over 2012.

In conclusion, 2013 was a year of substantial achievement in which we produced record results and moved beyond simply managing some key challenges to actually establishing a foundation for sustainably strong results. This made it truly a watershed year in our ongoing transformation. But the long-term, sustained profitability we seek is not a destination; it is instead a condition that we must first achieve and then proactively maintain through ongoing, disciplined adherence to our priorities, as well as through innovation, adaptability, resilience and an ability to recognize and seize opportunity, taking measured risks where necessary.

I wish to thank our employees who work hard each day taking care of our customers and delivering them safely to their destinations. As well, thank you to our customers, shareholders, suppliers and other partners for their loyalty and support. It is our commitment to fulfill your expectations by building a stronger, sustainably profitable Air Canada.

Calin Rovinescu
President and Chief Executive Officer

2. INTRODUCTION AND KEY ASSUMPTIONS

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers, as the context may require, to Air Canada and/or one or more of Air Canada's subsidiaries, including its wholly-owned operating subsidiaries, Touram Limited Partnership ("Air Canada Vacations") and Air Canada *rouge* LP doing business under the trade name Air Canada *rouge*TM ("Air Canada *rouge*"). This MD&A provides the reader with a review and analysis, from the perspective of management, of Air Canada's financial results for the fourth quarter and the full year 2013. This MD&A should be read in conjunction with Air Canada's audited consolidated financial statements and notes for 2013. All financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), as set out in the CPA Canada Handbook – Accounting ("CPA Handbook"), which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), except 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 21 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of February 11, 2014. Certain comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year. Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 18 "Risk Factors" of this MD&A. Air Canada issued a news release dated February 12, 2014 reporting on its results for the fourth quarter and the full year 2013. This news release is available on Air Canada's website at **www.aircanada.com** and on SEDAR's website at **www.sedar.com**. For further information on Air Canada's public disclosures, including Air Canada's Annual Information Form, consult SEDAR at **www.sedar.com**.

CAUTION REGARDING FORWARD-LOOKING INFORMATION

Air Canada's public communications may include 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, energy prices, currency exchange and interest rates, competition, employee and labour relations, pension issues, 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 this MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of February 11, 2014 (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. As part of its assumptions, Air Canada assumes Canadian GDP growth of 2.0% to 3.0% for 2014. In addition, Air Canada expects that the Canadian dollar will trade, on average, at C$1.10 per U.S. dollar in the first quarter of 2014 and the full year 2014 and that the price of jet fuel will average 93 cents per litre for the first quarter of 2014 and 92 cents per litre for the full year 2014.

3. ABOUT AIR CANADA

Air Canada is Canada's largest domestic, U.S. transborder and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market and in the international market to and from Canada. In 2013, Air Canada, together with Jazz and other regional airlines operating flights on behalf of Air Canada under capacity purchase agreements, operated, on average, 1,498 daily scheduled flights to 181 direct destinations on five continents, comprised of 60 Canadian cities, 54 destinations in the United States and a total of 67 cities in Europe, the Middle East, Asia, Australia, the Caribbean, Mexico and South America. Domestic, U.S. transborder and international departures accounted for approximately 67%, 25% and 8%, respectively, of the 1,498 average daily departures. In 2013, Air Canada carried 35.8 million passengers.

At December 31, 2013, Air Canada operated a mainline fleet of 183 aircraft comprised of 81 Airbus narrow-body aircraft, 57 Boeing and Airbus wide-body aircraft and 45 EMBRAER 190 regional jets. In 2013, all of Air Canada's 15 EMBRAER 175 aircraft were transferred from the mainline fleet to Sky Regional Airlines Inc. ("Sky Regional"), a lower cost regional provider.

The Air Canada Leisure Group was created in 2012 with a goal of improving the airline's earnings capabilities and strengthening its competitive position. This leisure travel group represents a coordinated strategy which leverages the strengths of Air Canada, Air Canada *rouge*, and Air Canada Vacations. Air Canada Vacations is a leading Canadian tour operator. Based in Montreal and Toronto, Air Canada Vacations operates its business in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, Central and South America, South Pacific, Australia and Asia) by developing, marketing and distributing vacation travel packages. Air Canada Vacations also offers cruise packages in North America, Europe and the Caribbean.

The Air Canada Leisure Group is positioning itself in the highly competitive leisure market, with a strong value proposition and competitive cost structure, while benefiting from Air Canada's widely-recognized and respected brand, operational expertise, extensive global network, strong airport infrastructure and world-class loyalty program. Through Air Canada *rouge*, Air Canada expects to improve margins on leisure routes previously operated by the mainline fleet and pursue opportunities in international leisure markets made viable by Air Canada *rouge's* more competitive cost structure.

Air Canada enhances its domestic and transborder network through capacity purchase agreements ("CPAs") with regional airlines, namely Jazz, Sky Regional, Air Georgian Limited ("Air Georgian") and Exploits Valley Air Services Ltd. ("EVAS"), which operate flights on behalf of Air Canada under the Air Canada Express banner. At December 31, 2013, the Air Canada Express fleet was comprised of 41 Bombardier regional jets, 86 Dash-8 turboprop aircraft, 15 EMBRAER 175 regional jets and 17 Beech 1900 aircraft.

Air Canada is a founding member of the Star Alliance® network. Through Star Alliance® network's 28 member airlines, Air Canada is able to offer its customers access to approximately 1,328 destinations in 195 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges and other common airport facilities.

Air Canada participates in a transatlantic joint venture with United Airlines and Deutsche Lufthansa AG through which the carriers provide customers with more choice and streamlined service on routings between North and Central America, and Africa, India, Europe and the Middle East. This transatlantic joint venture, including its revenue share structure, was implemented effective January 1, 2010. Air Canada also has the ability to create a transborder joint venture with United Airlines.

Through its long-term relationship with Aimia Canada Inc. (formerly Aeroplan Canada Inc. and referred to as "Aeroplan" in this MD&A), Air Canada's loyalty program provider, Air Canada is able to build customer loyalty by offering those customers who are Aeroplan® members the opportunity to earn Aeroplan® Miles when they fly with Air Canada and with the 27 other Star Alliance® member airlines. Aeroplan is also Air Canada's single largest customer. The relationship with Aeroplan is designed to provide a stable and recurring source of revenue from the purchase of Air Canada seats by Aeroplan, which in turn are provided to Aeroplan® members who choose to redeem their Aeroplan® Miles for travel on Air Canada. Additionally, Aeroplan® members may also choose to redeem their Aeroplan® Miles for travel with the Star Alliance® member airlines. Furthermore, Aeroplan® members who are among Air Canada's most frequent flyers are recognized and rewarded through Air Canada Altitude™, a recognition program delivering a range of premium travel privileges and benefits depending on the status level they have reached.

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

4. STRATEGY

Over the last several years, Air Canada has made significant progress in positioning itself to improve services to customers, create value for shareholders and transform its corporate culture to one that embraces leadership, accountability and entrepreneurship among its employees. The airline has been taking concrete, aggressive and targeted actions to successfully improve its earnings and lower the overall risk profile of the company through the execution of strategic initiatives designed to lower its cost structure, improve its balance sheet, increase its return on invested capital, further improve its market-leading customer service programs, de-risk its pension plans and provide a more stable and positive environment to its employees.

Key Priorities

Air Canada's global strategy for sustained value creation and profitability is based on the following four key priorities:

- Cost transformation and revenue improvement
- International growth
- Customer engagement
- Culture change

Air Canada's key priorities are summarized below as are some of the airline's key achievements in 2013.

Cost Transformation and Revenue Improvement

Margin expansion through sustainable cost reduction and revenue enhancements remains a key priority at Air Canada. Over the last several years, Air Canada has taken significant actions to reduce costs and generate incremental revenue.

Key achievements in 2013

- Launched Air Canada *rouge*, the airline's new lower-cost leisure carrier.
- Introduced four new high-density Boeing 777 aircraft in a three-class configuration, including a premium economy cabin.
- Announced a mainline narrow-body fleet renewal plan that includes commitments, options and rights to purchase up to 109 Boeing 737 MAX aircraft, which is expected to further lower operating costs and improve the airline's competitive position. Deliveries are scheduled to begin in 2017 with two aircraft, 16 aircraft in 2018, 18 aircraft in 2019, 16 aircraft in 2020 and nine aircraft in 2021, subject to certain deferral and acceleration rights. The agreement with Boeing is subject to conclusion of final documentation and other conditions.
- Transferred the entire fleet of EMBRAER 175 aircraft to a lower cost regional provider and announced the expansion of its long-standing relationship with Air Georgian, one of the airline's four regional airline partners.
- Concluded an enhanced commercial relationship with the Greater Toronto Airports Authority ("GTAA") which will allow the airline to grow its share of international connecting traffic at Toronto Pearson Airport on a more cost effective basis.
- Concluded an agreement with the Government of Canada pursuant to which special pension funding arrangements are now in place through to December 31, 2020.
- Completed a $1.4 billion refinancing of the 2010 high yield notes, significantly lowering the airline's debt costs, strengthening its balance sheet by increasing cash balances and extending the debt's maturity by four years, and improving its credit profile.
- Received approval by the Office of the Superintendent of Financial Institutions ("OSFI") to implement previously announced amendments to its Canadian defined benefit pension plans, effectively lowering the pension solvency deficit under these plans.
- Concluded a private offering of enhanced equipment trust certificates ("EETCs"), having a face amount of US$715 million to finance five high-density Boeing 777 aircraft on favourable terms.

The airline is taking tangible steps to improve its earnings through the execution of strategic initiatives designed to lower its cost structure and increase its competitiveness. These include:

- The growth of Air Canada *rouge* to enhance margins in leisure markets and to pursue opportunities in international leisure markets made viable by Air Canada *rouge*'s lower cost structure.

- The introduction, in the first quarter of 2014, of the last of five new high-density Boeing 777 aircraft configured for high volume, leisure-oriented international routes.

- The introduction of Boeing 787 aircraft to operate existing Boeing 767 routes in a more efficient manner and to pursue international growth opportunities made viable by this aircraft's lower operating costs.

Air Canada has estimated that these initiatives, combined with other on-going cost reduction initiatives which are expected to deliver annual cost savings in excess of $100 million over the medium term, will drive a 15% reduction in CASM when compared to 2012, assuming that all other cost drivers remain at 2012 levels. Air Canada plans to realize this 15% reduction in CASM over the next five years.

The weakening in the value of the Canadian dollar in late 2013 and into early 2014 presents a cost challenge which Air Canada continues to actively monitor in order to seek and pursue corrective actions. Under the airline's risk management practices, U.S. currency derivatives and U.S. dollar cash reserves, which amounted to US$1,547 million and US$743 million, respectively, as at December 31, 2013, are employed to offset approximately 50% of the net U.S. dollar currency exposure in 2014. The currency derivatives enable Air Canada to purchase U.S. dollars at a weighted average price of C$1.0341. These derivatives and U.S. dollar cash reserves would serve to mitigate the cash flow exposure from any adverse currency movements in 2014; however the benefit of these hedging activities is recorded as a foreign exchange gain and not within operating income. As part of its risk mitigation strategy, Air Canada is also evaluating fares and cargo rates, additional cost reduction and revenue generating initiatives and continues to manage capacity in a disciplined manner, while also taking into account other market conditions.

Air Canada *rouge*

Air Canada *rouge* launched its operations on July 1, 2013 with a start-up fleet of four aircraft transferred from the mainline fleet – two Boeing 767-300ER and two Airbus A319 aircraft – with destinations to Athens, Edinburgh, Venice, the Dominican Republic, Cuba, Costa Rica and Jamaica. By the end of 2013, the Air Canada *rouge* fleet was comprised of eight Airbus A319 and two Boeing 767 aircraft. In 2014, additional Airbus A319 and Boeing 767-300 aircraft will be transferred from Air Canada's mainline fleet to Air Canada *rouge*, with the expectation that Air Canada *rouge* will have up to 33 aircraft in its fleet by the end of 2014. As new Boeing 787 aircraft enter the mainline fleet, additional Boeing 767 aircraft are expected to be transferred to Air Canada *rouge*. Air Canada *rouge* may operate up to 20 Boeing 767 and 30 Airbus A319 aircraft, for a total of 50 aircraft.

Through Air Canada *rouge*, Air Canada expects to enhance margins on leisure routes previously operated by Air Canada mainline and pursue opportunities in international leisure markets made viable by Air Canada *rouge*'s more competitive cost structure. Air Canada *rouge* operates under the principle of maintaining a long-term cost structure consistent with that of its competitors in the leisure market. Air Canada has estimated that the Airbus A319 and the Boeing 767 aircraft in Air Canada *rouge*'s operating fleet has a 21% and 29% lower CASM, respectively, than the mainline-operated Airbus A319 and Boeing 767 aircraft. This lower cost structure level is driven by increased seat density of Air Canada *rouge*-operated aircraft, lower wage rates and more competitive work rules in labour agreements, and by reduced overhead costs. Air Canada believes that the new lower cost structure will remain competitive over the long-term.

Introduction of High-Density Boeing 777 Aircraft

In 2013 and early 2014, Air Canada took delivery of five high-density Boeing 777-300ER aircraft following the successful closing of a financing on favourable terms involving the private offering of enhanced equipment trust certificates ("EETCs") in the aggregate face amount of US$715 million. These aircraft offer a new three-cabin configuration comprised of International Business Class, Premium Economy Class and Economy Class and are being deployed on select markets where there is a higher demand for economy travel. Air Canada has estimated that the new Boeing 777 aircraft, with its higher seat density configuration (458 seats), has a 21% lower CASM than the 349-seat Boeing 777 aircraft in Air Canada's current operating fleet.

Introduction of Fuel-Efficient Boeing 787 Aircraft

Air Canada also expects to start generating further cost savings with the arrival of the Boeing 787 Dreamliner in 2014. Air Canada is scheduled to take delivery of six Boeing 787-8 aircraft in 2014 and the remaining 31 aircraft between 2015 and 2019. The Boeing 787 will operate existing routes currently operated by Boeing 767 aircraft and will also permit the airline to pursue new international growth opportunities in a more efficient manner. The introduction of these aircraft into the mainline fleet will allow the airline to reduce operating expenses through fuel and maintenance savings. Air Canada has estimated that the fuel and maintenance efficiencies associated with the Dreamliner, combined with a greater number of seats, will allow for a much better unit cost performance – 29% below that of the Boeing 767 aircraft it will replace.

Narrow-Body Fleet Renewal Program

In December 2013, Air Canada announced an agreement with The Boeing Company ("Boeing") which includes firm orders, options and certain rights to purchase up to 109 Boeing 737 MAX narrow-body aircraft. The new aircraft will replace Air Canada's existing mainline fleet of Airbus narrow-body aircraft, creating one of the world's youngest, most fuel efficient and simplified airline fleets. The agreement with Boeing, which is subject to conclusion of final documentation and other conditions, includes firm orders for 33 737 MAX 8 and 28 737 MAX 9 aircraft, with substitution rights between them as well as for the 737 MAX 7 aircraft. The agreement also provides for options for 18 Boeing 737 MAX aircraft and certain rights to purchase an additional 30. Deliveries are scheduled to begin in 2017 with two aircraft, and with the remaining deliveries between 2018 and 2021. Air Canada has estimated that the projected fuel burn and maintenance cost savings on a per seat basis of greater than 20% will generate an estimated CASM reduction of approximately 10% as compared to the airline's existing narrow-body fleet.

Regional Airline Diversification

The collective agreement concluded in 2012 with the Air Canada Pilots Association ("ACPA"), the union representing Air Canada's pilots, permits the airline to better manage its fleet and productivity which, in turn, allows Air Canada to better compete in the current industry environment and to reduce costs. The new agreement improves Air Canada's competitive position by allowing more flexibility in its relationship with regional airlines and in the composition of the mainline fleet. In particular, the collective agreement allows Air Canada to conduct business with multiple regional partners whereas in the past it was limited in this regard. It also provides Air Canada the ability to operate up to 60 76-seat jets at the regional level. In mid-2013, the airline completed the transfer of all of its 15 EMBRAER 175 aircraft from the mainline fleet to Sky Regional, a lower cost regional provider. As a result of Sky Regional's more competitive cost structure, which is primarily driven by lower wages, benefits and overhead costs, Air Canada estimates that this aircraft's CASM has been reduced by 11%.

In addition, in December 2013, Air Canada concluded a memorandum of understanding to expand its relationship and amend its capacity purchase agreement with Air Georgian. Air Georgian has been selected to operate a number of regional routes starting in mid-2014, including transborder routes, using Canadair regional jet aircraft. The implementation of the amendment to the capacity purchase agreement remains subject to the parties making any necessary filings, obtaining regulatory approvals and finalizing documentation.

Other Revenue Optimization and Cost Reduction Initiatives

Air Canada's business strategy is focused on continuously evaluating and improving its cost structure to remain competitive and seeking initiatives to optimize revenues. Over the last several years, Air Canada has made significant progress, as evidenced by the completion of its successful cost transformation program in 2011 which drove annual recurring revenue increases and cost reduction of over $530 million.

The airline has now transitioned to a more permanent approach to business transformation. Air Canada's Business Transformation team leads continuous efforts and has a mandate which is two-fold, namely to pursue cost reduction opportunities and to transform the way the airline operates. This includes reviewing business processes, including those relating to supply chain and maintenance planning, implementing cross-functional improvement projects and improving employee productivity. The airline also continues to focus on optimizing agreements with suppliers and on improving aircraft turnaround times.

The airline remains focused on identifying and implementing revenue generating opportunities. As part of this strategy to continually improve revenue performance, Air Canada is implementing a new passenger revenue management system aimed at optimizing its revenue performance on the basis of a passenger's full trip itinerary as opposed to managing its network routes on a leg basis. Given the number of connecting passengers Air Canada serves, this new system will allow the airline to better optimize passenger flows across the network. Air Canada has estimated incremental annual revenues of in excess of $100 million beginning in 2015 as a result of this change.

Pension

In December 2013, the Government of Canada formally approved the *Air Canada Pension Plan Funding Regulations*, *2014* (the "2014 Regulations") under the *Pension Benefits Standards Act, 1985*. According to the terms of the 2014 Regulations, which are applicable to the period between 2014 and 2020, Air Canada will be required to make special payments under Air Canada's defined benefit plans of at least $150 million annually with an average of $200 million per year, to contribute an aggregate minimum of $1,400 million over seven years in solvency deficit payments, in addition to its pension current service payments. Air Canada may elect to opt out of the 2014 Regulations and have past service payments in respect of all Air Canada pension plans, collectively, determined in accordance with normal funding rules.

Based on preliminary estimates, in aggregate, the domestic registered pension plans are estimated to be in a small surplus position on a solvency basis as at January 1, 2014. The Canadian registered pension plans solvency deficit at January 1, 2013 was $3.7 billion. The projected elimination of the $3.7 billion deficit was the result of several factors: (i) a 13.8% return on investments during 2013, (ii) the implementation of pension benefit amendments which are estimated to have decreased the solvency deficit by approximately $970 million, (iii) contributions made by Air Canada for the year of $225 million in respect of the solvency deficit and (iv) the application of a prescribed discount rate of 3.9% to calculate its future pension obligations. Refer to section 9.7 of this MD&A for additional information relating to Air Canada's pension plan obligations.

International Expansion

International growth is one of the building blocks for making Air Canada stronger and more profitable. Over the last several years, Air Canada has been intensifying its focus on markets with high growth economies, such as Asian markets. Air Canada has also been working with the GTAA to transform Toronto Pearson into a leading North American airport to gain a greater share of the global international-to-international connection market. In addition, the airline has been strengthening its market presence through commercial partnerships.

Key achievements in 2013

- Introduced service from Toronto to Seoul and from Toronto to Istanbul, increased frequencies to Beijing from Toronto and Vancouver, and upgraded service between Calgary and Tokyo Narita to offer daily departures.

- Announced a major expansion of international services to Europe from Toronto, Montreal, Vancouver and Calgary, including from Toronto to Milan, the only non-stop service between Canada and Milan.

- Announced the introduction of daily flights between Toronto-Pearson and Tokyo-Haneda, the only non-stop flight between Canada and Tokyo-Haneda.

- Announced the introduction of seasonal non-stop flights by Air Canada *rouge* between Toronto-Lisbon, Toronto-Manchester, Montreal-Barcelona and Montreal-Nice. Air Canada also announced a year-round service from Toronto to Dublin, Ireland.

- Concluded a number of new codeshare agreements, including with Turkish Airlines, Etihad and Aer Lingus.

- Announced the expansion of a long-standing commercial cooperation agreement with Air China.

- Increased sixth freedom revenue (international to international, including U.S.) connecting at Toronto Pearson by almost 3% from 2012;

- Concluded an enhanced cooperation agreement with the GTAA to grow global connecting traffic at Toronto Pearson Airport.

Air Canada believes that Canada's multi-ethnic demographic profile provides the airline opportunities to benefit from a growing demand for international travel. Combined with a powerful brand franchise and industry leading products and services, Air Canada plans on leveraging its network in order to benefit from the higher margins generally available in international markets. The airline will also continue to leverage its world class hub at Toronto Pearson International Airport and other Canadian hubs with the objective of increasing global connecting traffic via Canada.

In 2014, Air Canada plans on selectively and profitably expanding its international services by leveraging the following competitive advantages:

- A widely-recognized brand and a strong position in the market for transatlantic and transpacific travel to and from Canada and to and from South America via Canada;
- An extensive and expanding global network, which is enhanced by the airline's membership in Star Alliance®, numerous codeshare agreements and participation in a revenue sharing transatlantic joint venture with United Airlines and Lufthansa;
- A flexible fleet mix, which provides the airline with the ability to easily redeploy capacity when changes in demand occur;
- Air Canada Altitude™, Air Canada's frequent flyer program, which recognizes the airline's most frequent flyers by offering them a range of exclusive travel privileges, including the benefits derived from Air Canada's partnership with the Aeroplan program, which allows all customers to earn and redeem Aeroplan® Miles with Canada's leading coalition loyalty program;
- Competitive products and services, including lie-flat beds in the International Business Class cabin, concierge services and Maple Leaf® lounges;
- Geographically well-positioned hubs (Toronto, Montreal, Vancouver and Calgary), which provide competitive advantages to serve customers travelling to or from the U.S. to Asia and Europe; and
- Access to the world through traffic rights and the benefits contained in Canada's numerous bilateral air agreements with other countries.

Air Canada's wide-body fleet is an important element of its strategy to develop its network internationally and further strengthen its position as a global player and the airline continues to invest in aircraft and products and services. Air Canada has recently expanded its wide-body fleet by adding Boeing 777-300ER high-density aircraft to the mainline fleet. These aircraft, which offer three classes of service, International Business Class, Premium Economy Class and Economy Class, are being deployed on routes where there is high demand for economy travel and smaller demand for business travel, such as Montreal to Paris and Vancouver to Hong Kong. In 2014, Air Canada will introduce these new aircraft on flights to London Heathrow from Vancouver and Montreal where demand calls for a larger supply of Economy and Premium Economy seats, in addition to International Business Class.

In addition, starting in the spring of 2014, Air Canada will begin taking delivery of the first of 37 Boeing 787 Dreamliners. This aircraft features a brand new contemporary décor and three cabins of service, International Business Class with 180-degree lie-flat pod seating, Premium Economy Class and Economy Class. The aircraft also offers an extensive choice of in-flight entertainment on enhanced-definition, seat-back touch screens along with power outlets and USB ports available for all customers. As Air Canada takes delivery of these new aircraft, certain of its Boeing 767 aircraft will be transferred to Air Canada *rouge*. The Dreamliner will improve the airline's competitiveness on routes currently flown by the less cost efficient Boeing 767 aircraft, and will allow Air Canada to fly to new international destinations and return to or enter markets that were not feasible in the past.

In 2014, Air Canada plans on expanding its international services to Europe from Toronto, Montreal, Vancouver and Calgary. The airline's summer 2014 schedule includes the introduction of year-round, non-stop service from Toronto to Milan, Italy with up to five weekly flights, offering the only non-stop service between Canada and Milan. In addition, Air Canada will increase its year-round Toronto-Istanbul non-stop service to daily flights from three times weekly. Air Canada will also deploy larger aircraft from its international wide-body fleet on flights from Calgary to London Heathrow and Frankfurt, as well as from Montreal to Brussels and Geneva in order to meet travel and cargo demand during the peak summer season.

In addition, in 2014, Air Canada will continue to bolster its Asia-Pacific presence. Beginning on July 1, 2014, Air Canada will operate daily flights between Toronto-Pearson and Tokyo-Haneda (Tokyo International Airport) using the Boeing 787 Dreamliner. The new year-round service will be both the only non-stop flight between Canada and Tokyo-Haneda, located less than 30 minutes from downtown Tokyo, and the first daytime flight to Tokyo-Haneda from North America. This will be the first deployment of Air Canada's Dreamliner aircraft in the Asian market and will feature the airline's new seating and cabin amenities. The new route will complement Air Canada's existing service to Tokyo Narita International Airport from Toronto, Calgary and Vancouver, which Air Canada will continue to offer. Both Japanese airports offer a wealth of onward domestic and international connections through All Nippon Airways and other Star Alliance® partners.

Air Canada *rouge*'s lower cost structure enables Air Canada to compete on a more cost effective basis in the leisure market. While the Airbus A319 aircraft operated by Air Canada *rouge* are being used to provide service to leisure destinations previously operated by Air Canada mainline, the Boeing 767-300ER aircraft operated by Air Canada *rouge* are being used to provide service to certain European and high volume North American leisure destinations previously operated by the mainline fleet as well as to new leisure destinations in Europe. As part of the 2014 summer schedule, Air Canada *rouge* plans to launch seasonal non-stop flights to Barcelona, Dublin, Lisbon, Manchester, Nice and Rome and to continue to operate its summer routes to Athens, Edinburgh and Venice. In addition, routes previously operated by Air Canada from Toronto and Montreal to Cuba, Dominican Republic, Bahamas, Barbados, Haiti, Cancun and Tampa, Florida, will be converted beginning in the spring of 2014 to Air Canada *rouge* service, for a total of 44 routes serving 28 vacation destinations, including Air Canada *rouge*'s new European destinations.

In 2014, Air Canada plans to continue to grow global international to international transit traffic via Canada through its world-class hub in Toronto and its strong international gateways in Montreal, Vancouver and Calgary. The airline believes that it has the potential to grow international to international transit traffic, particularly from the U.S., over the coming years given its award-winning products and services, geographically well-positioned hubs in Canada, extensive network and other competitive advantages. Based on an airline industry benchmark indicating the percentage of traffic from the U.S. to Europe and Asia by non-U.S. carriers, Air Canada's share is only 0.3%. Air Canada has determined that its fair share of this international to international transit traffic should be 1.5% and has estimated that an increase to this level would drive incremental annual revenues of more than $400 million.

Over the last several years, Air Canada has been working closely with the GTAA to transform Toronto Pearson into a leading North American airport in order to gain a greater share of the global international to international connection market. In this regard, the GTAA and Air Canada recently concluded an enhanced commercial relationship which is designed to deliver continued improvements to customer service and which will place Air Canada in a better position to capture a larger share of growing international traffic flows on a more cost effective basis. Toronto Pearson has a strategic advantage due to its proximity to densely populated major markets in the U.S. and is also a destination for a large number of business and leisure travelers. Moreover, Air Canada and its Star Alliance® partners' operations are consolidated in one terminal, and Toronto Pearson has efficient in-transit facilities which allow passengers and their bags to move seamlessly between Canada and U.S. Customs and Immigration.

The further development of commercial alliances with major international carriers continues to be an important aspect of Air Canada's business strategy. These commercial arrangements provide Air Canada with an effective way of leveraging expansion and broadening its network appeal. Air Canada is extending its global reach through its membership in Star Alliance® and through its participation in a transatlantic revenue sharing joint venture with United Airlines and Deutsche Lufthansa AG, referred to as A++. By coordinating pricing, scheduling and sales, Air Canada is better able to serve customers by offering more travel options, while reducing travel times. Air Canada is also achieving greater critical mass and network scope through numerous codeshare and interline agreements. For example, to complement Air Canada's new service to Istanbul, in 2013, Air Canada and Turkish Airlines concluded a reciprocal code-sharing agreement which ensures seamless connections on a single itinerary for customers travelling beyond Istanbul, throughout Turkey and to points in Central Asia, Africa and the Middle East. Air Canada also recently announced the expansion of a long-standing commercial cooperation agreement with Air China which will enable seamless bookings and connections for customers and their bags via the carriers' Vancouver, Toronto and Beijing hubs to six new China destinations and six new destinations in Canada.

Customer Engagement

Increasing customer satisfaction levels and growing the airline's premium customer base remain key elements of Air Canada's business strategy. In 2013, Air Canada received the following important industry awards which demonstrate its customers' appreciation of the airline's extensive network, alliance relationships and leading products and services, as well as their recognition of the dedication and professionalism of Air Canada's employees in delivering its world class products and services.

Key achievements in 2013

- "Best Airline in North America" by Global Traveler magazine, for a fifth consecutive year;
- "Best North American Airline for International Travel" and "Best North American Airline In-Flight Experience" by Business Traveler magazine, 2013 Best in Business Travel awards;
- "Best North American Airline for International Travel" and "Best Flight Attendants in North America" by Premier Traveler magazine, Best of 2013 awards;
- "Best Flight Experience to Canada" by readers of Executive Travel Magazine in their annual "Leading Edge Awards" readership survey of frequent international travelers, for a sixth consecutive year; and
- "Best Airline in North America" in a worldwide survey of more than 18 million air travelers conducted by independent U.K. research firm, Skytrax, for their 2013 World Airline Awards, for a fourth consecutive year.

Early in 2013, Air Canada was also recognized for its airport and onboard product and service improvements. The airline has become the only international network carrier in North America to receive a Four-Star ranking according to Skytrax. The much-coveted rating is considered an airline industry benchmark and is based on detailed, independently conducted, quality analysis by Skytrax across more than 800 different areas of airport and onboard product and service delivery.

In addition, Air Canada was named "Canada's Favourite Airline for Business Travel" in the 2013 Ipsos Reid Business Traveler Survey. Air Canada was preferred by 81% of frequent business travelers, an improvement of 12 percentage points over the past five years. The survey showed consistently strong ratings in customer preference from many of the airline's value-added products and services, including its frequent flyer recognition program, flight schedule and network and premium class products and services.

Air Canada was voted Best North American Airline by Asia Pacific travel trade in the 24th Annual TTG Asia Travel Awards 2013. The voters of this award are readers of the various TTG Asia publications and based mostly in Asia where there is a very high expectation of airline services.

Air Canada strives to give travelers every reason to fly Air Canada. The airline recognizes that its success is dependent on consistently delivering superior value and innovative products, continually striving to provide the highest levels of customer service, and anticipating the changing needs of customers. In this regard, Air Canada is introducing a customer centricity system which will allow it to gain valuable customer insights and better understand what each customer base values most in enhancements. It will also allow Air Canada to more effectively target its marketing offers in order to stimulate traffic and improve yields.

In order to provide additional incentives for customers to choose Air Canada for their travel needs while remaining competitive with other market offerings, in 2013 Air Canada enhanced and re-launched its frequent flyer recognition program under a new name – Air Canada Altitude. Air Canada Altitude offers a range of privileges, including priority travel services, upgrades to Business Class, and recognition across the Star Alliance® network. Air Canada Altitude members benefit from Air Canada's partnership with the Aeroplan® program, which provides a wide range of ways to earn and redeem valuable Aeroplan Miles, including flights to over 1,200 destinations worldwide.

In addition, Air Canada launched a new program entitled "Air Canada Corporate Rewards" that offers powerful online tools to help businesses of all sizes better manage their travel, reduce costs and earn rewards to enhance travel. The Air Canada Corporate Rewards program is designed to make it simpler for companies of any size to track their travel investment, obtain savings and also earn rewards for flying with Air Canada. Members are eligible to receive offers for discounts on Air Canada flights and services along with rewards such as complimentary eUpgrades, Maple Leaf Lounge access, advance seat selection and other exclusive special offers. This program, along with other attributes, such as the airline's expansive global network, International Business Class service, Maple Leaf Lounges and Aeroplan and Altitude loyalty programs, are designed to further boost Air Canada's leading position as the carrier of choice among Canadian business travellers.

Fostering Positive Culture Change

A cornerstone of Air Canada's business strategy is to transform its corporate culture to one that embraces leadership, accountability and entrepreneurship. Air Canada believes that a healthy and dynamic corporate culture provides a competitive advantage which can have a significant impact on its long-term performance.

In 2014, Air Canada will continue fostering positive changes to its culture by promoting;

- Entrepreneurship
- Engagement
- Empowerment
- Earnings for Performance

Over the last several years, Air Canada has sought to foster a common sense of purpose, shared values and common goals among employees. This important initiative is being delivered in many forms, including through executive presentations, daily communiques, monthly letters from senior executives, quarterly conference calls, and in many daily interactions. Specifically, Air Canada has focused on effectively communicating the rationale behind its strategic initiatives and the importance of adapting to changing market conditions.

Air Canada believes that employees are more likely to embrace culture change if they take an active part in the transformation. As such, Air Canada will continue to encourage employee feedback and ideas as employees are often in a good position to identify improvements and changes for success.

The cross-functional approach of the airline's operational excellence team is also driving employee engagement while increasing customer satisfaction levels. Air Canada has initiatives in place to ensure that existing and new employees understand how the airline and its employees work together to deliver on the customer promise. These include a new employee on-boarding experience and integrated management practices, as well as programs intended to foster Air Canada's leadership behaviours and values.

Air Canada's recognition programs celebrate employees who are living the airline's values and demonstrate great customer service in a variety of ways. Air Canada has also received several distinctive awards such as the previously mentioned Skytrax Four-Star ranking and Canada's Top 100 Employers for 2014. These initiatives and awards enable Air Canada's employees to enhance their role as brand ambassadors.

The airline is equally focused on ensuring that employees have the tools and training required to provide a culture of top customer care. Air Canada's customized and adapted language training for frontline employees ensures that customers receive service in their language of choice. In addition, Air Canada also offers specific programs geared towards different employee groups to foster professional development and growth. Internal networking opportunities, coaching and cross-branch projects allow Air Canada to keep employees exposed to its key business priorities.

To continue on this path of excellence, Air Canada is introducing innovative cross-functional customer service training, as well as defined-competency based leadership brand training, supported by both on-line and in-class learning offerings.

To encourage the development of a corporate culture, which is focused on transformation and performance, Air Canada has a profit sharing program in place which allows eligible employees to be rewarded for their contributions and share in the financial success of the airline. The profit sharing pool under the program is established based on 7.5% of adjusted profits (a financial measure similar to the adjusted net income measure reported by Air Canada) for the first 7% of Air Canada's adjusted profit margin, plus 25% of all adjusted profits above a 7% adjusted profit margin. Based on the financial results for the year ended December 31, 2013, the profit sharing program will pay out $31 million in early 2014. In addition, to further encourage employees to become owners of Air Canada, Air Canada employees have the ability to participate in the airline's Employee Share Ownership Plan, which has recently been refreshed to provide more flexibility for enrollment and a better company contribution. As at December 31, 2013, in aggregate, 23,698,796 shares or almost 8% of total issued and outstanding shares were held by Air Canada employees and unions under various programs, including 17,647,059 shares under a trust arrangement in connection with pension arrangements concluded in 2009.

In 2014, the airline will continue to promote employee awareness on the importance of Air Canada achieving its financial goals and will continue to communicate the message that a healthy financial profile can provide stability, lower risk and growth opportunities.

Air Canada is proud to be recognized as one of "Canada's Top 100 Employers" in an annual survey by Mediacorp Canada Inc., confirming the airline's progress on culture change. The national competition selects top companies after conducting a detailed review of their operations and human resources practices, including a comparison of others in their industry and region. The annual competition evaluates and identifies the country's leading companies and organizations for attracting and retaining employees. The competition focuses on eight key areas: physical workplace; work and social atmosphere; health, financial and family benefits; vacation and time off; employee communications; performance management; training and skills development and community involvement. In citing Air Canada, Mediacorp noted that Air Canada "recognizes and encourages employee volunteers through the Volunteer Involvement Program – donating airline tickets to charitable organizations where employees volunteer."

5. OVERVIEW

In 2013, Air Canada generated adjusted net income of $340 million, the highest in Air Canada's history and an improvement of $285 million from 2012. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information. On a GAAP basis, Air Canada reported net income of $10 million or $0.02 per diluted share compared to a net loss of $136 million or $0.51 per diluted share in 2012, an improvement of $146 million or $0.53 per diluted share.

Full Year 2013 Financial Summary

The following provides an overview of Air Canada's results of operations and financial position for the full year 2013 compared to the full year 2012.

- Operating revenues of $12,382 million, an increase of $268 million or 2% from 2012.
- Passenger revenues of $11,021 million, an increase of $284 million or 2.6% from 2012, on traffic growth of 2.1% and a yield improvement of 0.5%.
- An ASM capacity increase of 1.9% from 2012, slightly below the 2.0% to 2.5% full year 2013 ASM capacity growth projected in Air Canada's news release dated November 8, 2013. The lower than projected ASM capacity growth was due to minor adjustments in the flying schedule versus what Air Canada had assumed in its forecast.
- RASM growth of 0.6% from 2012, mainly reflecting the yield improvement of 0.5%.
- An adjusted CASM reduction of 1.5% from 2012, in line with the 1.5% to 2.0% decrease projected in Air Canada's news release dated November 8, 2013. Refer to section 20 "Non-GAAP Financial Measures" for additional information.
- Operating income of $619 million compared to operating income of $442 million in 2012, an improvement of $177 million. In 2012 and 2013, Air Canada recorded operating expense reductions related to benefit plan amendments of $127 million and $82 million, respectively, as a result of amendments to defined benefit pension plans determined in accordance with new collective agreements concluded in 2011 and 2012 and changes to non-unionized employee pension plans.
- Net income of $10 million or $0.02 per diluted share compared to a net loss of $136 million or $0.51 per diluted share in 2012. The net income in 2013 included foreign exchange losses of $120 million due to a weaker Canadian dollar, an interest charge of $95 million pertaining to the purchase of the airline's senior secured notes which were to become due in 2015 and 2016, an impairment charge of $30 million, and the favourable impact of benefit plan amendments of $82 million. The net loss in 2012 included foreign exchange gains of $106 million, the favourable impact of benefit plan amendments of $127 million as described above, a loss on the airline's investment in Aveos of $65 million and a net loss from discontinued operations – Aveos of $55 million.
- EBITDAR (excluding benefit plan amendments) of $1,433 million compared to EBITDAR (excluding benefit plan amendments) of $1,320 million in 2012, an increase of $113 million. Refer to section 20 "Non-GAAP Financial Measures" for additional information.
- Adjusted net income of $340 million or $1.20 per diluted share compared to adjusted net income of $55 million or $0.20 per diluted share in 2012, an improvement of $285 million or $1.00 per diluted share. Refer to section 20 "Non-GAAP Financial Measures" for additional information.
- Negative free cash flow of $231 million, a decline of $430 million from 2012. While operating cash flows improved year-over-year, which was consistent with the improvement in operating earnings, free cash flow was impacted by the addition of four Boeing 777-300ER aircraft delivered in 2013. 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 9.5 of this MD&A for additional information.

- Adjusted net debt amounted to $4,351 million at December 31, 2013, an increase of $214 million from December 31, 2012. The increase in adjusted net debt was largely due to the purchase of four Boeing 777 aircraft in 2013. The airline's adjusted net debt to EBITDAR (excluding benefit plan amendments) ratio was 3.0 at December 31, 2013 versus a ratio of 3.1 at December 31, 2012. Air Canada uses this ratio to manage its financial leverage risk and its objective is to maintain the ratio below 3.5. 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 9.3 of this MD&A for additional information.

- Unrestricted liquidity (cash, short-term investments and undrawn lines of credit) of $2,364 million at December 31, 2013 or 19% of annual operating revenues (December 31, 2012 – $2,018 million or 17% of annual operating revenues). Unrestricted liquidity refers to the sum of cash, cash equivalents, short-term investments and the amount of available credit under Air Canada's revolving credit facilities. At December 31, 2013, cash and short-term investments amounted to $2,208 million and undrawn lines of credit amounted to $156 million. At December 31, 2012, cash and short-term investments amounted to $1,973 million and undrawn lines of credit amounted to $45 million. Air Canada's principal objective in managing liquidity risk is to maintain a minimum unrestricted liquidity level of $1.7 billion.

- Return on invested capital ("ROIC") at December 31, 2013 of 11.0% versus 7.9% at December 31, 2012. Air Canada's goal is to achieve a sustainable ROIC of 10% to 13% by 2015. Refer to section 20 "Non-GAAP Financial Measures" for additional information.

Fourth Quarter 2013 Financial Summary

The following is an overview of Air Canada's results of operations and financial position for the fourth quarter of 2013 compared to the fourth quarter of 2012.

- Operating revenues of $2,894 million, an increase of $55 million or 2% from the fourth quarter 2012.

- Passenger revenues of $2,560 million, an increase of $47 million or 1.9% from the fourth quarter of 2012, on traffic growth of 2.5% as yield declined 0.6% year-over-year.

- An ASM capacity increase of 3.5% from the fourth quarter of 2012, in line with the 3.0% to 4.0% fourth quarter 2013 ASM capacity increase projected in Air Canada's news release dated November 8, 2013.

- A RASM decrease of 1.7% from the fourth quarter of 2012, reflecting a 0.9 percentage point decline in passenger load factor and the yield decrease of 0.6%.

- An adjusted CASM reduction of 2.3% from the fourth quarter of 2012, in line with the 2.0% to 3.0% decrease projected in Air Canada's news release dated November 8, 2013. Refer to section 20 "Non-GAAP Financial Measures" for additional information.

- Operating income of $135 million compared to operating income of $47 million in the fourth quarter of 2012, an improvement of $88 million. In the fourth quarter of 2013, Air Canada recorded an operating expense reduction in benefit plan amendments of $82 million.

- A net loss of $6 million or $0.02 per diluted share compared to a net loss of $60 million or $0.22 per diluted share in the fourth quarter of 2012. The net loss in 2013 included foreign exchange losses of $55 million due to a weaker Canadian dollar and the favourable impact of benefit plan amendments of $82 million. The net loss in 2012 included foreign exchange gains of $9 million.

- EBITDAR (excluding benefit plan amendments) of $277 million compared to EBITDAR of $283 million in the fourth quarter of 2012, a decrease of $6 million. Refer to section 20 "Non-GAAP Financial Measures" for additional information. Air Canada estimates that December 2013 EBITDAR was negatively impacted by $15 million as a result of severe weather conditions.

- Adjusted net income of $3 million or $0.01 per diluted share compared to an adjusted net loss of $5 million or $0.02 per diluted share in the fourth quarter of 2012, an improvement of $8 million or $0.03 per diluted share. Refer to section 20 "Non-GAAP Financial Measures" for additional information.

- Negative free cash flow of $276 million, a decline of $255 million from the fourth quarter of 2012. While operating cash flows improved year-over-year, which was consistent with the improvement in operating earnings, free cash flow was impacted by the addition of two Boeing 777-300ER aircraft delivered in the fourth quarter of 2013. 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 9.5 of this MD&A for additional information.

6. RESULTS OF OPERATIONS – FULL YEAR 2013 VERSUS FULL YEAR 2012

The following table and discussion compares results of Air Canada for the full year of 2013 versus the full year of 2012.

	Full Year		Change	
(Canadian dollars in millions, except per share figures)	**2013**	**2012**	**$**	**%**
Operating revenues				
Passenger	$ 11,021	$ 10,737	$ 284	3
Cargo	474	488	(14)	(3)
Other	887	889	(2)	–
Total revenues	**12,382**	**12,114**	**268**	**2**
Operating expenses				
Aircraft fuel	3,534	3,561	(27)	(1)
Wages, salaries, and benefits	2,247	2,110	137	6
Benefit plan amendments(1)	(82)	(127)	45	(35)
Capacity purchase agreements	1,123	1,072	51	5
Airport and navigation fees	983	992	(9)	(1)
Aircraft maintenance	632	672	(40)	(6)
Sales and distribution costs	613	603	10	2
Depreciation, amortization and impairment(2)	578	669	(91)	(14)
Aircraft rent	318	336	(18)	(5)
Food, beverages and supplies	289	291	(2)	(1)
Communications and information technology	190	188	2	1
Other	1,338	1,305	33	3
Total operating expenses	**11,763**	**11,672**	**91**	**1**
Operating income	**619**	**442**	**177**	
Non-operating income (expense)				
Foreign exchange gain (loss)	(120)	106	(226)	
Interest income	32	37	(5)	
Interest expense(3)	(397)	(304)	(93)	
Interest capitalized	46	18	28	
Net financing expense relating to employee benefits	(208)	(288)	80	
Gain (loss) on financial instruments recorded at fair value	37	(20)	57	
Loss on investments in Aveos	–	(65)	65	
Other	(7)	(6)	(1)	
Total non-operating expense	**(617)**	**(522)**	**(95)**	
Income (loss) before income taxes and discontinued operations	**2**	**(80)**	**82**	
Income taxes	8	(1)	9	
Net income (loss) from continuing operations	**$ 10**	**$ (81)**	**$ 91**	
Net loss from discontinued operations – Aveos	**$ –**	**$ (55)**	**$ 55**	
Net income (loss)	**$ 10**	**$ (136)**	**$ 146**	
Adjusted net income(4)	**$ 340**	**$ 55**	**$ 285**	
EBITDAR, excluding benefit plan amendments(1)(5)	**$ 1,433**	**$ 1,320**	**$ 113**	
EBITDAR(5)	**$ 1,515**	**$ 1,447**	**$ 68**	
Basic and diluted earnings (loss) per share from continuing operations	**$ 0.02**	**$ (0.31)**	**$ 0.33**	
Basic and diluted loss per share from discontinued operations	**$ –**	**$ (0.20)**	**$ 0.20**	
Basic and diluted earnings (loss) per share	**$ 0.02**	**$ (0.51)**	**$ 0.53**	
Adjusted net income per share – diluted(4)	**$ 1.20**	**$ 0.20**	**$ 1.00**	

(1) *In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans. In 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.*

(2) *In 2013, Air Canada recorded an impairment charge of $30 million, of which $24 million related to Airbus A340-300 aircraft.*

(3) *In 2013, Air Canada recorded an interest charge of $95 million related to the purchase of its senior secured notes which were to become due in 2015 and 2016.*

(4) *Adjusted net income (loss) and adjusted net income (loss) per share – diluted are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.*

(5) *EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.*

System passenger revenues increased 2.6% from 2012

In 2013, on capacity growth of 1.9%, system passenger revenues of $11,021 million increased $284 million or 2.6% from 2012 system passenger revenues of $10,737 million. The increase in system passenger revenues year-over-year was due to traffic growth of 2.1% and a yield improvement of 0.5%. In 2013, system premium cabin revenues decreased $4 million or 0.2%, driven by a traffic decline of 2.3% partly offset by yield growth of 2.1%.

The table below provides passenger revenue by geographic region for 2013 and 2012.

Passenger Revenue	2013 $ Million	2012 $ Million	$ Change	% Change
Canada	4,237	4,178	59	1.4
U.S. transborder	2,176	2,130	46	2.1
Atlantic	2,263	2,114	149	7.1
Pacific	1,618	1,568	50	3.2
Other	727	747	(20)	(2.7)
System	**11,021**	**10,737**	**284**	**2.6**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for 2013 versus 2012.

Full Year 2013 Versus Full Year 2012	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	1.4	2.0	2.3	0.2	(0.8)	(0.5)
U.S. transborder	2.1	(0.1)	1.7	1.4	0.1	1.9
Atlantic	7.1	2.0	2.1	–	5.0	5.0
Pacific	3.2	6.7	4.3	(1.9)	(1.1)	(3.3)
Other	(2.7)	(4.7)	(3.2)	1.3	0.2	1.8
System	**2.6**	**1.9**	**2.1**	**0.1**	**0.5**	**0.6**

In 2013, Air Canada's system capacity was 1.9% higher than in 2012, with capacity growth reflected in all markets with the exception of the U.S. transborder and Other markets.

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

- The 2.1% traffic increase which reflected traffic growth in all markets with the exception of the Other markets.
- The 0.5% yield increase which reflected yield growth in all markets with the exception of the domestic and Pacific markets. A favourable foreign currency impact of $27 million in 2013 was a contributing factor in the yield improvement year-over-year. The impact of a higher proportion of longer-haul flying in 2013 partly offset the yield growth.

The 0.6% RASM increase was mainly due to the yield growth of 0.5%. RASM improvements were recorded in all markets with the exception of the domestic and Pacific markets.

Refer to section 7 of this MD&A for year-over-year percentage changes in passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter for the fourth quarter 2013 and each of the four previous quarters.

Domestic passenger revenues increased 1.4% from 2012

In 2013, on a capacity increase of 2.0%, domestic passenger revenues of $4,237 million increased $59 million or 1.4% from 2012. The increase in domestic passenger revenues was mainly due to traffic growth of 2.3%. The 2.0% capacity increase reflected capacity growth on all major domestic services with the exception of routes within Ontario and Quebec. While overall domestic market capacity increased starting in May 2013, regional competitive pressures mainly increased in the fourth quarter of 2013.

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

- The 2.3% traffic increase which reflected traffic growth on all major domestic services with the exception of regional routes within Ontario and Quebec where capacity was reduced year-over-year.

- Domestic yield decreased 0.8% which reflected declines on all major domestic routes with the exception of transcontinental routes, linking Toronto, Montreal and Ottawa with major western Canadian cities, and on routes within western Canada. Rapidair™ routes, linking Toronto and Montreal/Ottawa, regional routes within Ontario and Quebec, and routes to the Maritimes were impacted by increased industry capacity and aggressive pricing activities.

The 0.5% RASM decrease was due to the yield decline of 0.8% partly offset by a 0.2 percentage point improvement in passenger load factor. RASM improvements were recorded on all major domestic services with the exception of regional routes within Ontario and Quebec and on routes within western Canada.

U.S. transborder passenger revenues increased 2.1% from 2012

In 2013, with capacity essentially unchanged from 2012, U.S. transborder passenger revenues of $2,176 million increased $46 million or 2.1% from 2012. The increase in U.S. transborder passenger revenues was mainly due to traffic growth of 1.7% and an increase in baggage fee revenues year-over-year (baggage fee revenues are not included in Air Canada's yield and RASM results).

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

- The traffic increase of 1.7% which reflected traffic growth on all major U.S. transborder services with the exception of certain services, such as western Canada-western U.S. and Hawaii, where capacity was reduced year-over-year.

- A year-over-year increase in baggage fee revenues.

- The 0.1% yield increase which reflected yield growth on U.S. long-haul routes and on routes to Florida and Hawaii, which was largely offset by the impact of increased industry capacity and aggressive pricing activities on U.S. short-haul routes, such as Boston, New York and Washington, D.C., as well as the impact of a higher proportion of longer-haul flying when compared to 2012. A favourable foreign currency impact of $11 million in 2013 was a contributing factor in the yield improvement year-over-year.

The 1.9% RASM increase was mainly due to a 1.4 percentage point improvement in passenger load factor. RASM improvements were recorded on all major U.S. transborder services with the exception of U.S. short-haul routes where RASM remained at 2012 levels.

Atlantic passenger revenues increased 7.1% from 2012

In 2013, on a capacity increase of 2.0%, Atlantic passenger revenues of $2,263 million increased $149 million or 7.1% from 2012 due to yield and traffic growth of 5.0% and 2.1%, respectively. The capacity growth of 2.0% reflected capacity increases on all major Atlantic services with the exception of Spain, Greece and Switzerland.

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

- The 5.0% yield increase which reflected yield growth on all major Atlantic services. A favourable currency impact of $22 million also contributed to the yield increase in 2013.
- The 2.1% traffic increase which reflected traffic growth on all major Atlantic services with the exception of certain services, such as Spain and Greece and Switzerland, where capacity was reduced year-over-year. Air Canada benefits from increased traffic through its transatlantic revenue sharing joint venture with United Airlines and Lufthansa, referred to as A++. In addition, the successful launch of Air Canada *rouge* on July 1st, 2013 allowed the airline to capture additional traffic from Canada to Europe.

The 5.0% RASM increase was due to the yield growth of 5.0% as passenger load factor was unchanged from 2012. RASM improvements were recorded on all major Atlantic services.

Pacific passenger revenues increased 3.2% from 2012

In 2013, on capacity growth of 6.7%, Pacific passenger revenues of $1,618 million increased $50 million or 3.2% from 2012. The increase in Pacific passenger revenues was due to traffic growth of 4.3% as yield declined 1.1% year-over-year. The 6.7% Pacific capacity increase reflected capacity growth on all major Pacific services.

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

- The 4.3% traffic increase which reflected traffic growth on all major Pacific services with the exception of Australia and, to a lesser extent, Japan.
- The 1.1% yield decrease which reflected yield declines on services to Japan, Australia and Korea. Air Canada's Japan service was negatively impacted by increased industry capacity on the Pacific, aggressive pricing activities and a weaker Japanese Yen versus the Canadian dollar in 2013. The weaker economic environment in Australia resulted in a decline in higher-yielding product bookings and fare discounting in an effort to stimulate traffic. In addition, increased industry capacity and a higher proportion of lower yielding traffic put pressure on yields on services to Korea. Overall, the Pacific market had an unfavourable currency impact of $15 million in 2013, of which $30 million was due to a weaker Japanese Yen.

The 3.3% RASM decrease was mainly due to a 1.9 percentage point decline in passenger load factor and the yield decrease of 1.1%.

Other passenger revenues decreased 2.7% from 2012

In 2013, on a capacity reduction of 4.7%, Other passenger revenues (comprised of routes to the Caribbean, Mexico and Central and South America) of $727 million decreased $20 million or 2.7% from 2012. The decline in Other passenger revenues was mainly due to a traffic decrease of 3.2%. The capacity reduction reflected capacity decreases on services to South America and on routes to traditional sun destinations.

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

- The overall 3.2% traffic decrease which reflected traffic declines on all major services in the Other markets.
- The overall 0.2% yield increase which reflected yield growth on routes to South America. Early in 2013, the South American markets were impacted by increased industry capacity and more aggressive pricing activities led by U.S. carriers. By the end of 2013, the South American markets had rebounded with strong passenger load factors and stronger yields.

The 1.8% RASM increase was mainly due to a 1.3 percentage point improvement in passenger load factor.

Cargo revenues decreased 2.9% from 2012

In 2013, cargo revenues of $474 million decreased $14 million or 2.9% from 2012 due to a yield decline of 3.4% partly offset by traffic growth of 0.5%.

The table below provides cargo revenue by geographic region for 2013 and 2012.

Cargo Revenue	Full Year 2013 $ Million	Full Year 2012 $ Million	Change $ Million
Canada	63	68	(5)
U.S. transborder	18	17	1
Atlantic	171	177	(6)
Pacific	185	184	1
Other	37	42	(5)
System	**474**	**488**	**(14)**

The table below provides year-over-year percentage changes in cargo revenues and operating statistics for 2013 versus 2012.

Full Year 2013 Versus Full Year 2012	Cargo Revenue % Change	Capacity (ETMs) % Change	Rev / ETM % Change	Traffic (RTMs) % Change	Yield / RTM % Change
Canada	(7.7)	1.9	(9.4)	(6.4)	(1.4)
U.S. transborder	0.9	0.5	0.4	3.4	(2.4)
Atlantic	(3.2)	1.4	(4.6)	(0.8)	(2.5)
Pacific	1.1	5.7	(4.4)	3.7	(2.5)
Other	(13.2)	(7.6)	(6.0)	(5.9)	(7.8)
System	**(2.9)**	**2.1**	**(4.9)**	**0.5**	**(3.4)**

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

- The 3.4% yield decrease which reflected yield declines in all markets. Despite favourable currency impacts, cargo yields in 2013 were negatively impacted by aggressive pricing activities in an effort to stimulate traffic.
- The 0.5% traffic increase which reflected traffic growth in the U.S. transborder and Pacific markets. Weaker demand for cargo services and increased competition were the main reasons for the traffic declines in the domestic, Atlantic and Other markets. The Atlantic market was also impacted by weaker economic conditions.

Refer to section 7 of this MD&A for year-over-year percentage changes in cargo revenues, capacity, traffic, passenger load factor, yield and RASM by quarter for the fourth quarter of 2013 and each of the four previous quarters.

Other revenues decreased $2 million from 2012

Other revenues consist primarily of revenues from the sale of the ground portion of vacation packages, ground handling services, and other airline-related services, as well as revenues related to the lease or sublease of aircraft to third parties.

In 2013, Other revenues of $887 million decreased $2 million from 2012. A reduction in aircraft sublease and property lease revenues year-over-year was almost fully offset by an increase in passenger and airline-related fees and by higher ground package revenues at Air Canada Vacations when compared to 2012.

CASM (excluding benefit plan amendments) decreased 1.5% from 2012. Adjusted CASM decreased 1.5% from 2012

The following table compares Air Canada's 2013 and 2012 CASM.

	Full Year		Change	
(cents per ASM)	**2013**	**2012**	**cents**	**%**
Aircraft fuel	5.15	5.29	(0.14)	(2.6)
Wages and salaries	2.48	2.41	0.07	2.9
Benefits	0.67	0.72	(0.05)	(6.9)
Benefit plan amendments(1)	(0.12)	(0.19)	0.07	36.8
Capacity purchase agreements	1.64	1.59	0.05	3.1
Airport and navigation fees	1.43	1.47	(0.04)	(2.7)
Aircraft maintenance	0.92	1.00	(0.08)	(8.0)
Sales and distribution costs	0.89	0.90	(0.01)	(1.1)
Depreciation, amortization and impairment	0.84	0.99	(0.15)	(15.2)
Aircraft rent	0.46	0.50	(0.04)	(8.0)
Food, beverages and supplies	0.42	0.43	(0.01)	(2.3)
Communications and information technology	0.28	0.28	–	–
Other	2.09	1.96	0.13	6.6
CASM	**17.15**	**17.35**	**(0.20)**	**(1.1)**
Remove:				
Benefit plan amendments(1)	0.12	0.19	(0.07)	(36.8)
CASM (excluding benefit plan amendments)	**17.27**	**17.54**	**(0.27)**	**(1.5)**

(1) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans. In 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

CASM	**17.15**	**17.35**	**(0.20)**	**(1.1)**
Remove:				
Fuel expense, the cost of ground packages at Air Canada Vacations, benefit plan amendments and impairment charges	(5.55)	(5.57)	0.02	(0.4)
Adjusted CASM(1)	**11.60**	**11.78**	**(0.18)**	**(1.5)**

(1) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating expenses increased 1% from 2012

In 2013, operating expenses of $11,763 million increased $91 million or 1% from 2012, mainly reflecting increases in wages, salaries and benefits and capacity purchase costs. In addition, the result of an unfavourable impact of a weaker Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), when compared to 2012, increased operating expenses by $147 million. Furthermore, Air Canada recorded an operating expense reduction of $82 million in benefit plan amendments in 2013 versus an operating expense reduction of $127 million in 2012, an unfavourable variance of $45 million. Partly offsetting these increases was the impact of lower jet fuel prices and a reduction in the volume of fuel consumed, as well as decreases in depreciation, amortization and impairment, aircraft maintenance and aircraft rent expenses.

Fuel expense decreased 1% from 2012

In 2013, fuel expense of $3,534 million decreased $27 million or 1% from 2012. The decrease in fuel expense was mainly due to lower jet fuel prices, which accounted for a decrease of $84 million, and a lower volume of fuel consumed assisted by the airline's fuel efficiency program, which accounted for a decrease of $25 million. Partly offsetting these decreases was the unfavourable impact of a weaker Canadian dollar versus the U.S. dollar when compared to 2012, which accounted for an increase of $82 million to fuel expense in 2013.

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

	Full Year		Change	
(Canadian dollars in millions, except where indicated)	2013	2012	$	%
Aircraft fuel expense – GAAP	**$ 3,534**	**$ 3,561**	**$ (27)**	**(1)**
Add: Net cash payments on fuel derivatives(1)	21	40	(19)	(48)
Economic cost of fuel – Non-GAAP(2)	**$ 3,555**	**$ 3,601**	**$ (46)**	**(1)**
Fuel consumption (thousands of litres)	3,992,617	4,020,988	(28,371)	(0.7)
Fuel cost per litre (cents) – GAAP	88.5	88.6	(0.1)	–
Economic fuel cost per litre (cents) – Non-GAAP(2)	89.0	89.6	(0.6)	(0.6)

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

(2) The economic cost of fuel 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. 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 $2,247 million in 2013, an increase of $137 million or 6% from 2012

In 2013, wages and salaries expense of $1,704 million increased $80 million or 5% from 2012. The increase in wages and salaries year-over-year was mainly due to an increase of 2.0% in the average number of full-time equivalent (FTE) employees, higher average salaries and an increase in expense accruals related to the annual employee profit sharing programs. The growth in employment levels was mainly due to the increase in capacity and to a higher proportion of wide-body flying year-over-year.

In 2013, employee benefits expense of $543 million increased $57 million or 12% from 2012, mainly due to the impact of lower discount rates which increase the service cost of pension and other employee benefits.

Capacity purchase costs increased 5% from 2012

In 2013, capacity purchase costs of $1,123 million increased $51 million or 5% from 2012, mainly due to an increase in block hours flown by Sky Regional under its capacity purchase agreement with Air Canada, higher rates under Air Canada's capacity purchase agreement with Jazz (the "Jazz CPA") and an unfavourable currency impact. These increases were partly offset by a decline in block hours flown by Jazz under the Jazz CPA.

Airport and navigation fees decreased 1% from 2012

In 2013, airport and navigation fees of $983 million decreased $9 million or 1% from 2012, despite increased volume, mainly due to lower airport user fee rates versus 2012.

Aircraft maintenance expense decreased 6% from 2012

In 2013, aircraft maintenance expense of $632 million decreased $40 million or 6% from 2012. The decrease in aircraft maintenance expense was largely due to a lower volume of engine maintenance events. Partly offsetting this decrease were an increase in deicing activity and an unfavourable currency impact.

Sales and distribution costs increased 2% from 2012

In 2013, sales and distribution costs of $613 million increased $10 million or 2% from 2012 on passenger revenue growth of 2.6%. A decrease in commission expense was more than offset by an increase in credit card expenses, which was in line with sales and revenue growth, higher transaction fees paid to global distribution service providers which was largely due to a higher volume of transactions, as well as an unfavourable currency impact.

Depreciation, amortization and impairment expense decreased 14% from 2012

In 2013, depreciation, amortization and impairment expense of $578 million decreased $91 million or 14% from 2012.

In 2013, Air Canada recorded an impairment charge of $30 million, including $24 million related to four Airbus A340-300 aircraft (none of which were operated by Air Canada). No such impairment charge was recorded in 2012. More than offsetting this increase was the impact of certain engine and airframe maintenance events becoming fully amortized, the disposal of CRJ-100 aircraft (previously leased to and operated by Jazz), and a decrease in depreciation expense related to the airline's interior refurbishment programs.

Aircraft rent expense decreased 5% from 2012

In 2013, aircraft rent expense of $318 million decreased $18 million or 5% from 2012. The decline in aircraft rent expense was mainly due to lower lease rates when compared to 2012 (due to the impact of more favourable rates on lease renewals) and to aircraft lease terminations (for aircraft not being operated by Air Canada). Partly offsetting these decreases was a $4 million unfavourable currency impact.

Other operating expenses increased 3% from 2012

In 2013, Other operating expenses of $1,338 million increased $33 million or 3% from 2012, mainly due to higher terminal handling costs, an increase in Air Canada Vacations' land costs which was primarily due to higher passenger volumes, and an increase of $12 million in Remaining other expenses which included one-time startup expenses related to the transfer of EMBRAER 175 aircraft to Sky Regional.

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

	Full Year		Change	
(Canadian dollars in millions)	**2013**	**2012**	**$**	**%**
Terminal handling	$ 196	$ 184	$ 12	7
Air Canada Vacations' land costs	327	319	8	3
Building rent and maintenance	131	124	7	6
Crew cycle	120	116	4	3
Miscellaneous fees and services	128	138	(10)	(7)
Remaining other expenses	436	424	12	3
Other operating expenses	**$ 1,338**	**$ 1,305**	**$ 33**	**3**

Non-operating expense amounted to $617 million in 2013 compared to non-operating expense of $522 million in 2012

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

	Full Year		Change
(Canadian dollars in millions)	**2013**	**2012**	**$**
Foreign exchange gain (loss)	$ (120)	$ 106	$ (226)
Interest income	32	37	(5)
Interest expense	(397)	(304)	(93)
Interest capitalized	46	18	28
Net financing expense relating to employee benefits	(208)	(288)	80
Gain (loss) on financial instruments recorded at fair value	37	(20)	57
Loss on investment in Aveos	–	(65)	65
Other	(7)	(6)	(1)
Total non-operating expense	**$ (617)**	**$ (522)**	**$ (95)**

Factors contributing to the year-over-year change in full year non-operating expense included:

- Losses on foreign exchange, mainly related to U.S. denominated long-term debt, which amounted to $120 million in 2013 compared to gains of $106 million in 2012. The losses in 2013 were mainly attributable to a weaker Canadian dollar at December 31, 2013 when compared to December 31, 2012. The December 31, 2013 closing exchange rate was US$1 = C$1.0636 while the December 31, 2012 closing exchange rate was US$1 = C$0.9949. In 2013, losses on foreign exchange translation of $187 million were partly offset by gains on foreign currency derivatives of $68 million. Refer to section 12 of this MD&A for further information on foreign exchange risk management practices.

- In 2013, Air Canada recorded a charge of $95 million in interest expense pertaining to the purchase of its senior secured notes which were to become due in 2015 and 2016, comprised of $61 million related to tender premiums paid to noteholders, in respect of notes purchased, and $34 million related to the write-off of existing transaction costs and discounts. Refer to section 9.8 of this MD&A for additional information.

- An increase in interest capitalized of $28 million which was mainly due to a standby charge related to the EETC financing incurred prior to aircraft delivery and to higher purchase deposit balances. Refer to section 9.6 for additional information.

- A decrease in net financing expense relating to employee benefits of $80 million which was mainly due to the impact of lower pension liabilities.

- Gains related to fair value adjustments on financial instruments which amounted to $37 million in 2013 versus losses of $20 million in 2012. Refer to section 12 of this MD&A for additional information.

In 2012, Air Canada recorded a loss on its investment in Aveos' parent holding company as a result of Aveos' filing for court protection pursuant to the CCAA and ceasing operations in March 2012. As a result, Air Canada reduced the carrying value of its investment in Aveos' parent holding 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 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. In 2013, a cash outflow of $29 million (a cash outflow of $26 million in 2012) was incurred in relation to this separation program.

7. RESULTS OF OPERATIONS – FOURTH QUARTER 2013 VERSUS FOURTH QUARTER 2012

The following table and discussion compares results of Air Canada for the fourth quarter 2013 versus the fourth quarter of 2012.

	Fourth Quarter		Change	
(Canadian dollars in millions, except per share figures)	**2013**	**2012**	**$**	**%**
Operating revenues				
Passenger	$ 2,560	$ 2,513	$ 47	2
Cargo	128	126	2	2
Other	206	200	6	3
Total revenues	**2,894**	**2,839**	**55**	**2**
Operating expenses				
Aircraft fuel	831	821	10	1
Wages, salaries, and benefits	553	528	25	5
Benefit plan amendments[1]	(82)	–	(82)	–
Capacity purchase agreements	280	263	17	6
Airport and navigation fees	232	231	1	–
Aircraft maintenance	158	161	(3)	(2)
Sales and distribution costs	138	133	5	4
Depreciation, amortization and impairment	148	155	(7)	(5)
Aircraft rent	76	81	(5)	(6)
Food, beverages and supplies	71	68	3	4
Communications and information technology	45	47	(2)	(4)
Other	309	304	5	2
Total operating expenses	**2,759**	**2,792**	**(33)**	**(1)**
Operating income	**135**	**47**	**88**	
Non-operating income (expense)				
Foreign exchange gain (loss)	(55)	9	(64)	
Interest income	10	9	1	
Interest expense	(73)	(68)	(5)	
Interest capitalized	10	7	3	
Net financing expense relating to employee benefits	(53)	(72)	19	
Gain on financial instruments recorded at fair value	22	7	15	
Other	(2)	1	(3)	
Total non-operating expense	**(141)**	**(107)**	**(34)**	
Loss before income taxes and discontinued operations	**(6)**	**(60)**	**54**	
Income taxes	–	–	–	
Net loss	**$ (6)**	**$ (60)**	**$ 54**	
Adjusted net income (loss)[2]	**$ 3**	**$ (5)**	**$ 8**	
EBITDAR, excluding benefit plan amendments[1][3]	**$ 277**	**$ 283**	**$ (6)**	
EBITDAR[3]	**$ 359**	**$ 283**	**$ 76**	
Basic and diluted loss per share	**$ (0.02)**	**$ (0.22)**	**$ 0.20**	
Adjusted net income (loss) per share –diluted	**$ 0.01**	**$ (0.02)**	**$ 0.03**	

(1) *In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans.*

(2) *Adjusted net income (loss) and adjusted net income (loss) per share – diluted are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.*

(3) *EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.*

System passenger revenues increased 1.9% from the fourth quarter of 2012

In the fourth quarter of 2013, on capacity growth of 3.5%, system passenger revenues of $2,560 million increased $47 million or 1.9% from 2012 fourth quarter system passenger revenues of $2,513 million. The increase in fourth quarter system passenger revenues year-over-year was due to traffic growth of 2.5% partly offset by a 0.6% decline in fourth quarter yields.

In the fourth quarter of 2013, system premium cabin revenues increased $3 million or 0.5% on traffic and yield growth of 0.3% and 0.2%, respectively.

The table below provides passenger revenue by geographic region for the fourth quarter of 2013 and the fourth quarter of 2012.

Passenger Revenue	Fourth Quarter 2013 $ Million	Fourth Quarter 2012 $ Million	Change $ Million	% Change
Canada	1,040	1,051	(11)	(1.1)
U.S. transborder	523	484	39	8.1
Atlantic	462	450	12	2.7
Pacific	353	366	(13)	(3.2)
Other	182	162	20	11.5
System	**2,560**	**2,513**	**47**	**1.9**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the fourth quarter of 2013 versus the fourth quarter of 2012.

Fourth Quarter 2013 Versus Fourth Quarter 2012	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	(1.1)	3.2	2.6	(0.4)	(3.6)	(4.1)
U.S. transborder	8.1	1.6	4.0	1.8	4.2	6.6
Atlantic	2.7	5.9	1.7	(3.1)	0.7	(3.2)
Pacific	(3.2)	4.4	0.7	(3.0)	(4.0)	(7.4)
Other	11.5	0.6	5.0	3.4	6.5	11.1
System	**1.9**	**3.5**	**2.5**	**(0.9)**	**(0.6)**	**(1.7)**

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the fourth quarter 2013 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q4'12	Q1'13	Q2'13	Q3'13	Q4'13
Passenger revenues	5.8	0.1	3.2	4.9	1.9
Capacity (ASMs)	1.3	(1.1)	2.2	3.0	3.5
Traffic (RPMs)	4.2	1.1	1.6	2.9	2.5
Passenger load factor (pp change)	2.3	1.8	(0.5)	(0.1)	(0.9)
Yield	1.2	(1.1)	1.5	2.0	(0.6)
RASM	4.2	1.1	0.9	1.8	(1.7)

In the fourth quarter of 2013, Air Canada's system capacity was 3.5% higher than in the fourth quarter of 2012, with capacity growth reflected in all markets.

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

- The 2.5% traffic increase which reflected traffic growth in all markets.
- The 0.6% yield decrease which reflected yield declines in the domestic and Pacific markets partly offset by yield growth in the U.S. transborder, Atlantic and Other markets. The impact of a higher proportion of longer-haul flying in the fourth quarter of 2013 was also a contributing factor in the yield decline year-over-year. A favourable foreign currency impact of $24 million partly offset the yield decrease.

The 1.7% RASM decrease was due to a passenger load factor decline of 0.9 percentage points and the yield decrease of 0.6%. RASM declines were recorded in all markets with the exception of the U.S. transborder and Other markets.

Domestic passenger revenues decreased 1.1% from the fourth quarter of 2012

In the fourth quarter of 2013, on capacity growth of 3.2%, domestic passenger revenues of $1,040 million decreased $11 million or 1.1% from the fourth quarter of 2012. The decrease in domestic passenger revenues was due to a yield decline of 3.6% partly offset by traffic growth of 2.6%.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the fourth quarter 2013 and each of the previous four quarters.

Canada	Year-over-Year by Quarter (% Change)				
	Q4'12	Q1'13	Q2'13	Q3'13	Q4'13
Passenger revenues	7.2	1.5	3.1	2.1	(1.1)
Capacity (ASMs)	0.1	(0.6)	3.1	2.3	3.2
Traffic (RPMs)	3.3	1.8	3.0	1.7	2.6
Passenger load factor (pp change)	2.6	2.0	–	(0.5)	(0.4)
Yield	3.9	(0.1)	0.1	0.5	(3.6)
RASM	7.3	2.3	–	–	(4.1)

In the fourth quarter of 2013, domestic capacity growth of 3.2% reflected capacity increases on transcontinental routes, linking Toronto, Montreal and Ottawa with major western Canadian cities, and on routes within western Canada and to the Maritimes.

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

- The 2.6% traffic increase which reflected traffic growth on all major domestic services with the exception of regional routes within Ontario and Quebec where capacity was reduced year-over-year.
- The 3.6% yield decrease which reflected yield declines on all major domestic services, reflecting increased industry capacity and competitive pricing activities.

Domestic RASM decreased 4.1% from the fourth quarter of 2012.

U.S. transborder passenger revenues increased 8.1% from the fourth quarter of 2012

In the fourth quarter of 2013, on a capacity growth of 1.6%, U.S. transborder passenger revenues of $523 million increased $39 million or 8.1% from the fourth quarter of 2012. The increase in U.S. transborder passenger revenues was due to yield and traffic growth of 4.2% and 4.0%, respectively.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the fourth quarter 2013 and each of the previous four quarters.

U.S. Transborder	Year-over-Year by Quarter (% Change)				
	Q4'12	Q1'13	Q2'13	Q3'13	Q4'13
Passenger revenues	(3.3)	(2.6)	(0.3)	4.7	8.1
Capacity (ASMs)	2.7	0.4	(0.8)	(1.6)	1.6
Traffic (RPMs)	4.2	1.0	1.6	0.5	4.0
Passenger load factor (pp change)	1.1	0.4	1.9	1.7	1.8
Yield	(10.0)	(5.5)	(1.7)	4.7	4.2
RASM	(8.6)	(4.9)	0.7	7.0	6.6

In the fourth quarter of 2013, capacity on the U.S. transborder market increased 1.6% from the fourth quarter of 2012, reflecting capacity increases on U.S. short-haul routes and on services to Florida and Las Vegas.

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

- The 4.2% yield improvement which reflected higher average fares and a greater proportion of higher-yielding traffic in the Economy cabin. Yield growth was recorded on all major U.S. transborder services. A favourable currency impact of $6 million also contributed to the yield improvement in the fourth quarter of 2013. The yield growth was achieved in spite of the impact of a higher proportion of longer-haul flying when compared to 2012.
- The 4.0% traffic increase which reflected traffic growth on all major U.S. transborder services with the exception of services to Hawaii where capacity was reduced year-over-year.

The 6.6% RASM increase was due to the yield growth of 4.2% and a 1.8 percentage point improvement in passenger load factor. RASM improvements were recorded on all major U.S. transborder services.

Atlantic passenger revenues increased 2.7% from the fourth quarter of 2012

In the fourth quarter of 2013, on capacity growth of 5.9%, Atlantic passenger revenues of $462 million increased $12 million or 2.7% from the fourth quarter of 2012. The increase in Atlantic passenger revenues was due to traffic and yield growth of 1.7% and 0.7%, respectively.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the fourth quarter 2013 and each of the previous four quarters.

Atlantic	Year-over-Year by Quarter (% Change)				
	Q4'12	Q1'13	Q2'13	Q3'13	Q4'13
Passenger revenues	12.5	1.9	8.8	11.0	2.7
Capacity (ASMs)	0.1	(2.9)	2.5	2.1	5.9
Traffic (RPMs)	5.6	2.2	0.9	3.1	1.7
Passenger load factor (pp change)	4.1	3.8	(1.3)	0.8	(3.1)
Yield	7.8	0.8	7.7	7.6	0.7
RASM	13.7	6.1	6.0	8.6	(3.2)

In the fourth quarter of 2013, Atlantic capacity increased 5.9% from the fourth quarter of 2012, reflecting capacity growth on all major Atlantic services with the exception of services to Greece and Spain, which reflected an earlier end to seasonal operations when compared to the fourth quarter of 2012, and on services from Western Canada to Germany which reflected a seasonal capacity reduction in December 2013.

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

- The 1.7% traffic increase which reflected traffic growth on all major Atlantic services with the exception of certain services to the United Kingdom which was impacted by increased competitive pressures. Traffic declines on services to Greece and Spain were in line with the capacity reductions on those services while the airline's services to Scandinavia faced additional competitive capacity.

- The 0.7% yield improvement which reflected higher average fares and a greater proportion of higher-yielding traffic, particularly in the Economy cabin. Yield growth was recorded on all major Atlantic services. A favourable currency impact of $11 million also contributed to the yield improvement year-over-year.

The 3.2% RASM decrease was due to a 3.1 percentage point decline in passenger load factor, as overall traffic improvements were not sufficient to cover the capacity increases despite being partly offset by the yield growth of 0.7%.

Pacific passenger revenues decreased 3.2% from the fourth quarter of 2012

In the fourth quarter of 2013, on capacity growth of 4.4%, Pacific passenger revenues of $353 million decreased $13 million or 3.2% from the fourth quarter of 2012. The decrease in Pacific passenger revenues was due to a yield decline of 4.0% partly offset by traffic growth of 0.7%.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the fourth quarter 2013 and each of the previous four quarters. Revenues and related statistical data associated with Australia, which were previously classified within the Other category, have been reclassified into Pacific services, including in the comparative figures.

Pacific	Year-over-Year by Quarter (% Change)				
	Q4'12	Q1'13	Q2'13	Q3'13	Q4'13
Passenger revenues	11.8	9.2	3.7	3.8	(3.2)
Capacity (ASMs)	2.9	4.0	5.7	12.1	4.4
Traffic (RPMs)	5.0	5.4	2.3	8.5	0.7
Passenger load factor (pp change)	1.7	1.2	(2.9)	(2.9)	(3.0)
Yield	6.7	4.0	1.1	(4.8)	(4.0)
RASM	8.9	5.5	(2.3)	(7.9)	(7.4)

In the fourth quarter of 2013, the 4.4% Pacific capacity increase reflected capacity growth on services to Korea, Hong Kong and China partly offset by capacity reductions on services to Japan and Australia.

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

- The 4.0% yield decrease which reflected yield declines on all major Pacific services with the exception of Australia and Korea. Air Canada's Japan service was adversely impacted by increased industry capacity in the Pacific, aggressive pricing activities and a weaker Japanese Yen when compared to the fourth quarter of 2012. Significant increased industry capacity and a higher proportion of lower-yielding traffic put pressure on yields on services to China and Hong Kong.

- The 0.7% traffic increase which reflected traffic growth on services to China and Hong Kong. Air Canada's service to Japan was impacted by increased industry capacity. Traffic on services to Australia declined in line with the capacity reduction. Air Canada's winter service to Korea reverted to a daily service from Vancouver (previously the service to Korea was split between Toronto and Vancouver).

The 7.4% RASM decrease was due to the yield decline of 4.0% and a 3.0 percentage point decline in passenger load factor.

Other passenger revenues increased 11.5% from the fourth quarter of 2012

In the fourth quarter of 2013, on capacity growth of 0.6%, Other passenger revenues (comprised of routes to the Caribbean, Mexico and Central and South America) of $182 million increased $20 million or 11.5% from the fourth quarter of 2012. The increase in Other passenger revenues was due to yield and traffic growth of 6.5% and 5.0%, respectively.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the fourth quarter 2013 and each of the previous four quarters. Revenues and related statistical data associated with Australia, which were previously classified within the Other category, have been reclassified into Pacific services, including in the comparative figures.

Other	Year-over-Year by Quarter (% Change)				
	Q4'12	Q1'13	Q2'13	Q3'13	Q4'13
Passenger revenues	(2.4)	(12.0)	(5.1)	0.6	11.5
Capacity (ASMs)	2.0	(8.5)	(4.8)	(3.9)	0.6
Traffic (RPMs)	2.1	(7.8)	(3.2)	(3.7)	5.0
Passenger load factor (pp change)	0.1	0.6	1.3	0.1	3.4
Yield	(4.9)	(4.7)	(2.6)	4.1	6.5
RASM	(4.8)	(4.0)	(1.0)	4.2	11.1

In the fourth quarter of 2013, capacity growth on routes to traditional sun destinations was largely offset by a capacity reduction on services to South America.

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

- The overall 6.5% yield improvement which reflected higher fares on routes to traditional sun destinations and on services to South America.
- The overall 5.0% traffic increase which reflected strong passenger demand on routes to traditional sun destinations and on services to South America.

The overall 11.1% RASM increase was due to the yield growth of 6.5% and a passenger load factor improvement of 3.4 percentage points. RASM improvements were recorded on all major services in the Other markets. The airline's service to South America performed particularly well, with a double-digit RASM improvement when compared to the fourth quarter of 2012.

Cargo revenues increased 1.6% from the fourth quarter of 2012

In the fourth quarter of 2013, cargo revenues of $128 million increased $2 million or 1.6% from the fourth quarter of 2012, mainly due to traffic growth of 4.3% as yield declined 2.9% year-over-year.

The table below provides cargo revenue by geographic region for the fourth quarter of 2013 and the fourth quarter of 2012.

Cargo Revenue	Fourth Quarter 2013 $ Million	Fourth Quarter 2012 $ Million	Change $ Million
Canada	16	17	(1)
U.S. transborder	5	4	1
Atlantic	46	44	2
Pacific	50	47	3
Other	11	14	(3)
System	**128**	**126**	**1.6**

The table below provides year-over-year percentage changes in system cargo revenues and operating statistics for the fourth quarter 2013 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q4'12	Q1'13	Q2'13	Q3'13	Q4'13
Cargo Revenues	1.3	(8.8)	(6.5)	1.7	1.6
Capacity (ETMs)	1.2	(2.4)	3.5	1.2	3.5
Revenue per ETM	0.1	(6.5)	(9.7)	1.1	(2.2)
Traffic (RTMs)	5.1	(5.1)	(0.2)	2.9	4.3
Yield per RTM	(3.6)	(3.8)	(6.3)	(0.6)	(2.9)

The table below provides year-over-year percentage changes in cargo revenues and operating statistics for the fourth quarter of 2013 versus the fourth quarter of 2012.

Fourth Quarter 2013 Versus Fourth Quarter 2012	Cargo Revenue % Change	Capacity (ETMs) % Change	Rev / ETM % Change	Traffic (RTMs) % Change	Yield / RTM % Change
Canada	(6.1)	4.6	(10.2)	0.9	(6.9)
U.S. transborder	8.3	8.5	(0.2)	15.2	(6.0)
Atlantic	3.9	4.3	(0.4)	6.0	(2.1)
Pacific	6.8	2.5	4.2	7.4	(0.5)
Other	(19.5)	(0.4)	(19.3)	(14.8)	(5.5)
System	**1.6**	**3.5**	**(2.2)**	**4.3**	**(2.9)**

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

- The 4.3% traffic increase which reflected traffic growth in all markets with the exception of the Other markets.
- The 2.9% yield decrease which reflected yield declines in all markets. The air freight environment remains highly competitive. Despite favourable currency impacts, aggressive pricing activities in an effort to stimulate traffic negatively impacted cargo yields in the fourth quarter of 2013.

Other revenues increased 3% from the fourth quarter of 2012

In the fourth quarter of 2013, Other revenues of $206 million increased $6 million or 3% from the fourth quarter of 2012, mainly due to higher ground package revenues at Air Canada Vacations and an increase in passenger and airline-related fees. These increases were largely offset by a decrease in aircraft sublease revenues, in part due to the expiry of certain Airbus A340 subleases, when compared to the fourth quarter of 2012.

CASM (excluding benefit plan amendments) decreased 1.8% from the fourth quarter of 2012. Adjusted CASM decreased 2.3% from the fourth quarter of 2012

The following table compares Air Canada's fourth quarter 2013 and fourth quarter 2012 CASM.

	Fourth Quarter		Change	
(cents per ASM)	**2013**	**2012**	**cents**	**%**
Aircraft fuel	5.18	5.30	(0.12)	(2.3)
Wages and salaries	2.68	2.70	(0.02)	(0.7)
Benefits	0.76	0.71	0.05	7.0
Benefit plan amendments(1)	(0.51)	–	(0.51)	–
Capacity purchase agreements	1.74	1.70	0.04	2.4
Airport and navigation fees	1.45	1.49	(0.04)	(2.7)
Aircraft maintenance	0.99	1.04	(0.05)	(4.8)
Sales and distribution costs	0.86	0.86	–	–
Depreciation, amortization and impairment	0.92	1.00	(0.08)	(8.0)
Aircraft rent	0.48	0.52	(0.04)	(7.7)
Food, beverages and supplies	0.44	0.44	–	–
Communications and information technology	0.28	0.30	(0.02)	(6.7)
Other	1.94	1.98	(0.04)	(2.0)
CASM	**17.21**	**18.04**	**(0.83)**	**(4.6)**
Remove:				
Benefit plan amendments(1)	(0.51)	–	(0.51)	–
CASM (excluding benefit plan amendments)	**17.72**	**18.04**	**(0.32)**	**(1.8)**

(1) In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans.

CASM	**17.21**	**18.04**	**(0.83)**	**(4.6)**
Remove:				
Fuel expense, the cost of ground packages at Air Canada Vacations, benefit plan amendments and impairment charges	(5.12)	(5.67)	0.55	(9.7)
Adjusted CASM(1)	**12.09**	**12.37**	**(0.28)**	**(2.3)**

(1) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating expenses decreased 1% from the fourth quarter of 2012

In the fourth quarter of 2013, operating expenses of $2,759 million decreased $33 million or 1% from the fourth quarter of 2012, mainly reflecting the impact of an operating expense reduction of $82 million in benefit plan amendments and lower jet fuel prices year-over-year. Largely offsetting these decreases was the result of an unfavourable impact of a weaker Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), when compared to the fourth quarter of 2012, which increased operating expenses by $75 million in the fourth quarter of 2012. Higher fourth quarter 2013 wages, salaries and benefits expenses also served to offset the decrease in operating expenses.

Fuel expense increased 1% from the fourth quarter of 2012

In the fourth quarter of 2013, fuel expense of $831 million increased $10 million or 1% from the fourth quarter of 2012, mainly due to the unfavourable impact of a weaker Canadian dollar versus the U.S. dollar when compared to the fourth quarter of 2012, which accounted for a $41 million increase. Partly offsetting this increase was the impact of lower jet fuel prices, which accounted for a $32 million decrease to fuel expense in the fourth quarter of 2013.

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

	Fourth Quarter		Change	
(Canadian dollars in millions, except where indicated)	2013	2012	$	%
Aircraft fuel expense – GAAP	**$ 831**	**$ 821**	**$ 10**	**1**
Add: Net cash payments on fuel derivatives[1]	3	9	(6)	(67)
Economic cost of fuel – Non-GAAP[2]	**$ 834**	**$ 830**	**$ 4**	**1**
Fuel consumption (thousands of litres)	942,940	941,397	1,543	0.2
Fuel cost per litre (cents) – GAAP	88.2	87.2	1.0	1.2
Economic fuel cost per litre (cents) – Non-GAAP[2]	88.4	88.2	0.2	0.3

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

(2) The economic cost of fuel 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. 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 $553 million in the fourth quarter of 2013, an increase of $25 million or 5% from the fourth quarter of 2012

In the fourth quarter of 2013, wages and salaries expense of $431 million increased $12 million or 3% from the fourth quarter of 2012, largely due to an increase in expense accruals related to the annual employee profit sharing programs as well as higher average salaries.

In the fourth quarter of 2013, employee benefits expense of $122 million increased $13 million or 12% from the fourth quarter of 2012, mainly due to the impact of lower discount rates which increase the service cost of pension and other employee benefits.

Capacity purchase costs increased 6% from the fourth quarter of 2012

In the fourth quarter of 2013, capacity purchase costs of $280 million increased $17 million or 6% from the fourth quarter of 2012, mainly due to an increase in block hours flown by Sky Regional under its capacity purchase agreement with Air Canada, higher rates under the Jazz CPA and an unfavourable currency impact. These increases were partly offset by a decline in block hours flown by Jazz under the Jazz CPA.

Aircraft maintenance expense decreased 2% from the fourth quarter of 2012

In the fourth quarter of 2013, aircraft maintenance expense of $158 million decreased $3 million or 2% from the fourth quarter of 2012, mainly due to a lower volume of engine and airframe maintenance events. Largely offsetting this decrease was the impact of Air Canada having recorded a favourable adjustment of $32 million related to its end of lease maintenance return provision in the fourth quarter of 2012 while a favourable adjustment of $9 million was recorded in the fourth quarter of 2013. An unfavourable currency impact and higher deicing activity year-over-year were also offsetting factors.

Sales and distribution costs increased 4% from the fourth quarter of 2012

In the fourth quarter of 2013, sales and distribution costs of $138 million increased $5 million or 4% from the fourth quarter of 2012 on passenger revenue growth of 1.9%. The increase in sales and distributions costs year-over-year was largely due to an increase in transaction fees paid to global distribution service providers which was largely driven by a higher volume of transactions, an increase in credit card expenses which was in line with sales and revenue growth, and an unfavourable currency impact. A decrease in commission expense partly offset these increases.

Depreciation, amortization and impairment expense decreased 5% from the fourth quarter of 2012

In the fourth quarter of 2013, depreciation, amortization and impairment expense of $148 million decreased $7 million or 5% from the fourth quarter of 2012, largely due to the impact of certain engine and airframe maintenance events becoming fully amortized, the disposal of CRJ-100 aircraft (previously leased to and operated by Jazz), and a decrease in depreciation expense related to the airline's interior refurbishment programs.

Aircraft rent expense decreased 6% from the fourth quarter of 2012

In the fourth quarter of 2013, aircraft rent expense of $76 million decreased $5 million or 6% from the fourth quarter of 2012. The decrease in aircraft rent expense was mainly due to more favourable rates on lease renewals and aircraft lease terminations (in respect of aircraft not operated by Air Canada).

Other operating expenses increased 2% from the fourth quarter of 2012

In the fourth quarter of 2013, Other operating expenses of $309 million increased $5 million or 2% from the fourth quarter of 2012.

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

	Fourth Quarter		Change	
(Canadian dollars in millions)	2013	2012	$	%
Air Canada Vacations' land costs	$ 66	$ 57	$ 9	16
Terminal handling	48	42	6	14
Building rent and maintenance	34	32	2	6
Crew cycle	30	29	1	3
Miscellaneous fees and services	28	33	(5)	(15)
Remaining other expenses	103	111	(8)	(7)
Other operating expenses	**$ 309**	**$ 304**	**$ 5**	**2**

Non-operating expense amounted to $141 million in the fourth quarter of 2013 compared to non-operating expense of $107 million in the fourth quarter of 2012

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

	Fourth Quarter		Change
(Canadian dollars in millions)	2013	2012	$
Foreign exchange gain (loss)	$ (55)	$ 9	$ (64)
Interest income	10	9	1
Interest expense	(73)	(68)	(5)
Interest capitalized	10	7	3
Net financing expense relating to employee benefits	(53)	(72)	19
Gain on financial instruments recorded at fair value	22	7	15
Other	(2)	1	(3)
Total non-operating expense	**$ (141)**	**$ (107)**	**$ (34)**

Factors contributing to the year-over-year change in fourth quarter non-operating expense included:

- Losses on foreign exchange, mainly related to U.S. denominated long-term debt, which amounted to $55 million in the fourth quarter of 2013 compared to gains of $9 million in the fourth quarter of 2012. The losses in the fourth quarter of 2013 were mainly attributable to a weaker Canadian dollar at December 31, 2013 when compared to September 30, 2013. The December 31, 2013 closing exchange rate was US$1 = C$1.0636 while the September 30, 2013 closing exchange rate was US$1 = C$1.0303. In the fourth quarter of 2013, losses on foreign exchange translation of $93 million were partly offset by gains on foreign currency derivatives of $38 million. Refer to section 12 of this MD&A for additional information.

- An increase in interest capitalized of $3 million which was mainly due to a standby charge related to the EETC financing incurred prior to aircraft delivery.

- A decrease in net financing expense relating to employee benefits of $19 million which was mainly due to the impact of lower pension liabilities.

- Gains related to fair value adjustments on financial instruments which amounted to $22 million in the fourth quarter of 2013 versus gains of $7 million in the fourth quarter of 2012. Refer to section 12 of this MD&A for additional information.

8. FLEET

Mainline and Air Canada *rouge*

The following table provides Air Canada's and Air Canada *rouge*'s operating fleet as at December 31, 2013 (refer to the **Air Canada Express** section below for information on the fleet of aircraft operated by regional airlines operating flights on behalf of Air Canada under capacity purchase agreements with Air Canada).

	Total Seats	Number of Operating Aircraf	Average Age	Owned	Finance Lease	Owned – Special Purpose Entities(1)	Operating Lease
Mainline							
Wide-Body Aircraft							
Boeing 77H-300	458	4	0.3	4	–	–	–
Boeing 777-300	349	12	5.8	3	1	–	8
Boeing 777-200	270	6	6.1	4	–	–	2
Boeing 767-300	211	27	20.2	5	9	2	11
Airbus A330-300	265	8	13.2	–	–	8	–
Narrow-Body Aircraft							
Airbus A321	174	10	11.8	–	–	5	5
Airbus A320	146	41	20.7	–	–	–	41
Airbus A319	120	30	15.7	14	10	2	4
EMBRAER 190	97	45	6.8	45	–	–	–
Total Mainline		**183**	**13.7**	**75**	**20**	**17**	**71**
Air Canada *rouge*							
Wide-Body Aircraft							
Boeing 767-300(2)	264	2	11.0	–	–	–	2
Narrow-Body Aircraft							
Airbus A319(3)	142	8	15.3	6	–	–	2
Total Air Canada *rouge*		**10**	**14.5**	**6**	**–**	**–**	**4**
Total Mainline and Air Canada *rouge*		**193**	**13.7**	**81**	**20**	**17**	**75**

(1) *Aircraft under finance leases and aircraft under lease from special purpose entities that are consolidated by Air Canada are carried on Air Canada's consolidated statement of financial position.*

(2) *Starting in 2014, Boeing 767-300 aircraft operated by Air Canada rouge will have a seat density of 282.*

(3) *The six Airbus A319 aircraft reflected as owned in the table above are owned by Air Canada and leased to Air Canada rouge.*

The following table provides the number of aircraft in Air Canada's operating fleet as at December 31, 2013, as well as Air Canada's expected operating fleet, including aircraft currently operated and expected to be operated by Air Canada *rouge*, as at December 31, 2014, December 31, 2015 and December 31, 2016.

	Actual	Planned					
	December 31, 2013	2014 Fleet Changes	December 31, 2014	2015 Fleet Changes	December 31, 2015	2016 Fleet Changes	December 31, 2016
Mainline							
Boeing 787-8	–	6	6	4	10	3	13
Boeing 787-9	–	–	–	2	2	5	7
Boeing 777-300	16	1	17	–	17	–	17
Boeing 777-200	6	–	6	–	6	–	6
Boeing 767-300	27	(6)	21	(4)	17	(5)	12
Boeing 737 MAX	–	–	–	–	–	–	–
Airbus A330-300	8	–	8	–	8	–	8
Airbus A321[(1)]	10	–	10	5	15	–	15
Airbus A320[(1)]	41	–	41	5	46	–	46
Airbus A319	30	(17)	13	(5)	8	–	8
EMBRAER 190	45	–	45	(20)	25	–	25
Total Mainline	183	(16)	167	(13)	154	3	157
Air Canada *rouge*							
Boeing 767-300	2	6	8	4	12	3	15
Airbus A319	8	17	25	5	30	–	30
Total Air Canada *rouge*	10	23	33	9	42	3	45
Total Mainline and Air Canada *rouge*	193	7	200	(4)	196	6	202

(1) In 2015, Air Canada plans to replace 20 EMBRAER 190 aircraft with 10 larger narrow-body leased aircraft. As of the date of this MD&A, the type of replacement aircraft has not yet been determined however, solely for illustrative purposes, in the table above, Air Canada has assumed these to be five Airbus A320 and five Airbus A321 aircraft.

Air Canada has an agreement with Boeing to take delivery of 37 Boeing 787 aircraft, the first six of which are scheduled for 2014 and the remaining 31 between 2015 and 2019. The firm order is comprised of 15 787-8 and 22 787-9 aircraft. The 15 787-8 aircraft are scheduled for delivery starting in the spring of 2014 while the 22 larger-capacity 787-9 aircraft are scheduled for delivery starting in July 2015.

In December 2013, Air Canada announced that it had selected the Boeing 737 MAX aircraft as its new replacement narrow-body aircraft. The renewal of its narrow-body fleet with more fuel efficient aircraft is a key element of the airline's on-going cost transformation program. Air Canada continues to evaluate the potential replacement of its EMBRAER 190 fleet with more cost efficient, larger narrow-body aircraft that are better suited to its current and future network strategy. As part of the Boeing 737 MAX order, Boeing will be purchasing 20 of the 45 EMBRAER 190 aircraft currently in the airline's fleet. The EMBRAER 190 aircraft exiting the fleet will initially be replaced with larger leased narrow-body aircraft until the airline takes delivery of the Boeing 737 MAX aircraft. In the first half of 2014, Air Canada will be reviewing various options regarding its remaining 25 EMBRAER 190 aircraft, including whether to continue to operate them or to replace them with an as of yet undetermined number of larger aircraft in the 100 to 150 seat range.

Refer to section 9.6 of this MD&A for information on Air Canada's aircraft purchase commitments.

Air Canada Express

The following table provides, as at December 31, 2013, the number of aircraft operated by Jazz, Sky Regional and other airlines operating flights on behalf of Air Canada under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada.

	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
Total	**122**	**20**	**17**	**159**

The following table provides, as at December 31, 2014, the number of aircraft planned to be operated by Jazz, Sky Regional and other airlines operating flights on behalf of Air Canada under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada.

	Planned December 31, 2014			
	Jazz	Sky Regional	Other	Total
EMBRAER 175	–	15	–	15
CRJ-200	25	–	5	30
CRJ-705	16	–	–	16
Dash 8-100	34	–	–	34
Dash 8-300	26	–	–	26
Dash 8-400	21	5	–	26
Beech 1900	–	–	17	17
Total	**122**	**20**	**22**	**164**

In December 2013, Air Canada announced that it had signed a memorandum of understanding to expand its relationship and amend its capacity purchase agreement with Air Georgian. Air Georgian has been selected to operate a number of additional regional routes, including transborder routes, in mid-2014 using Canadian Regional Jet aircraft. The implementation of the amendment to the capacity purchase agreement remains subject to regulatory approvals and final documentation. This is an important next step in the airline's regional airline diversification strategy and on-going cost transformation program.

9. FINANCIAL AND CAPITAL MANAGEMENT

9.1. Liquidity

Air Canada manages its liquidity needs through a variety of strategies which include improving 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 9.6, 9.7 and 9.8 of this MD&A for information on Air Canada's capital commitments, pension funding obligations and contractual obligations. Air Canada monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as 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 liquidity level of $1.7 billion. This minimum target level was determined in conjunction with Air Canada's liquidity risk management strategy and replaces the previous target of maintaining at least 15% of 12 month trailing revenues. At December 31, 2013, unrestricted liquidity amounted to $2,364 million or 19% of annual operating revenues, comprised of cash and short-term investments of $2,208 million and undrawn lines of credit of $156 million. This compared to unrestricted liquidity of $2,018 million (comprised of cash and short-term investments of $1,973 million and undrawn lines of credit of $45 million) or 17% of annual operating revenues at December 31, 2012.

9.2. Financial Position

The following table provides a condensed consolidated statement of financial position of Air Canada as at December 31, 2013 and as at December 31, 2012.

(Canadian dollars in millions)	December 31, 2013	December 31, 2012	$ Change
Assets			
Cash, cash equivalents and short-term investments	$ 2,208	$ 1,973	$ 235
Other current assets	1,080	1,028	52
Current assets	3,288	3,001	287
Property and equipment	5,073	4,711	362
Intangible assets	304	314	(10)
Goodwill	311	311	–
Deposits and other assets	494	510	(16)
Total assets	**$ 9,470**	**$ 8,847**	**$ 623**
Liabilities			
Current liabilities	$ 3,190	$ 3,259	$ (69)
Long-term debt and finance leases	3,959	3,259	700
Pension and other benefit liabilities	2,687	4,686	(1,999)
Maintenance provisions	656	571	85
Other long-term liabilities	375	419	(44)
Total liabilities	**10,867**	**12,194**	**(1,327)**
Total equity	**(1,397)**	**(3,347)**	**1,950**
Total liabilities and equity	**$ 9,470**	**$ 8,847**	**$ 623**

Movements in current assets and current liabilities are described in section 9.4 of this MD&A. Long-term debt and finance leases are discussed in sections 9.3 and 9.5 of this MD&A.

At December 31, 2013, Property and equipment amounted to $5,073 million, an increase of $362 million from December 31, 2012. The increase in Property and equipment was mainly due to additions to property and equipment of $957 million in 2013, largely offset by the impact of depreciation and impairment expense of $530 million. The additions to Property and equipment included flight equipment purchases of $595 million, which included four Boeing 777-300ER aircraft which were delivered in June, August, November and December 2013, respectively, capitalized maintenance costs of $102 million, and purchase deposits and assets under development of $152 million.

At December 31, 2013, Pension and other benefit liabilities decreased $1,999 million from December 31, 2012. The decrease in the pension and other benefit liabilities was the result of several factors including an increase in the discount rates used to value the liabilities, a 13.8% return on pension plan assets during 2013, the impact of pension benefit plan amendments and past service cash payments of $220 million made during 2013, partially offset by the impact of a change in mortality assumptions. Refer to section 9.7 of this MD&A for additional information on Air Canada's pension funding obligations.

9.3. Adjusted Net Debt

The following table reflects Air Canada's adjusted net debt balances as at December 31, 2013 and as at December 31, 2012.

(Canadian dollars in millions, except where indicated)	December 31, 2013	December 31, 2012	$ Change
Total long-term debt and finance leases	$ 3,959	$ 3,259	$ 700
Current portion of long-term debt and finance leases	374	499	(125)
Total long-term debt and finance leases, including current portion	4,333	3,758	575
Less cash, cash equivalents and short-term investments	(2,208)	(1,973)	(235)
Net debt	**$ 2,125**	**$ 1,785**	**$ 340**
Capitalized operating leases(1)	2,226	2,352	(126)
Adjusted net debt	**$ 4,351**	**$ 4,137**	**$ 214**
EBITDAR (excluding benefit plan amendments)	**$ 1,433**	**$ 1,320**	**$ 113**
Adjusted net debt to EBITDAR ratio	**3.0**	**3.1**	**(0.1)**

(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 management with a measure of its net indebtedness. Air Canada includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7.0. 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 $318 million for the twelve months ended December 31, 2013 and $336 million for the twelve months ended December 31, 2012.

At December 31, 2013, total long-term debt and finance leases, including current portion, amounted to $4,333 million, an increase of $575 million from December 31, 2012. The increase was mainly due to the proceeds received under the private offering of new senior secured notes and a new senior secured credit facility, net of the repayment of the existing senior secured notes. In addition, Air Canada took delivery of four Boeing 777-300ER aircraft which were financed under the private offering of enhanced equipment trust certificates, which is further discussed in section 9.8 of this MD&A. The unfavourable impact of a weaker Canadian dollar as at December 31, 2013 compared to December 31, 2012 on Air Canada's foreign currency denominated debt (mainly U.S. dollars), which accounted for an increase of $209 million, was also a contributing factor to the increase to long-term debt and finance leases.

Adjusted net debt amounted to $4,351 million at December 31, 2013, an increase of $214 million from December 31, 2012, mainly due to the higher long-term debt and finance lease balances as described above, partially offset by higher cash balances. At December 31, 2013, the adjusted net debt to EBITDAR ratio amounted to 3.0 versus a ratio of 3.1 at December 31, 2012. Air Canada uses this ratio to manage its financial leverage risk and has an objective to maintain the ratio below 3.5.

At December 31, 2013, Air Canada's weighted average cost of capital (WACC) was approximately 9.3%. WACC is based on an estimate by management and consists of an estimated cost of equity of 20% and an average cost of debt and finance leases of 6%.

9.4. Working Capital

The following table provides information on Air Canada's working capital balances as at December 31, 2013 and as at December 31, 2012.

(Canadian dollars in millions)	December 31, 2013	December 31, 2012	$ Change
Cash, cash equivalents and short-term investments	$ 2,208	$ 1,973	$ 235
Accounts receivable	589	550	39
Other current assets	491	478	13
Accounts payable and accrued liabilities	(1,129)	(1,161)	32
Advance ticket sales	(1,687)	(1,599)	(88)
Current portion of long-term debt and finance leases	(374)	(499)	125
Net working capital	**$ 98**	**$ (258)**	**$ 356**

The net positive working capital of $98 million at December 31, 2013 represented an improvement of $356 million from December 31, 2012. This increase in net working capital was largely due to the impact of positive cash from operations of $731 million recorded in 2013, an improvement of $88 million over 2012. In addition, the financing activities relating to the new senior secured notes and the new senior secured credit facility, as further described in section 9.8 of this MD&A, increased unrestricted cash balances by $112 million. Additions to capital assets which amounted to $962 million, or $367 million net of the financing drawn upon the delivery of four Boeing 777-300ER aircraft received in 2013, partially offset the working capital improvements described above.

9.5. Consolidated Cash Flow Movements

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

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	2013	2012	$ Change	2013	2012	$ Change
Net cash flows from operating activities	**$ 68**	**$ 70**	**$ (2)**	**$ 731**	**$ 643**	**$ 88**
Proceeds from borrowings	304	–	304	1,973	132	1,841
Reduction of long-term debt and finance lease obligations	(238)	(156)	(82)	(1,646)	(442)	(1,204)
Issue of common shares, net	8	–	8	14	–	14
Shares purchased for cancellation	–	(5)	5	–	(5)	5
Other	–	–	–	(15)	(16)	1
Net cash flows from (used in) financing activities	**74**	**(161)**	**235**	**326**	**(331)**	**657**
Short-term investments	59	137	(78)	(210)	27	(237)
Additions to property, equipment and intangible assets	(344)	(91)	(253)	(962)	(444)	(518)
Proceeds from sale of assets	35	31	4	70	50	20
Other	46	(12)	58	41	32	9
Net cash flows from (used in) investing activities	**(204)**	**65**	**(269)**	**(1,061)**	**(335)**	**(726)**
Decrease in cash and cash equivalents	**(62)**	**(26)**	**(36)**	**(4)**	**(23)**	**19**
Cash and cash equivalents, beginning of period	812	780	32	754	777	(23)
Cash and cash equivalents, end of period	**$ 750**	**$ 754**	**$ (4)**	**$ 750**	**$ 754**	**$ (4)**

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

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	2013	2012	$ Change	2013	2012	$ Change
Cash flows from (used for) operating activities	**$ 68**	**$ 70**	**$ (2)**	**$ 731**	**$ 643**	**$ 88**
Additions to property, equipment and intangible assets	(344)	(91)	(253)	(962)	(444)	(518)
Free cash flow(1)	**$ (276)**	**$ (21)**	**$ (255)**	**$ (231)**	**$ 199**	**$ (430)**

(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 generated from the business after investing in capital assets, which is available to meet ongoing financial obligations, including repaying debt and reinvesting in Air Canada.

Free cash flow

Free cash flow declined $255 million in the fourth quarter of 2013 and $430 million in the full year 2013 compared to the same periods in 2012. While operating cash flows improved year-over-year, which was consistent with the improvement in operating earnings, free cash flow was impacted by the addition of four Boeing 777-300ER aircraft delivered in 2013 (two aircraft delivered in the fourth quarter of 2013). These aircraft were financed through the proceeds from the private offering of enhanced equipment trust certificates, which is further described in section 9.6 of this MD&A.

Net cash flows from (used in) financing activities

Proceeds from borrowings amounted to $304 million in the fourth quarter of 2013 ($1,973 million in the full year 2013). As further described in section 9.8 of this MD&A, in 2013, Air Canada completed financings of new senior secured notes and a new senior secured credit facility, resulting in net proceeds of approximately $1,300 million. Air Canada received proceeds of $304 million representing the portion of the proceeds under the private offering of enhanced equipment trust certificates (further described in section 9.6 of this MD&A) available upon the delivery of the third and fourth Boeing 777-300ER aircraft in November and December 2013. Reduction of long-term debt and finance lease obligations amounted to $238 million in the fourth quarter of 2013 ($1,646 million in the full year 2013), which included debt repayments of $70 million during the fourth quarter of 2013 ($1,127 million for the full year 2013) related to the existing senior secured notes, as further described in section 9.8 of this MD&A.

9.6. Capital Expenditures and Related Financing Arrangements

Private Offering of Enhanced Equipment Trust Certificates

On May 9, 2013, Air Canada completed a private offering of three tranches of enhanced equipment trust certificates with a combined aggregate face amount of US$715 million, in connection with the financing of five new Boeing 777-300ER aircraft. Four of these five Boeing 777 aircraft were delivered in June, August, November and December 2013, respectively, with the remaining aircraft scheduled for delivery in February 2014. The trust certificates have a weighted average interest rate of approximately 4.7% per annum.

Boeing

As at December 31, 2013, Air Canada had outstanding purchase commitments with Boeing for the acquisition of 37 Boeing 787 aircraft. The first six deliveries are scheduled for 2014 and the remaining 31 between 2015 and 2019. Air Canada has purchase options for 13 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing and delivery positions) and purchase rights for 10 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on Boeing's then current pricing).

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

In addition, in February 2014, Air Canada took delivery of the last of five Boeing 777 aircraft. This aircraft, together with four Boeing 777 aircraft which were delivered in 2013, are financed through the proceeds from the private offering of enhanced equipment trust certificates as described above. Subject to certain conditions, Air Canada has purchase rights for 13 Boeing 777 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing).

In December 2013, as part of the airline's narrow-body fleet renewal plan, Air Canada announced an agreement with Boeing, which is subject to completion of final documentation and other conditions, which includes firm orders for 33 737 MAX 8 and 28 737 MAX 9 aircraft, with substitution rights between them as well as for the 737 MAX 7 aircraft. It also provides for options for 18 aircraft and certain rights to purchase an additional 30 aircraft. Deliveries are scheduled to begin in 2017 with two aircraft, and the remaining deliveries between 2018 and 2021, subject to certain deferral and acceleration rights.

Capital Commitments

As outlined in the table below, the estimated aggregate cost of the future firm Boeing 787 aircraft deliveries and other capital purchase commitments as at December 31, 2013 approximates $4,986 million (of which $3,392 million is subject to committed financing, subject to the fulfillment of certain terms and conditions). The table below excludes the capital expenditures related to the purchase of Boeing 737 MAX aircraft as such agreement remains subject to the conclusion of final documentation and other conditions. While the table below reflects available financing commitments covering 31 of 37 Boeing 787 firm aircraft orders as discussed above, Air Canada will be seeking and expects to achieve more favourable financing arrangements closer to the delivery dates of these aircraft.

(Canadian dollars in millions)	2014	2015	2016	2017	2018	Thereafter	Total
Projected committed expenditures	$ 916	$ 727	$ 1,067	$ 1,378	$ 643	$ 255	$ 4,986
Projected planned but uncommitted expenditures	195	248	212	241	192	not available	not available
Projected planned but uncommitted capitalized maintenance(1)	202	149	123	123	123	not available	not available
Total projected expenditures(2)	**1,313**	**1,124**	**1,402**	**1,742**	**958**	**not available**	**not available**
Projected financing on committed expenditures	(678)	(578)	(844)	(1,158)	(134)	–	$ (3,392)
Total projected expenditures, net of financing	**$ 635**	**$ 546**	**$ 558**	**$ 584**	**$ 824**	**not available**	**not available**

(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 $123 million has been made.*

(2) *U.S. dollar amounts are converted using the December 31, 2013 closing exchange rate of US$1 = C$1.0636. The estimated aggregate cost of aircraft is based on delivery prices that include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day U.S. LIBOR rate at December 31, 2013.*

9.7. 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. The Canadian registered pension plans solvency deficit at January 1, 2013 was $3.7 billion. The next required valuations to be made as at January 1, 2014, will be completed in the first half of 2014, but as described below, they will not increase the 2014 pension past service cost funding obligations. Based on preliminary estimates, in aggregate, the domestic registered pension plans are estimated to be in a small surplus position on a solvency basis as at January 1, 2014.

The projected elimination of the $3.7 billion deficit was the result of several factors: (i) a 13.8% return on investments during 2013, (ii) the implementation of previously disclosed pension benefit amendments which are estimated to have decreased the solvency deficit by approximately $970 million, (iii) contributions made by Air Canada for the year of $225 million in respect of the solvency deficit and (iv) the application of a prescribed discount rate of 3.9% to calculate its future pension obligations.

The discount rate used to value the pension obligations is determined pursuant to guidance of the Canadian Institute of Actuaries. The discount rate used at January 1, 2013 was 3.0%. Air Canada applied a prescribed discount rate of 3.9% at January 1, 2014. Every 10 basis points change in the discount rate would result in approximately a $150 million change to the solvency liabilities. Four years ago, Air Canada began a program with the objective of materially de-risking its pension plans, and a new investment strategy with liability driven initiatives was introduced. The strategy contributed to achieving a return over the four-year period of 11.8%, a first quartile performance (versus Canadian large pension plans), while lowering the overall risk profile. As of December 31, 2013, 70% of the pension liabilities are matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk. It is Air Canada's objective over the mid-term, assuming appropriate market conditions, to match 100% of the pension liabilities with fixed income products.

Pension funding obligations are generally dependent on a number of factors, including the assumptions used in the most recently filed actuarial valuation reports for current service (including the applicable prescribed discount rate used or assumed in the actuarial valuation), the plan demographics at the valuation date, the existing plan provisions, existing pension legislation and changes in economic conditions (mainly the return on fund assets and changes in interest rates). Actual contributions that are determined on the basis of future valuation reports filed annually may vary significantly from projections. In addition to changes in plan demographics and experience, actuarial assumptions and methods may be changed from one valuation to the next, including due to changes in plan experience, financial markets, future expectations, and changes in legislation and other factors.

In July 2009, the Government of Canada adopted the *Air Canada 2009 Pension Regulations*. The Air Canada 2009 Pension Regulations relieved Air Canada from making any past service contributions (i.e. special payments to amortize the plan deficits) to its domestic defined benefit registered pension plans in respect of the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contribution was the lesser of (i) $150 million, $175 million, and $225 million in respect of 2011, 2012, and 2013, respectively, on an accrued basis, and (ii) the maximum past service contribution permitted under the *Canadian Income Tax Act*. Current service contributions continued to be made in the normal course while the *Air Canada 2009 Pension Regulations* were in effect.

In December 2013, further to an agreement reached with Air Canada in March 2013, the Government of Canada formally approved the *Air Canada Pension Plan Funding Regulations, 2014* (the "2014 Regulations") under the *Pension Benefits Standards Act, 1985* in respect of special payments required to be made to amortize the deficit under Air Canada's defined benefit plans applicable to the period between 2014 to 2020 inclusively, expiring December 31, 2020. According to the terms of the 2014 Regulations, Air Canada will be required to make payments of at least $150 million annually with an average of $200 million per year, to contribute an aggregate minimum of $1,400 million over seven years in solvency deficit payments, in addition to its pension current service payments.

Under the agreement reached with the Government of Canada in March 2013, in respect of the plan years during which Air Canada funds its plans pursuant to the 2014 Regulations, Air Canada is subject to a series of covenants and undertakings, including a prohibition on dividends and share repurchases, as well as certain limitations on executive compensation arrangements. As requested by the Government of Canada, Air Canada has also agreed to use reasonable efforts, during the negotiations of the next collective agreements with Air Canada's Canadian-based unions, to seek to include in those collective agreements provisions which would have employees contribute fifty per cent of their pension plan normal costs, and has agreed not to implement pension plan benefit improvements without regulatory approval.

Air Canada may elect to opt out of the 2014 Regulations and have past service payments in respect of all Air Canada pension plans, collectively, determined in accordance with normal funding rules.

Air Canada would consider opting out of the new pension regulations when the annual solvency deficit payments under normal funding rules, which are determined using deficit levels over three years, would be less than $200 million and when there would be a strong basis for confidence that the airline's derisking strategy would make a future significant deficit unlikely to re-occur. Air Canada does not expect to opt out of the 2014 Regulations in 2014.

Giving effect to the Air Canada 2009 Pension Regulations as outlined above, total employer pension funding contributions during 2013 amounted to $475 million.

(Canadian dollars in millions)	2013
Past service domestic registered plans	$ 220
Current service domestic registered plans	168
Other pension arrangements(1)	87
Pension funding obligations	**$ 475**

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

Assuming Air Canada funds its pension obligations under the 2014 Regulations, Air Canada's projected pension funding obligations, on a cash basis, for the years 2014 to 2018 would be as follows:

(Canadian dollars in millions)	2014	2015	2016	2017	2018
Past service domestic registered plans	$ 202	$ 200	$ 200	$ 200	$ 200
Current service domestic registered plans	149	145	141	136	131
Other pension arrangements(1)	88	93	96	99	93
Total projected pension funding obligations	**$ 439**	**$ 438**	**$ 437**	**$ 435**	**$ 424**

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

9.8. Contractual Obligations

Private Offerings of Senior Secured Notes and Senior Secured Credit Facility

On September 26, 2013, Air Canada completed private offerings of senior secured notes, consisting of (i) US$400 million principal amount of 6.750% senior secured first lien notes due 2019 and $300 million principal amount of 7.625% senior secured first lien notes due 2019 (the "New Senior First Lien Notes") and (ii) US$300 million principal amount of 8.750% senior secured second lien notes due 2020 (the "New Senior Second Lien Notes" and together with the New Senior First Lien Notes, the "New Senior Notes"). Air Canada also completed the closing of its US$400 million new senior secured (first lien) credit facility, comprised of a US$300 million term loan maturing in 2019 and a US$100 million revolving credit facility (collectively, the "New Credit Facility"). As at December 31, 2013, Air Canada had not drawn on the revolving credit facility. The weighted average interest rate of the new financing arrangements is approximately 7% per annum.

Air Canada received, in total, net proceeds of approximately $1,300 million from the sale of the New Senior Notes and from term loan borrowings under the New Credit Facility (in each case, after deduction of the applicable transaction costs, fees and expenses). Air Canada applied a portion of such net proceeds and borrowings to purchase all of its outstanding 9.250% Senior Secured Notes due 2015, 10.125% Senior Secured Notes due 2015 and 12.000% Senior Second Lien Notes due 2016 (collectively, the "Existing Notes") that were validly tendered on or before the early tender deadline (which was September 18, 2013), in connection with the cash tender offers commenced by the Corporation on September 5, 2013. In October 2013, Air Canada used a portion of the remaining net proceeds and borrowings to redeem the remaining Existing Notes of $70 million not tendered prior to the early tender deadline. Air Canada is using the remaining net proceeds for working capital and general corporate purposes.

In conjunction with the purchase of the Existing Notes, the premiums paid to noteholders, in the amount of $61 million, as well as the write-off of existing transaction costs and discounts related to the Existing Notes, in the amount of $34 million, were recorded as an interest charge in the third quarter of 2013.

The table below provides interest and principal repayment obligations on Air Canada's long-term debt and finance lease obligations as at December 31, 2013. The table below also includes the impact of the financing associated with one Boeing 777-300ER aircraft, the proceeds of which are currently held in escrow and will be drawn during the first quarter of 2014 upon delivery of the aircraft. Refer to section 9.6 of this MD&A for additional information. The table below also reflects the completion of the private offerings of senior secured notes and the new senior secured credit facility described above.

(Canadian dollars in millions)	2014	2015	2016	2017	2018	Thereafter	Total
Principal							
Long-term debt obligations	$ 312	$ 613	$ 317	$ 426	$ 309	$ 2,092	$ 4,069
Finance lease obligations	62	61	26	27	30	122	328
Total principal obligations	**374**	**674**	**343**	**453**	**339**	**2,214**	**4,397**
Interest							
Long-term debt obligations	229	192	172	180	137	176	1,086
Finance lease obligations	30	23	19	16	13	37	138
Total interest obligations	**259**	**215**	**191**	**196**	**150**	**213**	**1,224**
Total long-term debt and finance lease obligations	**$ 633**	**$ 889**	**$ 534**	**$ 649**	**$ 489**	**$ 2,427**	**$ 5,621**
Operating lease obligations	**$ 359**	**$ 306**	**$ 250**	**$ 219**	**$ 191**	**$ 419**	**$ 1,744**
Committed capital expenditures	**$ 916**	**$ 727**	**$ 1,067**	**$ 1,378**	**$ 643**	**$ 255**	**$ 4,986**
Total obligations	**$ 1,908**	**$ 1,922**	**$ 1,851**	**$ 2,246**	**$ 1,323**	**$ 3,101**	**$ 12,351**
EETC financing related to one Boeing 777 aircraft (principal and interest)	**$ 14**	**$ 14**	**$ 14**	**$ 13**	**$ 36**	**$ 112**	**$ 203**
Total obligations, including the impact of the EETC financing related to one Boeing 777 aircraft(1)(2)	**$ 1,922**	**$ 1,936**	**$ 1,865**	**$ 2,259**	**$ 1,359**	**$ 3,213**	**$ 12,554**

(1) Total contractual obligations exclude commitments for goods and services required in the ordinary course of business. Also excluded are other long-term liabilities mainly due to reasons of uncertainty of timing of cash flows and items that are non-cash in nature.

(2) The table above excludes the future minimum non-cancelable commitment under the Jazz CPA of $801 million in 2014, the future minimum non-cancelable commitment under capacity purchase agreements with other regional carriers of $109 million in 2014 and the minimum annual commitment to purchase Aeroplan® Miles from Aeroplan of $218 million for 2014. Future commitments for 2015 and beyond are not yet determinable.

Covenants in Credit Card Agreements

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

The terms of Air Canada's principal credit card processing agreements for credit card processing services in North America are in effect for another four years each, and the agreements contain triggering events upon which the Corporation is required to provide the credit card processor with cash deposits. The obligation to provide cash deposits and the required amount of deposits are each based upon a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio for Air Canada and the unrestricted cash and short-term investments of the Corporation. In 2013, Air Canada made no cash deposits under these agreements (nil in 2012).

Air Canada also has agreements with another processor for the provision of certain credit card processing services requirements for markets other than North America and for its cargo operations worldwide where such agreements also contain deposit obligations.

Ratings

Air Canada's corporate credit and/or Air Canada's New Senior Notes are rated (as of the dates indicated below) by the following rating agencies:

- Moody's Investors Service, Inc. ("Moody's");
- Standard & Poor's Rating Services ("Standard & Poor's");
- Fitch Ratings, Inc. ("Fitch"); and
- DBRS Limited ("DBRS").

Moody's Ratings

On November 27, 2013, Moody's upgraded the following ratings relating to Air Canada:

- Air Canada's corporate family rating to B3 from Caa1 and probability of default ratings to B3-PD from Caa1-PD.
- New Senior First Lien Notes ratings to B1 from B2 and its New Senior Second Lien Notes rating to Caa1 from Caa2.
- Air Canada's speculative grade liquidity rating was raised to SGL-2 from SGL-3.
- The ratings on Air Canada's 2013-1 Class A, Class B and Class C enhanced equipment trust certificates were upgraded by one notch to Baa2, Ba3, and B2, respectively.
- The rating outlook was changed to stable from positive.

Standard & Poor's Ratings

On September 9, 2013 and September 17, 2013, Standard & Poor's assigned the following ratings relating to Air Canada's refinancing:

- Air Canada's corporate credit rating: B-, stable trend.
- New Senior First Lien Notes rating of B+ and New Senior Second Lien Notes rating of CCC+.
- Air Canada's recovery ratings: New Senior First Lien Notes ratings of 1 and a New Senior Second Lien Notes rating of 5.

The ratings on Air Canada's 2013-1 Class A, Class B and Class C enhanced equipment trust certificates are: A-, BB, and B, respectively.

On April 9, 2013, Standard & Poor's affirmed its corporate rating on Air Canada as "B-" and revised the outlook to stable from negative.

Fitch Ratings

On September 18, 2013, Fitch assigned the following ratings relating to Air Canada's refinancing:

- Air Canada's long-term issuer default rating (IDR): B.
- New Senior First Lien Notes rating of BB and a New Senior Second Lien Notes rating of BB-.
- Air Canada's recovery ratings: New Senior First Lien Notes ratings of RR1 and a New Senior Second Lien Notes rating of RR2.

The ratings on Air Canada's 2013-1 Class A, Class B and Class C enhanced equipment trust certificates are: A, BB+ and BB-, respectively.

DBRS Ratings

On November 14, 2013, DBRS reaffirmed Air Canada's Issuer Rating of "B" with a stable trend.

Ratings are intended to provide investors with an independent view of credit quality. However, they are not a recommendation to buy, sell or hold securities and may be subject to revision or withdrawal at any time by the rating organization. Each rating should be evaluated independently of any other rating.

9.9. Share Information

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

	Number of Shares at		
	January 31, 2014	December 31, 2013	December 31, 2012
Issued and outstanding shares			
Class A variable voting shares	29,875,032	26,577,512	33,006,104
Class B voting shares	254,657,472	257,954,927	241,437,699
Total issued and outstanding shares	**284,532,504**	**284,532,439**	**274,443,803**
Class A variable voting and Class B voting shares potentially issuable			
Warrants	–	–	10,000,000
Shares held in trust for employee recognition award	1,337,312	1,337,377	1,445,082
Stock options	10,075,344	10,079,694	8,410,403
Total shares potentially issuable	**11,412,656**	**11,417,071**	**19,855,485**
Total outstanding and potentially issuable shares	**295,945,160**	**295,949,510**	**294,299,288**

Earnings per Share

The following reflects the share amounts used in the computation of basic and diluted earnings per share:

	Fourth Quarter		Full Year	
	2013	2012	2013	2012
Weighted average number of shares outstanding – basic	282	276	277	276
Effect of dilution	9	5	7	2
add back anti-dilutive impact	(9)	(5)	–	(2)
Weighted average number of shares outstanding – diluted	**282**	**276**	**284**	**276**

Warrants

In 2013, Air Canada purchased for cancellation 2,083,333 warrants expiring July 30, 2013 for an aggregate purchase price of $2 million, representing the average trading price, at the time of purchase, of Air Canada shares on the Toronto Stock Exchange less the exercise price of $1.51 of each warrant. In addition, the outstanding number of ordinary shares increased by 7,916,667 upon exercise of warrants with proceeds to Air Canada of $12 million.

In 2012, 79,430,300 warrants with an exercise price of $2.20 expired. Upon expiry, the value ascribed to the Share capital related to the warrants of $18 million was reclassified to the Deficit. No warrants were exercised during 2012.

Air Canada has no warrants left outstanding.

10. QUARTERLY FINANCIAL DATA

The following table summarizes quarterly financial results for Air Canada for the last eight quarters.

	2012				2013			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Operating revenues	$ 2,961	$ 2,988	$ 3,326	$ 2,839	$ 2,952	$ 3,057	$ 3,479	$ 2,894
Aircraft fuel	889	888	963	821	870	831	1,002	831
Ownership (DAR)(1)(2)	265	249	255	236	251	211	210	224
Other operating expenses(3)	1,898	1,788	1,685	1,735	1,937	1,841	1,851	1,704
Operating expenses	3,052	2,925	2,903	2,792	3,058	2,883	3,063	2,759
Operating income (loss)	(91)	63	423	47	(106)	174	416	135
Total non-operating income (expense)(4)	(128)	(223)	(64)	(107)	(154)	(197)	(125)	(141)
Recovery of (provision for) income taxes	–	(1)	–	–	–	–	8	–
Discontinued operations – Aveos(5)	(55)	–	–	–	–	–	–	–
Net income (loss)	$ (274)	$ (161)	$ 359	$ (60)	$ (260)	$ (23)	$ 299	$ (6)
Diluted earnings (loss) per share	$ (0.99)	$ (0.59)	$ 1.28	$ (0.22)	$ (0.95)	$ (0.09)	$ 1.05	$ (0.02)
EBITDAR, excluding benefit plan amendments(3)(6)	$ 174	$ 312	$ 551	$ 283	$ 145	$ 385	$ 626	$ 277
EBITDAR(6)	$ 174	$ 312	$ 678	$ 283	$ 145	$ 385	$ 626	$ 359
Adjusted net income (loss)(7)	$ (162)	$ (7)	$ 229	$ (5)	$ (143)	$ 115	$ 365	$ 3
Adjusted net income (loss) per diluted share(7)	$ (0.58)	$ (0.02)	$ 0.82	$ (0.02)	$ (0.52)	$ 0.41	$ 1.29	$ 0.01

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

(2) *In the first quarter of 2013, Air Canada recorded an impairment charge of $24 million related to Airbus A340-300 aircraft.*

(3) *In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of $82 million related to changes to early retirement provisions in Air Canada's defined benefit pension plans. In the third quarter of 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.*

(4) *In the third quarter of 2013, Air Canada recorded an interest charge of $95 million related to the purchase of its senior secured notes which were to become due in 2015 and 2016.*

(5) *In the first quarter of 2012, Air Canada recorded a loss on its investments in Aveos of $65 million.*

(6) *EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.*

(7) *Adjusted net income (loss) and adjusted net income (loss) per diluted share are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.*

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

	2012				2013			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Revenue passenger miles (millions)	12,946	13,868	16,258	12,574	13,087	14,093	16,726	12,882
Available seat miles (millions)	16,344	16,606	18,835	15,484	16,164	16,972	19,404	16,033
Passenger load factor (%)	79.2	83.5	86.3	81.2	81.0	83.0	86.2	80.3
Passengers RASM (cents)	15.2	15.9	15.9	16.0	15.4	16.0	16.2	15.7
CASM, excluding benefit plan amendments (cents)(1)	18.7	17.6	16.1	18.0	18.9	17.0	15.8	17.7
Adjusted CASM (cents)(2)	12.3	11.9	10.7	12.4	12.5	11.7	10.4	12.1
Economic fuel price per litre (cents)(3)	91.7	90.8	87.7	88.1	92.4	85.7	89.6	88.4

(1) *In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of $82 million related to changes to early retirement provisions in Air Canada's defined benefit pension plans. In the third quarter of 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.*

(2) *Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.*

(3) *Includes fuel handling expenses. Economic fuel price per litre is a non-GAAP financial measure. Refer to sections 6 and 7 of this MD&A for additional information.*

11. SELECTED ANNUAL INFORMATION

The following table provides selected annual information for Air Canada for the years 2011 through to 2013.

(Canadian dollars in millions, except per share figures)	Full Year 2013	Full Year 2012	Full Year 2011[(1)]
Operating revenues	$ 12,382	$ 12,114	$ 11,612
Operating expenses[(2)]	11,763	11,672	11,433
Operating income	619	442	179
Total non-operating expense and income taxes[(3)]	(609)	(523)	(428)
Net income (loss) from continuing operations	10	(81)	(249)
Net loss from discontinued operations – Aveos	–	(55)	–
Net income (loss)	$ 10	$ (136)	$ (249)
EBITDAR, excluding benefit plan amendments[(2)(4)]	$ 1,433	$ 1,320	$ 1,242
EBITDAR[(3)]	$ 1,515	$ 1,447	$ 1,242
Basic and diluted earnings (loss) per share from continuing operations	$ 0.02	$ (0.31)	$ (0.92)
Basic and diluted loss per share from discontinued operations	$ –	$ (0.20)	$ –
Diluted earnings (loss) per share	$ 0.02	$ (0.51)	$ (0.92)
Cash, cash equivalents and short-term investments	$ 2,208	$ 1,973	$ 2,099
Total assets	$ 9,470	$ 8,847	$ 9,633
Total long-term liabilities[(5)]	$ 8,051	$ 9,434	$ 10,910
Total liabilities	$ 10,867	$ 12,194	$ 13,639

(1) 2011 has not been restated for accounting standard changes related to consolidation of special purpose entities and employee benefits, as described in Air Canada's audited consolidated financial statements and notes for 2013. The accounting changes were effective January 1, 2013 with retrospective adjustments as at January 1, 2012.

(2) In 2013, Air Canada recorded an operating expense reduction of $82 million related to changes to early retirement provisions in Air Canada's defined benefit pension plans. In 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(3) In 2012, Air Canada recorded a $65 million loss on its investment in Aveos' parent holding company.

(4) EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

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

12. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

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

The following is a summary of "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:

	Fourth Quarter		Full Year	
(Canadian dollars in millions)	2013	2012	2013	2012
Fuel derivatives	$ (9)	$ (14)	$ (6)	$ (43)
Share forward contracts	29	3	42	5
Prepayment option on senior secured notes	2	15	2	15
Interest rate swaps	–	–	(1)	(1)
Other	–	3	–	4
Gain (loss) on financial instruments recorded at fair value	**$ 22**	**$ 7**	**$ 37**	**$ (20)**

Risk Management

Under its risk management policy, Air Canada manages its interest rate risk, foreign exchange risk, share based compensation risk and market risk through the use of various interest rates, foreign exchange, fuel and other derivative financial instruments. Air Canada uses derivative financial instruments only for risk management purposes, not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be offset by changes in cash flows related to the risk being hedged.

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

Interest Rate Risk Management

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

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

The ratio of fixed to floating rate obligations outstanding is designed to maintain flexibility in Air Canada's capital structure and is based upon a long-term objective of 60% fixed and 40% floating but allows the flexibility in the short-term to adjust to prevailing market conditions. The ratio at December 31, 2013, was 74% fixed and 26% floating, including the effects of interest rate swap positions (71% and 29%, respectively, as at December 31, 2012).

The following are the current derivatives employed in interest rate risk management activities and the adjustments recorded during 2013:

- As at December 31, 2013, Air Canada had two interest rate swap agreements in place with terms to July 2022 and January 2024 relating to two Boeing 767 aircraft financing agreements with an aggregate notional value of $62 million (US$58 million) (2012 – $65 million (US$66 million)). These swaps convert the lease payments on the two aircraft leases from fixed to floating rates. The fair value of these contracts as at December 31, 2013 was $10 million in favour of Air Canada (2012 – $13 million in favour of Air Canada). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In 2013, a Loss of $1 million was recorded in Gain (loss) on financial instruments recorded at fair value related to these derivatives (2012 – $2 million gain).

Interest income includes $29 million (2012 – $33 million) related to Cash and cash equivalents and Short-term investments, which are classified as held for trading. Interest expense reflected on the consolidated statement of operations relates to financial liabilities recorded at amortized cost.

Foreign Exchange Risk

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

Air Canada's cash inflows are primarily in Canadian dollars, while a large portion of its outflows are in U.S. dollars. This unbalanced mix results in an annual U.S. dollar shortfall from operations. In order to mitigate this imbalance, Air Canada has adopted a number of risk management strategies, which include:

- The practice of converting excess revenues from offshore currencies into U.S. dollars. In 2013, this conversion generated coverage for approximately 25% of the imbalance.

- Holding U.S. cash reserves as an economic hedge against changes in the value of the U.S. dollar. U.S. dollar cash and short-term investment balances, as at December 31, 2013, amounted to $791 million (US$743 million) ($581 million (US$584 million) as at December 31, 2012).

- Locking in the foreign exchange rate through the use of a variety of foreign exchange derivatives which have maturity dates corresponding to the forecasted dates of U.S. dollar shortfalls.

The target coverage of the above strategies is to cover 50% of the net U.S. dollar exposure on a rolling 12 month basis. The level of foreign exchange derivatives entered into and their related maturity dates are dependent upon a number of factors, including the amount of foreign revenue conversion available, U.S dollar net cash flows, as well as the amount attributed to aircraft and debt payments. Based on the notional amount of currency derivatives outstanding at December 31, 2013, as further described below, and the value of U.S. cash reserves, approximately 50% of net U.S. cash outflows are hedged in 2014.

- As at December 31, 2013, Air Canada had outstanding foreign currency options and swap agreements to purchase U.S. dollars and Euros against Canadian dollars on $1,645 million (US$1,547 million) and $72 million (EUR $34 million, GBP $16 million) which mature in 2014 and 2015 at a weighted average rate of $1.0341 per $1.00 U.S. dollar (2012 – $1,289 million (US$1,296 million) which matured in 2013). The fair value of these foreign currency contracts as at December 31, 2013 was $13 million in favour of Air Canada (2012 – less than $1 million in favour of Air Canada). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In 2013, a gain of $68 million was recorded in Foreign exchange gain (loss) related to these derivatives (2012 – $20 million gain).

Fuel Price Risk Management

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

Air Canada uses derivative contracts based on jet fuel, heating oil and crude-oil based contracts. Air Canada's policy permits hedging of up to 75% of the projected jet fuel purchases for the next 12 months, 50% for the next 13 to 24 months and 25% for the next 25 to 36 months. These are maximum (but not mandated) limits. There is no minimum monthly hedging requirement. There are regular reviews to adjust the strategy in light of market conditions.

In 2013:

- Air Canada recorded a loss of $6 million in Loss on financial instruments recorded at fair value on Air Canada's consolidated statement of operations related to fuel derivatives ($43 million loss in 2012).
- Air Canada purchased crude-oil and refined products-based call options and call spreads covering a portion of 2013 and 2014 fuel exposure. The cash premium related to these contracts was $39 million ($51 million in 2012 for 2012 and 2013 exposures).
- Fuel derivative contracts cash settled with a fair value of $29 million in favour of Air Canada ($3 million in favour of Air Canada in 2012).

As of December 31, 2013, approximately 20% of Air Canada's anticipated purchases of jet fuel for 2014 are hedged at an average West Texas Intermediate ("WTI") equivalent capped price of US$100 per barrel. Air Canada's contracts to hedge anticipated jet fuel purchases over the 2014 period are comprised of call options with notional volumes of 5,136,000 barrels. The fair value of the fuel derivatives portfolio at December 31, 2013 was $20 million in favour of Air Canada ($16 million in favour of Air Canada in 2012) and is recorded within Prepaid expenses and other current assets on Air Canada's consolidated statement of financial position.

13. CRITICAL ACCOUNTING ESTIMATES

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

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

Employee Future Benefits

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

Assumptions

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

Financial Assumptions

Discount Rate

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

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

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

	Pension Benefits		Other Employee Future Benefits	
	2013	2012	2013	2012
Discount rate used to determine:				
Accrued benefit cost for the year ended December 31	4.30%	5.20%	4.17%	4.90%
Accrued benefit liability as at December 31	4.90%	4.30%	4.80%	4.17%
Rate of future increases in compensation used to determine:				
Accrued benefit cost for the year ended December 31	2.50%	2.50%	not applicable	not applicable
Accrued benefit obligation as at December 31	2.50%	2.50%	not applicable	not applicable

Actuarial assumptions

Mortality rates

The cost and related liabilities of Air Canada's pension plans and other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations include several economic and demographic assumptions including mortality rates. For the December 31, 2013 accounting valuations, the mortality assumption has been updated to reflect the results of a mortality study specific to Air Canada pension plan membership which was completed in the fourth quarter of 2013. The change in mortality rate assumptions resulted in an actuarial remeasurement of the accounting liabilities with the impact being recorded in other comprehensive income. The improvements in assumed mortality rates are consistent with those presented by the Canadian Institute of Actuaries ("CIA") which issued a draft report during the third quarter of 2013 proposing new mortality tables for use in the valuation of Canadian pension and benefit plans. The CIA is expected to issue further guidance for mortality rate assumptions by early 2014, and Air Canada's experience will be remeasured against the revised CIA tables.

Sensitivity Analysis

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

Sensitivity analysis on 2013 pension expense and net financing expense relating to pension benefit liabilities, based on different actuarial assumptions with respect to discount rate is set out below. The effects on each pension plan of a change in an assumption are weighted proportionately to the total plan obligation to determine the total impact for each assumption presented.

	0.25 Percentage Point	
	Decrease	Increase
Discount rate on obligation assumption		
Pension expense	$ 15	$ (14)
Net financing expense relating to pension benefit liabilities	4	8
Total	**$ 19**	**$ (6)**
Increase (decrease) in pension obligation	**$ 530**	**$ (537)**

An increase of one year in the mortality rate assumption would increase the pension benefit obligation by $394 million.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 6% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2013 (2012 – 6.75%). The rate is assumed to decrease gradually to 5% by 2015. A one percentage point increase in assumed health care trend rates would have increased the total of current service and interest costs by $4 million and the obligation by $55 million. A one percentage point decrease in assumed health care trend rates would have decreased the total of current service and interest costs by $4 million and the obligation by $53 million.

A 0.25 percentage point decrease in discount rate would have increased the total of current and interest costs by less than $1 million and the obligation by $42 million. A 0.25 percentage point increase in discount rate would have decreased the total of current and interest costs by less than $1 million and the obligation by $36 million.

Impairment Considerations of Long-Lived Assets

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

Depreciation and Amortization Period for Long-Lived Assets

Air Canada makes estimates about the expected useful lives of long-lived assets and the expected residual values of the assets based on the estimated current fair value of the assets, Air Canada's fleet plans and the cash flows they generate. Changes to these estimates, which can be significant, could be caused by a variety of factors, including changes to maintenance programs, changes in jet fuel prices and other operating costs, changes in utilization of the aircraft, and changing market prices for new and used aircraft of the same or similar types. Estimates and assumptions are evaluated at least annually. Generally, these adjustments are accounted for on a prospective basis, through depreciation and amortization expense. For the purposes of sensitivity analysis on these estimates, a 50% reduction to residual values on aircraft with remaining useful lives greater than five years results in an increase of $22 million to annual depreciation expense. For aircraft with shorter remaining useful lives, the residual values are not expected to change significantly.

Maintenance Provisions

The recording of maintenance provisions related to return conditions on aircraft leases requires management to make estimates of the future costs associated with the maintenance events required under the lease return condition and estimates of the expected future maintenance condition of the aircraft at the time of lease expiry. These estimates take into account current costs of these maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in maintenance expense in the period. The effect of any changes in estimates, including changes in discount rates, inflation assumptions, cost estimates or lease expiries, is also recognized in maintenance expense in the period. Assuming the aggregate cost for return conditions increases by 5%, holding all other factors constant, there would be a cumulative balance sheet adjustment to increase the provision by $32 million at December 31, 2013 and an increase to maintenance expense in 2014 of approximately $4 million. For illustrative purposes, if the discount rates were to increase by 1%, holding all other factors constant, there would be a cumulative balance sheet adjustment to decrease the provision by $15 million at December 31, 2013. Due to low market rates of interest, a 1% decrease in discount rates was not considered a reasonable scenario.

14. ACCOUNTING POLICIES

The following is an overview of accounting standard changes that Air Canada will be required to adopt in future years. The Corporation does not expect to adopt any of these standards before their effective dates. The Corporation continues to evaluate the impact of these standards on its consolidated financial statements.

IFRS 9 – Financial Instruments

IFRS 9 introduces new requirements for the classification and measurement of financial assets. IFRS 9 requires all recognized financial assets that are within the scope of IAS 39 Financial Instruments: Recognition and Measurement to be measured at amortized cost or fair value in subsequent accounting periods following initial recognition. Specifically, financial assets that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding are generally measured at amortized cost at the end of subsequent accounting periods. All other financial assets including equity investments are measured at their fair values at the end of subsequent accounting periods.

IFRS 9 was amended in November 2013, to (i) include guidance on hedge accounting, (ii) allow entities to early adopt the requirement to recognize changes in fair value attributable to changes in an entity's own credit risk, from financial liabilities designated under the fair value option, in OCI, without having to adopt the remainder of IFRS 9, and (iii) remove the previous mandatory effective date of January 1, 2015, although the standard is available for early adoption.

Amendments to IAS 32 – Financial Instruments: Presentation

IAS 32 addresses inconsistencies when applying the offsetting requirements, and is effective for annual periods beginning on or after January 1, 2014.

15. OFF-BALANCE SHEET ARRANGEMENTS

The following is a summary of Air Canada's more significant off-balance sheet arrangements.

Guarantees

Performance Obligations Relating to Aircraft Leasing Agreements

With respect to 12 aircraft leases, the difference between the reduced rents as a result of the implementation of the Plan of Reorganization, Compromise and Arrangement under the Companies' Creditors Arrangement Act ("CCAA") on September 30, 2004, and amounts which would have been due under the original lease contracts will be forgiven at the expiry date of the leases if no material default has occurred by such date. In the event of a material default, which does not include any cross defaults to other unrelated agreements (including agreements with the counterparties of these aircraft leases), this difference plus interest will become due and payable and all future rent will be based on the original contracted rates. Rent expense is being recorded on the renegotiated lease agreements, and any additional liability would be recorded only at the time management believes the amount is likely to be incurred.

Guarantees in Fuel Facilities Arrangements

Air Canada participates in fuel facility arrangements operated through eight Fuel Facility Corporations, along with other airlines that contract for fuel services at various major airports in Canada. The Fuel Facility Corporations operate on a cost recovery basis. The purpose of the Fuel Facility Corporations is to own and finance the system that distributes the fuel to the contracting airlines, including leasing the land rights under the land leases. The aggregate debt of the five Fuel Facility Corporations in Canada that have not been consolidated by Air Canada under IFRS 10 Consolidated Financial Statements is approximately $394 million as at December 31, 2013 (December 31, 2012 – $390 million), which is Air Canada's maximum exposure to loss before taking into consideration the value of the assets that secure the obligations and any cost sharing that would occur amongst the other contracting airlines. Air Canada views this loss potential as remote. Each contracting airline participating in a Fuel Facility Corporation shares pro rata, based on system usage, in the guarantee of this debt. The maturities of these debt arrangements vary but generally extend beyond five years.

Indemnification Agreements

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

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

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

When Air Canada, as a customer, enters into technical service agreements with service providers, primarily service providers who operate an airline as their main business, Air Canada has from time to time agreed to indemnify the service provider against certain liabilities that arise from third party claims, which may relate to the services performed by the service provider.

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

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

16. RELATED PARTY TRANSACTIONS

At December 31, 2013, 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.

17. SENSITIVITY OF RESULTS

Air Canada's financial results are subject to many different internal and external factors which can have a significant impact on operating results. The following table describes, on an indicative basis, the financial impact that changes in certain assumptions would generally have had on Air Canada's operating results. These guidelines were derived from 2013 levels of activity and make use of management estimates. The impacts are not additive, do not reflect the interdependent relationship of the elements and actual results may vary significantly due to a wide range of factors many of which are beyond the control of Air Canada. An equivalent but opposite movement of the sensitivity factor in the table below would generally result in a similar impact in the opposite direction.

(Canadian dollars in millions, except where indicated) Key Variable		2013 Measure	Sensitivity Factor	Favourable/(Unfavourable) Estimated Operating Income Impact
Revenue Measures				
Passenger yield (cents)	System	19.1	1% increase in yield	$ 103
	Canada	25.1		$ 40
Traffic (RPMs) (millions)	System	56,788	1% increase in traffic	$ 98
	Canada	16,777		$ 38
Passenger load factor (%)	System	82.8	1 percentage point increase in passenger load factor	$ 118
RASM (cents)	System	15.9	1% increase in RASM	$ 100
Cost Measures				
Fuel – Jet fuel price (US$/barrel)(1)		131	US$1/barrel increase in price of jet fuel	$ (26)
Fuel – jet fuel price (CAD cents/litre)(1)		89	1% increase in price of jet fuel (CAD cents/litre)	$ (34)
Cost per ASM (excluding benefit plan amendments) (cents)		17.3	1% increase in CASM (excluding benefit plan amendments)	$ (118)
Adjusted cost per ASM (cents)(2)		11.6	1% increase in adjusted CASM	$ (80)

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

(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 of this MD&A for additional information.

(Canadian dollars in millions) Key Variable	2013 Measure	Sensitivity Factor	Favourable/(Unfavourable) Estimated Pre-Tax Income Impact
Currency Exchange			
C$ to US$	C$1 = US$1.10	1 cent increase in exchange rate (i.e. $1.10 to $1.09 per U.S. dollar)	
		Operating income(1)	$ 34
		Net interest expense	$ 2
		Revaluation of long-term debt and other long-term monetary items, net	$ 35
		Remeasurement of outstanding currency derivatives	$ (23)
		Pre-tax Income Impact	**$ 48**

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

18. RISK FACTORS

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

Risks Relating to Air Canada

Operating Results

Air Canada has sustained significant losses in the past and Air Canada may sustain significant losses in the future. A variety of factors, including economic conditions and other factors described in this Risk Factors section, may result in Air Canada incurring significant losses. Despite ongoing strategic and business initiatives, including efforts at securing cost reductions, revenue improvements as well as efforts relating to the launch of Air Canada *rouge*, Air Canada may not be able to successfully achieve or sustain positive net profitability or realize the objectives of any or all of its initiatives, including those which seek to decrease costs, improve yield or offset or mitigate risks facing Air Canada, including those relating to economic conditions, foreign exchange rates, labour issues, liquidity, competition, and volatility in fuel costs and other expenses.

Leverage

Air Canada has, and is expected to continue to have and incur, a significant amount of indebtedness, including substantial fixed obligations under aircraft leases and other financings (including the New Senior Notes and New Credit Facility, each completed in 2013), and as a result of challenging economic or other conditions affecting Air Canada, Air Canada may incur greater levels of indebtedness than currently exist. The amount of indebtedness that Air Canada currently has and which it may incur in the future could have a material adverse effect on Air Canada, for example, by (i) limiting Air Canada's ability to obtain additional financing, (ii) requiring Air Canada to dedicate a substantial portion of its cash flow from operations to payments on its indebtedness and fixed cost obligations, thereby reducing the funds available for other purposes, (iii) making Air Canada more vulnerable to economic downturns, and (iv) limiting Air Canada's flexibility in planning for, or reacting to, competitive pressures or changes in its business environment.

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

Need for Additional Capital and Liquidity

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

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

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

Foreign Exchange

Air Canada's financial results are sensitive to the fluctuating value of the Canadian dollar. In particular, Air Canada has a significant annual net outflow of U.S. dollars and is affected by fluctuations in the U.S./Canada dollar exchange rate. Management estimates that during 2013, a $0.01 strengthening of the Canadian dollar versus the U.S. dollar (i.e., $1.10 to $1.09 per U.S. dollar) would have had an estimated $34 million favourable impact on operating income and a $48 million favourable impact on pre-tax income. Conversely, a corresponding opposite change in the exchange rate would have had the corresponding opposite effect. Air Canada incurs significant expenses in U.S. dollars for items such as fuel, aircraft rental and maintenance charges, interest payments, debt servicing and computerized reservations system fees, while a substantial portion of its revenues are generated in Canadian dollars. A significant deterioration of the Canadian dollar relative to the U.S. dollar would increase the costs of Air Canada relative to its U.S. competitors and could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Due to the competitive nature of the airline industry and consumer sensitivity to travel costs, Air Canada may not be able to pass on increases in Canadian dollar costs to its customers by increasing its fares. In addition, Air Canada may be unable to appropriately hedge the risks associated with fluctuations in exchange rates.

Economic and Geopolitical Conditions

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

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

Fuel Costs

Fuel costs constituted the largest percentage of the total operating costs of Air Canada in 2013. Fuel prices may fluctuate widely depending on many factors including international market conditions, geopolitical events, jet fuel refining costs and the Canada/U.S. dollar exchange rate. Air Canada cannot accurately predict fuel prices. Since approximately 2007, fuel prices have significantly increased and fluctuated near or at historically high levels. Should fuel prices fluctuate significantly or increase significantly above current levels, fuel costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Due to the competitive nature of the airline industry, Air Canada may not be able to pass on increases in fuel prices to its customers by increasing its fares. Based on 2013 volumes, management estimates that a US$1 per barrel movement in the average price of jet fuel would have resulted in an approximate $26 million change in 2013 fuel expense for Air Canada (excluding any impact of fuel surcharges, foreign exchange rates and fuel hedging), assuming flying capacity remained unchanged and that refining spreads between WTI crude oil and jet fuel as well as foreign exchange rates remained constant.

Competition

North America

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

Canadian low-cost and other carriers have entered and/or expanded or announced their intention to compete in many of Air Canada's key domestic (including regional) markets and, along with some U.S. carriers have also entered and/or expanded their operations in the U.S. transborder and leisure-oriented markets. Carriers against which Air Canada competes, including U.S. carriers, may undergo (and some have undergone) substantial reorganizations (including by way of merger with or acquisition by another carrier), creating reduced levels of indebtedness and lower operating costs and may therefore be in a position to more effectively compete with Air Canada.

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

International

Air Canada is also facing increasing competition in international markets as carriers increase their international capacity, both by expansion and by shifting existing domestic capacity to international operations to avoid low-cost domestic competition.

Given Canada's diverse, sustained immigration levels and multicultural population, Canadian gateways such as Toronto, Montreal, and Vancouver are deemed attractive by international carriers. Alone for 2013, foreign carriers such as Air Algerie, Air China, British Airways, China Eastern Airlines, Egyptair, Korean Airlines, Philippines Airlines, Saudi Arabian Airlines, Sichuan Airlines, and Turkish Airlines have entered or announced their intention to enter or expand their operations into Canada.

Increased competition in the domestic, transborder or international markets could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Labour Costs and Labour Relations

Labour costs constituted another one of Air Canada's largest operating cost items in 2013. There can be no assurance that Air Canada will be able to maintain such costs at levels that do not negatively affect its business, results from operations and financial condition. There can be no assurance that future agreements with employees' unions or the outcome of arbitrations will be on terms consistent with Air Canada's expectations or comparable to agreements entered into by Air Canada's competitors. Any future agreements or outcome of negotiations or arbitrations including in relation to wages or other labour costs or work rules may result in increased labour costs or other charges, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Most of Air Canada's employees are unionized. 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 Air Canada's flight attendants, were concluded and, respectively, ratified or conclusively settled through arbitration. The agreement with the CAW is in effect until February 28, 2015 and the agreement with CUPE is in effect until March 31, 2015. In 2011, Air Canada also 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 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 is not currently a party to these proceedings. Air Canada expects that in both cases the legislation (and therefore the collective agreements concluded through the arbitration process) will be upheld.

No strikes or lock-outs may lawfully occur during the term of the collective agreements, nor during the negotiations of their renewal until a number of pre-conditions, in respect of the unions for Canadian-based employees, prescribed by the Canada Labour Code, have been satisfied. There can be no assurance that collective agreements will be further renewed without labour conflict or action or that there will not otherwise be any labour conflict or action that could also lead to a degradation, interruption or stoppage in Air Canada's service or otherwise adversely affect the ability of Air Canada to conduct its operations, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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

Pension Plans

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

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

Refer to section 9.7 of this MD&A for additional information relating to Air Canada's pension funding obligations. In December 2013, further to an agreement reached with Air Canada in March 2013, the Government of Canada formally approved the *Air Canada Pension Plan Funding Regulations, 2014* (the "2014 Regulations") under the *Pension Benefits Standards Act, 1985*. Absent the 2014 Regulations and under generally applicable regulations, Air Canada's pension funding obligations would be determined by a variety of factors, including regulatory developments, assumptions and methods used and changes in the economic conditions (mainly the return on fund assets and changes in interest rates) as well as the application of normal past service contribution rules which would generally require one fifth of any solvency deficit, determined on the basis of an average over the previous three years, to be funded each year in addition to required current service contributions.

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

Revenue and Alliance Environment

Air Canada also encounters substantial price competition. The prevalence of low-cost carriers, Internet travel websites and other travel products distribution channels, have resulted in a substantial increase in discounted and promotional fares initiated by Air Canada's competitors. A decision to match competitors' fares to maintain passenger traffic results in reduced yields which, in turn, could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Furthermore, Air Canada's ability to reduce its fares in order to effectively compete with other carriers is dependent on Air Canada's ability to achieve acceptable operating margins and may also be limited by government policies to encourage competition. Likewise, competitors continue to pursue commissions/incentive actions and, in many cases, increase these payments. The decision to modify Air Canada's current programs in order to remain competitive and maintain passenger traffic could result in increased costs to Air Canada's business.

Furthermore, consolidation within the airline industry could result in increased competition as some airlines emerging from such consolidations and entering into integrated commercial cooperation arrangements, such as joint ventures, may be able to compete more effectively, which could have a material adverse effect on Air Canada.

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

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

Limitations Due to Restrictive Covenants

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

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

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

Strategic, Business, Technology and Other Important Initiatives

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

For instance, a key component of Air Canada's business plan is the acquisition of new and more efficient Boeing 787 and Boeing 737 MAX aircraft. A delay or failure in the completion of Air Canada's fleet restructuring, including delays by the manufacturers in the delivery of the aircraft, or an inability to remove, as planned, certain aircraft from the fleet in coordination with the planned entry into service of new aircraft, could adversely affect the implementation of Air Canada's business plan which may, in turn, have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Airport User Fees and Air Navigation Fees

With the privatization of airports and air navigation authorities in Canada, airport and air navigation authorities have significantly increased their fees. Air Canada may not be in a position to prevent or develop alternatives to overcome fee increases. Though certain authorities have implemented some fee reductions, if authorities in Canada or elsewhere were to significantly increase their fees, Air Canada, its business, results from operations and financial condition could be materially adversely affected.

Dependence on Technology

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

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

Key Supplies and Suppliers

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

Aeroplan®

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

Regional Carriers

Air Canada seeks to enhance its network through capacity purchase agreements, including the Jazz CPA and other capacity purchase agreements with regional airlines, such as Sky Regional, operating flights on behalf of Air Canada.

Under the Jazz CPA, Jazz provides Air Canada's customers service in lower density markets and higher density markets at off-peak times throughout Canada and to and from certain destinations in the United States and also provides valuable traffic feed to Air Canada's mainline routes. Pursuant to the terms of the Jazz CPA, Air Canada pays Jazz a number of fees which are determined based upon certain costs incurred by Jazz. Air Canada also reimburses Jazz, without mark-up, for certain pass-through costs incurred directly by Jazz, such as fuel, navigation, landing and terminal fees and certain other costs. Significant increases in such pass-through costs, the failure by Jazz to adequately fulfill its obligations under the Jazz CPA, or other unexpected interruptions or cessation of Jazz's services which are beyond Air Canada's control could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, the Jazz CPA requires that Jazz maintain a minimum fleet size and contains a minimum average daily utilization guarantee which requires that Air Canada make certain minimum payments to Jazz regardless of the amount of flying done on its behalf by Jazz.

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

Star Alliance®

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

Interruptions or Disruptions in Service

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

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

Current Legal Proceedings

Investigations by Competition Authorities Relating to Cargo

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

In 2010, the European Commission rendered a decision finding that 12 air cargo carriers (including groups of related carriers) had infringed European Union competition law in the setting of certain cargo charges and rates for various periods between 1999 and 2006. Air Canada was among the carriers subject to the decision and a fine of 21 million Euros (approximately C$29 million) was imposed on Air Canada. Air Canada is appealing this decision and filed an application for appeal before the European General Court. In 2011, Air Canada paid the fine, as required, pending the outcome of its appeal.

As at December 31, 2013, Air Canada has a provision of $27 million relating to outstanding claims in this matter, which is recorded in accounts payable and accrued liabilities on Air Canada's consolidated statement of financial position. This provision is an estimate based upon the status of the investigations and proceedings at this time and Air Canada's assessment as to the potential outcome for certain of them. The provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Air Canada has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings and investigations. As stated above, Air Canada is appealing the decision issued by the European Commission and, if and as appropriate, based on the outcome of any updates regarding this appeal as well as developments regarding proceedings and investigations in other jurisdictions, may record adjustments to the provision and/or its income in subsequent periods as required.

Mandatory Retirement

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

Future Legal Proceedings

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

Key Personnel

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

Risks Relating to the Airline Industry

Terrorist Attacks and Security Measures

The potential for terrorist attacks and terrorist activity causes uncertainty in the minds of the traveling public. The occurrence of a terrorist attack (or attempted attacks) (whether domestic or international and whether involving Air Canada or another carrier or no carrier at all) and increasingly restrictive security measures, such as those relating to the content of carry-on baggage, passenger identification document requirements, and passenger screening procedures could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on Air Canada's flights. It could also lead to a substantial increase in insurance, airport security and other costs. Any resulting reduction in passenger revenues and/or increases in costs, including insurance, security or other costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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

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

Casualty Losses

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

Seasonal Nature of the Business, Other Factors and Prior Performance

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

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

Regulatory Matters

The airline industry is subject to extensive Canadian and foreign government regulations relating to, among other things, security, safety, consumer rights, privacy, licensing, competition, environment (including noise levels and carbon emissions) and, in some measure, pricing. For example, new and proposed legislation have been considered or adopted concerning carbon emissions emanating from the aviation industry. Such legislative initiatives include, for example, market-based mechanisms called emissions trading systems, which are being proposed and implemented to reduce the amount of carbon emissions through the setting of emissions allowances and charging aircraft operators for a certain percentage of theses allowances. The implementation of additional regulations or decisions, including those relating to carbon emissions, and others, whether by Transport Canada, the Competition Bureau and/or the Competition Tribunal, the Canadian Transportation Agency or other domestic or foreign governmental entities, may have a material adverse effect on Air Canada, its business, results from operations and financial condition.

The European Union passed legislation for an Emissions Trading System, which included carbon emissions from aviation commencing in 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. While this legislation is expected to result in increased costs relating to the purchase of emissions allowances, the net financial impact will, in part, depend upon how much of such cost, if any, will be recovered, including in the form of higher passenger fares and cargo rates. In November 2012, the European Commission announced that it would defer their Emissions Trading System for international aviation by approximately eleven months pending an anticipated agreement on a multilateral global alternative program being agreed by the ICAO General Assembly. Following the outcome of the International Civil Aviation Organization ("ICAO") General Assembly, the European Commission announced a new legislative proposal to introduce a European Regional Airspace Approach to be implemented between 2014 and 2020 until a single global international regime is adopted. Management cannot predict the outcome of such legislative process or the impact it may have on Air Canada, its business, results from operations and financial condition.

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

Air Canada is subject to domestic and foreign laws regarding privacy of passenger and employee data, including advance passenger information and access to airline reservation systems, which are not consistent in all countries in which Air Canada operates. The need to comply with these regulatory regimes results in additional operating costs and further regulation in this area could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Foreign jurisdictions (including the United States, European Union countries and other jurisdictions where Air Canada operates) have enacted and implemented and they and domestic regulators may in the future enact and implement consumer protection and passenger rights measures. Such measures may impose significant, unique, inconsistent or even conflicting obligations on Air Canada, which may result in increased liability and costs to Air Canada and which may adversely impact Air Canada, its business, results from operations and financial condition.

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

Availability of Insurance Coverage and Increased Insurance Costs

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

Third Party War Risk Insurance

There is a risk that the Government of Canada may not continue to provide an indemnity for third party war risk liability coverage, which it is currently providing to Air Canada and certain other carriers in Canada until December 31, 2015. In the event that the Government of Canada does not continue to provide such indemnity or amends such indemnity, Air Canada and other industry participants would have to turn to the commercial insurance market to seek such coverage. Air Canada estimates that such coverage would cost Air Canada approximately US$2.5 million per year. Alternative solutions, such as those envisioned by the ICAO and the International Air Transport Association ("IATA"), have not developed as planned, due to actions taken by other countries and the recent availability of supplemental insurance products. ICAO and IATA are continuing their efforts in this area; however, the achievement of a global solution is not likely in the immediate or near future. The U.S. federal government has set up its own facility to provide war risk coverage to U.S. carriers, thus removing itself as a key component of any global plan.

19. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

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

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

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

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

Management's Report on Disclosure Controls and Procedures

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined under National Instrument 52-109) and concluded, as at December 31, 2013, that such disclosure controls and procedures were effective.

Management's Report on Internal Controls over Financial Reporting

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's internal controls over financial reporting (as defined under National Instrument 52-109). In making this evaluation, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commissions ("COSO") in Internal Control – Integrated Framework (1992). Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2013, the Corporation's internal controls over financial reporting were effective. This evaluation took into consideration the Corporation's Corporate Disclosure Policy and the functioning of its Disclosure Policy Committee.

Changes in Internal Controls over Financial Reporting

There have been no changes to the Corporation's internal controls over financial reporting during the year ended December 31, 2013 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

20. NON-GAAP FINANCIAL MEASURES

Operating Income, Excluding the Impact of Benefit Amendments

Air Canada uses Operating income, excluding the impact of benefit plan amendments to assess the operating performance of its ongoing airline business without the effects of unusual items, such as benefit plan amendments, as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

Operating income, excluding benefit plan amendments 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.

Operating Income, excluding the impact of benefit plan amendments, is reconciled to operating income as follows:

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	2013	2012	$ Change	2013	2012	$ Change
GAAP operating income	$ 135	$ 47	$ 88	$ 619	$ 442	$ 177
Add back:						
Benefit plan amendments(1)	(82)	–	(82)	(82)	(127)	45
Operating income, excluding the impact of benefit plan amendments	**$ 53**	**$ 47**	**$ 6**	**$ 537**	**$ 315**	**$ 222**

(1) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans. In 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

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 as follows:

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	2013	2012	$ Change	2013	2012	$ Change
GAAP operating income	$ 135	$ 47	$ 88	$ 619	$ 442	$ 177
Add back:						
Aircraft rent	76	81	(5)	318	336	(18)
Depreciation, amortization and impairment	148	155	(7)	578	669	(91)
EBITDAR	**$ 359**	**$ 283**	**$ 76**	**$ 1,515**	**$ 1,447**	**$ 68**
Add back:						
Benefit plan amendments(1)	(82)	–	(82)	(82)	(127)	45
EBITDAR, excluding the impact of benefit plan amendments	**$ 277**	**$ 283**	**$ (6)**	**$ 1,433**	**$ 1,320**	**$ 113**

(1) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans. In 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

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, such as benefit plan amendments and impairment charges, as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

Fuel expense is excluded from operating expense results as it fluctuates widely depending on many factors, including international market conditions, geopolitical events, jet fuel refining costs and Canada/U.S. currency exchange rates. Air Canada also incurs expenses related to ground packages at Air Canada Vacations which some airlines, without comparable tour operator businesses, may not incur. In addition, these costs do not generate ASMs and therefore excluding these costs from operating expense results provides for a more meaningful comparison across periods when such costs may vary.

Therefore, excluding fuel expense, the cost of ground packages at Air Canada Vacations and unusual items from operating expenses generally allows for more meaningful analysis of Air Canada's operating expense performance and a more meaningful comparison to those of other airlines.

Adjusted CASM is 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)	Fourth Quarter			Full Year		
	2013	2012	$ Change	2013	2012	$ Change
GAAP operating expense	$ 2,759	$ 2,792	$ (33)	$ 11,763	$ 11,672	$ 91
Adjusted for:						
Aircraft fuel	(831)	(821)	(10)	(3,534)	(3,561)	27
Cost of ground packages at Air Canada Vacations	(66)	(57)	(9)	(327)	(319)	(8)
Benefit plan amendments(1)	82	–	82	82	127	(45)
Impairment charge(2)	(6)	–	(6)	(30)	–	(30)
Operating expense, adjusted for the above-noted items	$ 1,938	$ 1,914	$ 24	$ 7,954	$ 7,919	$ 35
ASMs (millions)	16,033	15,484	3.5%	68,573	67,269	1.9%
Adjusted CASM (cents)	¢ 12.09	¢ 12.37	(2.3)%	¢ 11.60	¢ 11.78	(1.5)%

(1) *In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans. In the third quarter of 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.*

(2) *In 2013, Air Canada recorded an impairment charge of $30 million, of which $24 million related to Airbus A340-300 aircraft.*

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)	Fourth Quarter			Full Year		
	2013	2012	$ Change	2013	2012	$ Change
Net income (loss) for the period attributable to shareholders	$ (7)	$ (61)	$ 54	$ 6	$ (140)	$ 146
Adjusted for:						
Benefit plan amendments(1)	(82)	–	(82)	(82)	(127)	45
Impairment charge(2)	6	–	6	30	–	30
Foreign exchange (gain) loss	55	(9)	64	120	(106)	226
Interest charge(3)	–	–	–	95	–	95
Net financing expense (income) relating to employee benefits	53	72	(19)	208	288	(80)
(Gain) loss on financial instruments recorded at fair value	(22)	(7)	(15)	(37)	20	(57)
Loss on investment in Aveos(4)	–	–	–	–	65	(65)
Discontinued operations – Aveos(5)	–	–	–	–	55	(55)
Adjusted net income (loss)	$ 3	$ (5)	$ 8	$ 340	$ 55	$ 285
Weighted average number of outstanding shares used in computing diluted income per share (in millions)	291	276	15	284	278	6
Adjusted net income (loss) per share – diluted	$ 0.01	$ (0.02)	$ 0.03	$ 1.20	$ 0.20	$ 1.00

(1) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans. In 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(2) In 2013, Air Canada recorded an impairment charge of $30 million, of which $24 million related to Airbus A340-300 aircraft.

(3) In 2013, Air Canada recorded an interest charge of $95 million related to the purchase of its senior secured notes which were to become due in 2015 and 2016.

(4) In 2012, Air Canada recorded a loss on its investments in Aveos of $65 million.

(5) In 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.

The following reflects the share amounts used in the computation of basic and diluted earnings per share on an adjusted net income per share basis:

	Fourth Quarter		Full Year	
	2013	2012	2013	2012
Weighted average number of shares outstanding – basic	282	276	277	276
Effect of dilution	9	5	7	2
add back anti-dilutive impact	–	(5)	–	–
Weighted average number of shares outstanding – diluted	291	276	284	278

Return on Invested Capital

Air Canada uses Return on invested capital to assess the efficiency with which it allocates its capital to generate returns. Return is based on Adjusted net income (loss) (as defined in the section above), excluding interest expense and implicit interest on operating leases. Invested capital includes average long-term debt, average finance lease obligations, the value of capitalized operating leases (calculated by multiplying annualized aircraft rent expense by 7) and the average market capitalization of Air Canada's outstanding shares. This measure 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.

(Canadian dollars in millions, except where indicated)	December 31, 2013	December 31, 2012	$ Change
Net income (loss) for the period attributable to shareholders of Air Canada (trailing 12 months)	$ 6	$ (140)	$ 146
Remove:			
Benefit plan amendments(1)	(82)	(127)	45
Impairment charge(2)	30	–	30
Foreign exchange (gain) loss	120	(106)	226
Interest charge(3)	95	–	95
Net financing expense relating to employee benefits	208	288	(80)
Gain (loss) on financial instruments recorded at fair value	(37)	20	(57)
Loss on investment in Aveos(4)	–	65	(65)
Discontinued operations – Aveos(5)	–	55	(55)
Adjusted net income (trailing 12 months)	**$ 340**	**$ 55**	**$ 285**
Adjusted for:			
Interest expense(6)	302	304	(2)
Implicit interest on operating leases(7)	156	165	(9)
Adjusted income before interest (trailing 12 months)	**$ 798**	**$ 524**	**$ 274**
Invested capital:			
Average long-term debt and finance leases(8)	4,046	3,942	104
Average market capitalization	1,014	328	686
Capitalized operating leases(9)	2,226	2,352	(126)
Invested capital	**$ 7,286**	**$ 6,622**	**$ 664**
Return on invested capital (%)	**11.0%**	**7.9%**	**3.1 pp**

(1) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans. In 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(2) In 2013, Air Canada recorded an impairment charge of $30 million, of which $24 million related to Airbus A340-300 aircraft.

(3) In 2013, Air Canada recorded an interest charge of $95 million related to the purchase of its senior secured notes which were to become due in 2015 and 2016.

(4) In 2012, Air Canada recorded a loss on its investments in Aveos of $65 million.

(5) In 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.

(6) Interest expense excludes the non-recurring interest expense charge on the repayment of the senior secured notes recognized in the third quarter of 2013 as described in (3) above.

(7) Interest implicit on operating leases is equal to 7.0% of 7 times the trailing 12 months of aircraft rent. 7.0% is a proxy and does not necessarily represent the actual implicit interest on operating leases for any given period.

(8) Average long-term debt and finance leases include the current portion and long-term portion.

(9) Capitalized operating leases are calculated by multiplying the trailing 12 months of aircraft rent by 7. Aircraft rent totaled $318 million for the twelve months ended December 31, 2013 (December 31, 2012 – $336 million).

21. GLOSSARY

ACPA – Refers to the Air Canada Pilots Association.

Adjusted CASM – Refers to operating expense per ASM adjusted to remove the effects of fuel expense, the cost of ground packages at Air Canada Vacations and unusual items. Refer to section 20 of this MD&A for additional information.

Adjusted net income (loss) – Refers to the consolidated net income (loss) of Air Canada attributable to the shareholders of Air Canada adjusted to remove the effects of (to the extent included in consolidated net income (loss)) foreign exchange gains or losses, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value and unusual items. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

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

Available Seat Miles or ASMs – Refers to a measure of passenger capacity calculated by multiplying the total number of seats available for passengers by the miles flown.

CASM – Refers to operating expense per ASM.

CUPE – Refers to the Canadian Union of Public Employees.

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

EBITDAR – Refers to earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent. EBITDAR is a non-GAAP financial measure. Refer to section 20 of this MD&A for additional information.

EETCs – Refers to Enhanced Equipment Trust Certificates issued in connection with the financing of aircraft. See section 9.6 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 – Refer to revenues from flights with origins and destinations principally in Central and South America and the Caribbean and Mexico.

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

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

Passenger Revenue per Available Seat Mile or RASM – Refers to average passenger revenue per ASM (baggage fee revenues, which are included in passenger revenues, are removed for the purposes of calculating RASM).

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

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

Revenue Passenger Carried – Refers to IATA's definition of passenger carried whereby passengers are counted on a flight number basis rather than by journey/itinerary or by leg.

Revenue Passenger Miles or RPMs – Refers to a measure of passenger traffic calculated by multiplying the total number of revenue passengers carried by the miles they are carried.

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 – Refers to average passenger revenue per RPM (baggage fee revenues, which are included in passenger revenues, are removed for the purposes of calculating yield).

Weighted average cost of capital or WACC – Refers to management's estimate of its cost of capital, in which each category of capital is proportionately weighted, and consists of an estimated cost of equity of 20% and an average cost of debt and finance leases of 6%.

STATEMENT OF MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The consolidated financial statements have been prepared by management. Management is responsible for the fair presentation of the consolidated financial statements in conformity with generally accepted accounting principles in Canada which incorporates International Financial Reporting Standards. Management is responsible for the selection of accounting policies and making significant accounting judgements and estimates. Management is also responsible for all other financial information included in management's discussion and analysis and for ensuring that this information is consistent, where appropriate, with the information contained in the consolidated financial statements.

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

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

The external auditors, PricewaterhouseCoopers LLP, conduct an independent audit of the consolidated financial statements in accordance with Canadian generally accepted auditing standards and express their opinion thereon. Those standards require that the audit is planned and performed to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The external auditors have unlimited access to the Audit, Finance and Risk Committee and meet with the Committee on a regular basis.

Calin Rovinescu
President and Chief Executive Officer

Michael Rousseau
Executive Vice President and Chief Financial Officer

February 11, 2014

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF AIR CANADA

We have audited the accompanying consolidated financial statements of Air Canada and its subsidiaries, which comprise the consolidated statement of financial position as at December 31, 2013, December 31, 2012 and January 1, 2012 and the consolidated statement of operations, statement of comprehensive income, statement of changes in equity and statement of cash flow for the years ended December 31, 2013 and December 31, 2012, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Air Canada and its subsidiaries as at December 31, 2013, December 31, 2012 and January 1, 2012 and their financial performance and their cash flows for the years ended December 31, 2013 and December 31, 2012 in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers LLP[1]

Montreal, Quebec
February 11, 2014

[1] CPA auditor, CA, public accountancy permit No. 18144

"PwC" refers to PricewaterhouseCoopers LLP, an Ontario limited liability partnership.

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

(Canadian dollars in millions)		December 31, 2013	December 31, 2012	January 1, 2012
ASSETS				
Current				
Cash and cash equivalents	Note 2P	$ 750	$ 754	$ 777
Short-term investments	Note 2Q	1,458	1,219	1,251
Total cash, cash equivalents and short-term investments		2,208	1,973	2,028
Restricted cash	Note 2R	92	96	76
Accounts receivable		589	550	712
Aircraft fuel inventory		71	84	92
Spare parts and supplies inventory	Note 2S	65	66	93
Prepaid expenses and other current assets		263	232	255
Total current assets		3,288	3,001	3,256
Property and equipment	Note 4	5,073	4,711	4,938
Intangible assets	Note 5	304	314	312
Goodwill	Note 6	311	311	311
Deposits and other assets	Note 7	494	510	595
Total assets		**$ 9,470**	**$ 8,847**	**$ 9,412**
LIABILITIES				
Current				
Accounts payable and accrued liabilities		$ 1,129	$ 1,161	$ 1,175
Advance ticket sales		1,687	1,599	1,554
Current portion of long-term debt and finance leases	Note 8	374	499	419
Total current liabilities		3,190	3,259	3,148
Long-term debt and finance leases	Note 8	3,959	3,259	3,707
Pension and other benefit liabilities	Note 9	2,687	4,686	5,563
Maintenance provisions	Note 10	656	571	548
Other long-term liabilities	Note 11	375	419	463
Total liabilities		**$ 10,867**	**$ 12,194**	**$ 13,429**
EQUITY				
Shareholders' equity				
Share capital	Note 13	827	813	840
Contributed surplus		80	62	58
Deficit		(2,367)	(4,281)	(4,989)
Total shareholders' equity		(1,460)	(3,406)	(4,091)
Non-controlling interests		63	59	74
Total equity		(1,397)	(3,347)	(4,017)
Total liabilities and equity		**$ 9,470**	**$ 8,847**	**$ 9,412**

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

On behalf of the Board of Directors:

David I. Richardson
Chairman

Christie J.B. Clark
Chair of the Audit, Finance and Risk Committee

CONSOLIDATED STATEMENT OF OPERATIONS

For the year ended December 31 (Canadian dollars in millions except per share figures)		2013	2012
Operating revenues			
Passenger	Note 20	$ 11,021	$ 10,737
Cargo	Note 20	474	488
Other		887	889
Total revenues		**12,382**	**12,114**
Operating expenses			
Aircraft fuel		3,534	3,561
Wages, salaries and benefits		2,247	2,110
Benefit plan amendments	Note 9	(82)	(127)
Capacity purchase agreements		1,123	1,072
Airport and navigation fees		983	992
Aircraft maintenance		632	672
Sales and distribution costs		613	603
Depreciation, amortization and impairment		578	669
Aircraft rent		318	336
Food, beverages and supplies		289	291
Communications and information technology		190	188
Other		1,338	1,305
Total operating expenses		**11,763**	**11,672**
Operating income		**619**	**442**
Non-operating income (expense)			
Foreign exchange gain (loss)		(120)	106
Interest income		32	37
Interest expense		(397)	(304)
Interest capitalized		46	18
Net financing expense relating to employee benefits	Note 9	(208)	(288)
Gain (loss) on financial instruments recorded at fair value	Note 17	37	(20)
Loss on investments in Aveos	Note 19	–	(65)
Other		(7)	(6)
Total non-operating expense		(617)	(522)
Income (loss) before income taxes and discontinued operations		**2**	**(80)**
Income taxes	Note 12	8	(1)
Net income (loss) from continuing operations		**$ 10**	**$ (81)**
Net loss from discontinued operations – Aveos	Note 19	**–**	**(55)**
Net income (loss)		**$ 10**	**$ (136)**
Net income (loss) attributable to:			
Shareholders of Air Canada		6	(140)
Non-controlling interests		4	4
Net income (loss)		**$ 10**	**$ (136)**
Net income (loss) per share attributable to shareholders of Air Canada	Note 15		
Basic earnings (loss) per share from continuing operations		$ 0.02	$ (0.31)
Diluted earnings (loss) per share from continuing operations		$ 0.02	$ (0.31)
Basic and diluted loss per share from discontinued operations		$ –	$ (0.20)
Diluted earnings (loss) per share		$ 0.02	$ (0.51)

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended December 31 (Canadian dollars in millions)		2013	2012
Comprehensive income			
Net income (loss)		$ 10	$ (136)
Other comprehensive income, net of taxes of nil:			
Remeasurements on employee benefit liabilities	Note 9	1,908	826
Total comprehensive income		**$ 1,918**	**$ 690**
Comprehensive income attributable to:			
Shareholders of Air Canada		$ 1,914	$ 686
Non-controlling interests		4	4
Total comprehensive income		**$ 1,918**	**$ 690**
Comprehensive income (loss) attributable to shareholders of Air Canada from:			
Continuing operations		$ 1,914	$ 741
Discontinued operations		–	(55)
		$ 1,914	**$ 686**

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

(Canadian dollars in millions)	Share capital	Contributed surplus	Deficit	Total shareholders' equity	Non-controlling interests	Total equity
January 1, 2012	$ 840	$ 58	$ (4,989)	$ (4,091)	$ 74	$ (4,017)
Net income (loss)	–	–	(140)	(140)	4	(136)
Remeasurements on employee benefit liabilities	–	–	826	826	–	826
Total comprehensive income	–	–	686	686	4	690
Share-based compensation	–	4	–	4	–	4
Expiration of warrants	(18)	–	18	–	–	–
Shares purchased and cancelled under issuer bid	(9)	–	4	(5)	–	(5)
Distributions	–	–	–	–	(19)	(19)
December 31, 2012	$ 813	$ 62	$ (4,281)	$ (3,406)	$ 59	$ (3,347)
Net income	–	–	6	6	4	10
Remeasurements on employee benefit liabilities	–	–	1,908	1,908	–	1,908
Total comprehensive income	–	–	1,914	1,914	4	1,918
Share-based compensation	–	12	–	12	–	12
Performance share units reclassed to equity settled (Note 2i)	–	7	–	7	–	7
Repurchase of warrants (Note 13)	(2)	–	–	(2)	–	(2)
Shares issued (Note 13)	16	(1)	–	15	–	15
December 31, 2013	$ 827	$ 80	$ (2,367)	$ (1,460)	$ 63	$ (1,397)

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

CONSOLIDATED STATEMENT OF CASH FLOW

For the year ended December 31 (Canadian dollars in millions)		2013	2012
Cash flows from (used for)			
Operating			
Net income (loss)		$ 10	$ (136)
Adjustments to reconcile to net cash from operations			
Depreciation, amortization and impairment		578	669
Foreign exchange (gain) loss	Note 17	200	(96)
Employee benefit funding (greater than) less than expense		(3)	76
Benefit plan amendments	Note 9	(82)	(127)
Fuel and other derivatives	Note 17	(33)	(36)
Loss on investments in Aveos	Note 19	–	65
Discontinued operations – Aveos	Note 19	(29)	29
Change in maintenance provisions		29	(2)
Changes in non-cash working capital balances		33	220
Provision for cargo investigations	Note 18	–	(8)
Other		28	(11)
Net cash flows from operating activities		**731**	**643**
Financing			
Proceeds from borrowings	Note 8	1,973	132
Reduction of long-term debt and finance lease obligations	Note 8	(1,646)	(442)
Issue of common shares, net		14	–
Shares purchased for cancellation		–	(5)
Distributions related to aircraft special purpose leasing entities		–	(16)
Other		(15)	–
Net cash flows from (used in) financing activities		**326**	**(331)**
Investing			
Short-term investments		(210)	27
Additions to property, equipment and intangible assets		(962)	(444)
Proceeds from sale of assets		70	50
Other		41	32
Net cash flows used in investing activities		**(1,061)**	**(335)**
Decrease in cash and cash equivalents		**(4)**	**(23)**
Cash and cash equivalents, beginning of year		754	777
Cash and cash equivalents, end of year		**$ 750**	**$ 754**

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

For the years ended December 31, 2013 and 2012
(Canadian dollars in millions – except per share amounts)

1. GENERAL INFORMATION

The accompanying audited consolidated financial statements (the "financial statements") are of Air Canada (the "Corporation"). The term "Corporation" also refers to, as the context may require, Air Canada and/or one or more of its subsidiaries, including its principal wholly-owned operating subsidiaries, Touram Limited Partnership ("Air Canada Vacations") and Air Canada *rouge* LP doing business under the brand name Air Canada *rouge*™ ("Air Canada *rouge*"). These financial statements also include certain aircraft leasing entities, which are consolidated under IFRS 10 Consolidated Financial Statements, with nominal equity owned by other parties.

Air Canada is incorporated and domiciled in Canada. The address of its registered office is 7373 Côte-Vertu Boulevard West, Saint-Laurent, Quebec.

Air Canada is Canada's largest domestic, US transborder and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-US transborder market as well as the international markets to and from Canada. Certain of the scheduled passenger services offered on domestic and Canada-US transborder routes are operated under the brand name "Air Canada Express" and operated by third parties such as Jazz Aviation LP ("Jazz") and Sky Regional Airlines Inc. ("Sky Regional") through capacity purchase agreements (each a "CPA"). Air Canada also offers scheduled passenger services on domestic and Canada-US transborder routes through capacity purchase agreements on other regional carriers, including those operating aircraft of 18 seats or less, some of which are referred to as Tier III carriers. Through Air Canada's global route network, virtually every major market throughout the world is served either directly or through the Star Alliance network.

Air Canada Cargo, an operating division of Air Canada, is Canada's largest provider of air cargo services. Air Canada offers air cargo services on domestic and U.S. transborder routes as well as on international routes between Canada and major markets in Europe, Asia, South America and Australia.

In 2012, the Air Canada Leisure Group was created to co-ordinate the Corporation's activities in the leisure travel markets. The Air Canada Leisure Group consists of Air Canada Vacations and Air Canada *rouge*. Air Canada Vacations is a leading Canadian tour operator. Based in Montreal and Toronto, Air Canada Vacations operates its business in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, Central and South America, South Pacific, Australia and Asia) by developing, marketing and distributing vacation travel packages. Air Canada Vacations also offers cruise packages in North America, Europe and the Caribbean.

Air Canada *rouge* launched its operations on July 1, 2013 with a start-up fleet of four aircraft transferred from the mainline fleet – two Boeing 767-300ER and two Airbus A319 aircraft. By the end of 2013, the fleet was comprised of eight Airbus A319 and two Boeing 767 aircraft. Air Canada *rouge* provides scheduled passenger service within certain of Air Canada's leisure travel markets.

2. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Corporation prepares its financial statements in accordance with generally accepted accounting principles in Canada ("GAAP") as set out in the CPA Canada Handbook – Accounting ("CPA Handbook") which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

These financial statements were approved for issue by the Board of Directors of the Corporation on February 11, 2014.

These financial statements are based on the accounting policies as described below. These policies have been consistently applied to all the periods presented, unless otherwise stated.

A) BASIS OF MEASUREMENT

These financial statements have been prepared under the historical cost convention, except for the revaluation of cash, cash equivalents and short-term investments, restricted cash and derivative instruments which are measured at fair value.

B) PRINCIPLES OF CONSOLIDATION

These financial statements include the accounts of Air Canada and its subsidiaries. Subsidiaries are all entities (including structured entities) which Air Canada controls. For accounting purposes, control is established by an investor when it is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. All inter-company balances and transactions are eliminated.

Non-controlling interests represent equity interests in subsidiaries owned by outside parties. The share of net assets of subsidiaries attributable to non-controlling interests is presented as a component of equity.

Structured Entities

The Corporation has aircraft leasing and other agreements with a number of structured entities. Under IFRS 10 Consolidated Financial Statements, the Corporation controls and consolidates leasing entities covering aircraft (23 as at December 31, 2013), including the structured entity created for the benefit of the Enhanced Equipment Trust Certificates ("EETC") financing structure undertaken by Air Canada in 2013 in relation to the acquisition of five Boeing 777 aircraft, four of which were delivered in 2013. The Corporation has concluded that it controls these entities because the lease or other agreements with these structured entities give Air Canada the power to control the principal economic decision on lease expiry of whether to purchase the aircraft and thereby collapse the structured entity.

The Corporation also leases certain aircraft from structured entities where it does not guarantee any portion of the residual value of the aircraft on lease expiry. In the absence of residual value guarantees, the Corporation's maximum exposure to loss from its involvement with these structured entities is limited principally to its lease payments. These entities are not controlled and are not consolidated by the Corporation.

Impact upon adoption of IFRS 10 – Consolidated Financial Statements

The Corporation adopted IFRS 10 effective January 1, 2013, in accordance with the applicable transitional provisions. 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 previous IFRS, consolidation was required when an entity had 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.

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

Under the guidance of SIC Interpretation 12 – Consolidation of Special Purpose Entities which was applicable to periods prior to January 1, 2013, the Corporation consolidated three of the Fuel Facility Corporations located in Canada. The Corporation assessed its consolidation conclusions at January 1, 2013 under IFRS 10 and determined that it does not have control over and should not, consolidate the three Fuel Facility Corporations that were previously consolidated following the guidance in SIC-12.

The Corporation has accounted for this change in accounting policy using the relevant transitional provisions and derecognized the carrying amount of the assets, liabilities and non-controlling interests of the three Fuel Facility Corporations as at January 1, 2012. The adjustments for each financial statement line item affected are presented in the tables below.

Adjustments to consolidated statement of financial position

	December 31, 2012	January 1, 2012
Cash and cash equivalents	$ (4)	$ (71)
Short-term investments	(49)	–
Property and equipment	(160)	(150)
Current portion of long-term debt	(7)	(5)
Long-term debt	(190)	(199)
Other long-term liabilities	(8)	(6)
Decrease in net assets	**$ 8**	**$ 11**
Deficit	(3)	(6)
Non-controlling interests	(5)	(5)
Equity	**$ (8)**	**$ (11)**

Adjustments to consolidated statement of operations and statement of comprehensive income

	Year ended December 31, 2012
Other revenues	$ (6)
Depreciation, amortization and impairment	(9)
Increase in net income and comprehensive income	**$ 3**
Increase in net income and comprehensive income attributable to:	
Shareholders of Air Canada	3
Non-controlling interests	-
Equity	**$ 3**

These adjustments had an impact of $0.01 on basic and diluted earnings per share for the year ended December 31, 2012.

C) PASSENGER AND CARGO REVENUES

Passenger and cargo revenues are recognized when the transportation is provided, except for revenue on unlimited flight passes which is recognized on a straight-line basis over the period during which the travel pass is valid. The Corporation has formed alliances with other airlines encompassing loyalty program participation, interline agreements and code sharing and coordination of services including reservations, baggage handling and flight schedules. Revenues are allocated based upon formulas specified in the agreements and are recognized as transportation is provided. Passenger revenue also includes certain fees and surcharges and revenues from passenger-related services such as ticket changes, seat selection, and excess baggage which are recognized as the services are provided.

Airline passenger and cargo advance sales are deferred and included in Current liabilities. Advance sales also include the proceeds from the sale of flight tickets to Aimia Canada Inc. ("Aeroplan"), a corporation that provides loyalty program services to Air Canada and purchases seats from Air Canada pursuant to the Commercial Participation and Services Agreement between Aeroplan and Air Canada (the "CPSA").

D) CAPACITY PURCHASE AGREEMENTS

Air Canada has capacity purchase agreements with Jazz, Sky Regional and certain other regional carriers, including those operating aircraft of 18 seats or less, some of which are referred to as Tier III carriers. Under these agreements, Air Canada markets, tickets and enters into other commercial arrangements relating to these flights and records the revenue it earns under Passenger revenue. Operating expenses under capacity purchase agreements include the capacity purchase fees, which, under the capacity purchase agreement between the Corporation and Jazz (the "Jazz CPA"), are based on variable and fixed rates ("CPA Rates") plus mark-up and pass-through costs. The CPA Rates are periodically set by the parties for rate periods of three years. The parties set the rates through negotiations based on, amongst other things, Jazz's forecasted costs for the applicable rate period and an operating plan for the applicable rate period provided by Air Canada, and the results of benchmarking exercises, which compare Jazz costs to other regional carriers. Pass-through costs are non-marked-up costs charged to the Corporation and include fuel, airport and user fees and other costs. These expenses are recorded in the applicable category within Operating expenses.

E) AEROPLAN LOYALTY PROGRAM

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

Under the CPSA, Aeroplan purchases passenger tickets from Air Canada to meet its obligation for the redemption of Aeroplan Miles® for air travel. The proceeds from the sale of passenger tickets to Aeroplan are included in Advance ticket sales. Revenue related to these passenger tickets is recorded in passenger revenues when transportation is provided.

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

F) OTHER REVENUES

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

Other revenue also includes revenue related to the lease or sublease of aircraft to third parties. Lease or sublease revenues are recognized on a straight line basis over the term of the lease or sublease. Rental revenue from operating leases and subleases amounted to $53 in 2013 (2012 – $90).

In certain subleases of aircraft to Jazz, for accounting purposes, the Corporation acts as an agent and accordingly reports the sublease revenues net against aircraft rent expense as the terms of the sublease match the terms of the Corporation's lease. The Corporation acts as lessee and sublessor in these matters.

G) EMPLOYEE BENEFITS

The cost of pensions, other post-retirement and post-employment benefits earned by employees is actuarially determined annually as at December 31. The cost is determined using the projected unit credit method and assumptions including market interest rates, salary escalation, retirement ages of employees, mortality rates, and health care costs.

Past service costs are recognized immediately in income. Gains and losses on curtailments or settlements are recognized in the period in which the curtailment or settlement occurs.

Net actuarial gains and losses are recognized immediately in other comprehensive income and deficit without subsequent reclassification to income. The current service cost and recognized element of any past service cost of employee benefits expense is recorded in Wages, salaries and benefits. The interest arising on the net benefit obligations are presented in Net financing expense relating to employee benefits.

Certain of the Corporation's pension plans are subject to minimum funding requirements. The liability in respect of minimum funding requirements is determined using the projected minimum funding requirements, based on management's best estimates of the actuarially determined funded status of the plan, market discount rates and salary escalation estimates. The liability in respect of the minimum funding requirement and any subsequent remeasurement of that liability are recognized immediately in other comprehensive income and deficit without subsequent reclassification to income.

Impact upon adoption of Amendments to IAS 19 – Employee Benefits

The Corporation adopted the revised IAS 19 standard effective January 1, 2013, in accordance with the applicable transitional provisions. The amendments to IAS 19 make significant changes to the recognition and measurement of defined benefit pension expense and termination benefits, and expanded the disclosures for employee benefits. Actuarial gains and losses are renamed 'remeasurements' and are recognized immediately in Other comprehensive income ("OCI"). Remeasurements recognized in OCI are not 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 is computed based on the application of the discount rate to the net defined benefit asset or liability, including interest on any liability in respect of minimum funding requirements. The Corporation continues to immediately recognize in the deficit all pension and benefit adjustments recognized in OCI. The Corporation also continues to recognize interest expense on net post-employment benefit liabilities in Net financing expense related to employee benefits in the consolidated statement of operations.

The Corporation adopted these amendments retrospectively and adjusted its equity as at January 1, 2012 to recognize previously unrecognized past service costs. The financing expense and employee benefit expense for the comparable period have been adjusted to reflect the accounting changes for defined benefit plans. The adjustments for each financial statement line item affected are presented in the tables below.

Adjustments to consolidated statement of financial position

	December 31, 2013	December 31, 2012	January 1, 2012
Decrease in Pension and other benefit liabilities	$ (3)	$ (3)	$ –
Increase in Equity	$ 3	$ 3	$ –

Adjustments to consolidated statement of operations

	Year ended December 31	
	2013	2012
Increase in:		
Wages, salaries, and benefits	$ –	$ 1
Benefit plan amendments	–	(3)
Net financing expense relating to employee benefits	312	272
Decrease in net income	**$ 312**	**$ 270**
Decrease in net income after accounting change attributable to:		
Shareholders of Air Canada	312	270
Non-controlling interests	–	–
	$ 312	**$ 270**

These adjustments reduced basic and diluted earnings per share by $1.12 for the year ended December 31, 2013 (2012 – $0.97 for the year ended December 31, 2012).

Adjustments to consolidated statement of comprehensive income

	Year ended December 31	
	2013	2012
Increase in other comprehensive income:		
Remeasurements of post-employment benefit liabilities	$ 312	$ 273
Decrease in net income	(312)	(270)
Change in total comprehensive income	**$ –**	**$ 3**

With retrospective application of the amended standard as at January 1, 2013, restated net income for 2012 is lower than originally reported under the previous accounting standard. The decrease arises from net financing expense relating to the pension benefit liability which is calculated using the discount rate used to value the benefit obligation. As the discount rate is lower than the expected rate of return on plan assets, financing expense increases as the interest attributable to plan assets declines. The difference between the actual rate of return on plan assets and the discount rate is included in OCI as a remeasurement. Also, under the amended standard, the interest cost on the additional minimum funding liability is recorded in the consolidated statement of operations, whereas it was reported in other comprehensive income under the previous standard. The impact of this change is that restated net income for 2012 decreases and other comprehensive income increases by the same amount, with no net impact on total comprehensive income. The amended standard also accelerates 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 impact of this change is that restated net income and total comprehensive income for the twelve months ended December 31, 2012 increased $3 for Benefit plan amendments.

The amended standard did not have any net impact on the consolidated statement of cash flows.

H) EMPLOYEE PROFIT SHARING PLANS

The Corporation has employee profit sharing plans. Payments are calculated based on full calendar year results and an expense recorded throughout the year as a charge to Wages, salaries and benefits based on the estimated annual payment under the plan.

I) SHARE-BASED COMPENSATION PLANS

Certain employees of the Corporation participate in Air Canada's Long-Term Incentive Plan, which provides for the grant of stock options and performance share units ("PSUs"), as further described in Note 14. PSUs are notional share units which are exchangeable, on a one-to-one basis, as determined by the Board of Directors based on factors such as the remaining number of shares authorized for issuance under the Long-Term Incentive Plan as described in Note 14, for Air Canada shares, or the cash equivalent. The options and PSUs granted contain both time and performance based vesting features as those further described in Note 14.

The fair value of stock options with a graded vesting schedule is determined based on different expected lives for the options that vest each year, as it would be if the award were viewed as several separate awards, each with a different vesting date, and it is accounted for over the respective vesting period taking into consideration forfeiture estimates. For a stock option award attributable to an employee who is eligible to retire at the grant date, the fair value of the stock option award is expensed on the grant date. For a stock option award attributable to an employee who will become eligible to retire during the vesting period, the fair value of the stock option award is recognized over the period from the grant date to the date the employee becomes eligible to retire. The Corporation recognizes compensation expense and a corresponding adjustment to Contributed surplus equal to the fair value of the equity instruments granted using the Black-Scholes option pricing model taking into consideration forfeiture estimates. Compensation expense is adjusted for subsequent changes in management's estimate of the number of options that are expected to vest.

A prospective change in accounting for PSUs was made in 2013 from cash-settled instruments to equity-settled instruments based on settlement experience. Grants of PSUs are accounted for as equity settled instruments. Accordingly, the Corporation recognizes compensation expense offset by Contributed surplus equal to the market value of an Air Canada common share at the date of grant on a straight line basis over the applicable vesting period, taking into consideration forfeiture estimates. Compensation expense is adjusted for subsequent changes in management's current estimate of the number of PSUs that are expected to vest. Refer to Note 17 for a description of derivative instruments used by the Corporation to hedge the cash flow exposure to PSUs.

Air Canada also maintains an employee share purchase plan. Under this plan, contributions by the Corporation's employees are matched to a specific percentage by the Corporation. Employees must remain with the Corporation until March 31 of the subsequent year for vesting of the Corporation's contributions. These contributions are expensed in Wages, salaries, and benefits expense over the vesting period.

J) MAINTENANCE AND REPAIRS

Maintenance and repair costs for both leased and owned aircraft are charged to Aircraft maintenance as incurred, with the exception of maintenance and repair costs related to return conditions on aircraft under operating lease, which are accrued over the term of the lease, and major maintenance expenditures on owned and finance leased aircraft, which are capitalized as described below in Note 2T.

Maintenance and repair costs related to return conditions on aircraft leases are recorded over the term of the lease for the end of lease maintenance return condition obligations within the Corporation's operating leases, offset by a prepaid maintenance asset to the extent of any related power-by-the-hour maintenance service agreements or any recoveries under aircraft subleasing arrangements. The provision is recorded within Maintenance provisions using a discount rate taking into account the specific risks of the liability over the remaining term of the lease. Interest accretion on the provision is recorded in Other non-operating expense. For aircraft under operating leases which are subleased to third parties, the expense relating to the provision is presented net on the income statement of the amount recognized for any reimbursement of maintenance cost which is the contractual obligation of the sublessee. The reimbursement is recognized when it is virtually certain that reimbursement will be received when the Corporation settles the obligation. Any changes in the maintenance cost estimate, discount rates, timing of settlement or difference in the actual maintenance cost incurred and the amount of the provision is recorded in Aircraft maintenance in the period.

K) OTHER OPERATING EXPENSES

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

L) FINANCIAL INSTRUMENTS

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

Financial assets and financial liabilities, including derivatives, are recognized on the consolidated statement of financial position when the Corporation becomes a party to the contractual provisions of the financial instrument or derivative contract. All financial instruments are required to be measured at fair value on initial recognition. The Corporation's own credit risk and the credit risk of the counterparty are taken into consideration in determining the fair value of financial assets and financial liabilities, including derivative instruments. Measurement in subsequent periods is dependent upon the classification of the financial instrument. The Corporation classifies its financial assets as either fair value through profit or loss ("FVTPL"), loans and receivables or, held to maturity. The classification depends on the purpose for which the financial assets were acquired.

Management determines the classification of its financial assets at initial recognition. Financial assets at FVTPL are financial assets held for trading. A financial asset is classified in this category if acquired principally for the purpose of selling in the short term. Derivatives are also categorized as held for trading unless they are designated as hedges. Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Held-to-maturity financial assets are non-derivatives that have fixed and determinable payments and the entity has the ability and intent to hold the asset until maturity. For financial instruments classified as other than held-for-trading, transaction costs are added to the initial fair value of the related financial instrument. Financial assets and financial liabilities classified as held-for-trading are measured at FVTPL. Financial assets classified as held-to-maturity, loans and receivables, or other financial liabilities are measured at amortized cost using the effective interest rate method.

The Corporation assesses at the end of each reporting period whether there is objective evidence that a financial asset or a group of financial assets is impaired. For loans and receivables, the amount of the loss is measured as the difference between the asset's carrying value and the present value of estimated future cash flows. The carrying amount of the asset is reduced by the amount of the loss and the latter is recognized in the consolidated statement of operations.

The Corporation enters into interest rate, foreign currency, fuel derivatives and share forward contracts to manage the associated risks. Derivative instruments are recorded on the consolidated statement of financial position at fair value, including those derivatives that are embedded in financial or non-financial contracts that are required to be accounted for separately. Changes in the fair value of derivative instruments are recognized in Non-operating income (expense). These derivative contracts are included in the consolidated statement of financial position at fair value in Prepaid expenses and other current assets, Deposits and other assets, Accounts payable and accrued liabilities, or Other long-term liabilities based on the terms of the contractual agreements. All cash flows associated with purchasing and selling derivatives are classified as operating cash flows in the consolidated statement of cash flow.

The Corporation has implemented the following classifications:

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

Impact upon adoption of IFRS 13 – Fair Value Measurement

The Corporation adopted IFRS 13 on January 1, 2013 on a prospective basis. Under previous IFRS, guidance on measuring and disclosing fair value was dispersed among the specific standards requiring fair value measurements. IFRS 13 is a comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. This new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement. The adoption of IFRS 13 did not require any adjustments to the valuation techniques used by the Corporation to measure fair value and did not result in any measurement adjustments as at January 1, 2013.

M) FOREIGN CURRENCY TRANSLATION

The functional currency of Air Canada and its subsidiaries is the Canadian dollar. Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at rates of exchange in effect at the date of the consolidated statement of financial position. Non-monetary assets and liabilities, revenues and expenses arising from transactions denominated in foreign currencies, are translated at the historical exchange rate or the average exchange rate during the period, as applicable. Adjustments to the Canadian dollar equivalent of foreign denominated monetary assets and liabilities due to the impact of exchange rate changes are recognized in Foreign exchange gain (loss).

N) INCOME TAXES

The tax expense for the period comprises current and deferred income tax. Tax expense is recognized in the consolidated statement of operations, except to the extent that it relates to items recognized in OCI or directly in equity, in which case the tax is netted with such items.

The current income tax expense is calculated on the basis of the tax laws enacted or substantively enacted at the balance sheet date in the jurisdictions where the Corporation and its subsidiaries operate and generate taxable income. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulations are subject to interpretation. It establishes provisions where appropriate on the basis of amounts expected to be paid to the tax authorities.

Deferred income tax is recognized, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred tax liabilities are not recognized if they arise from the initial recognition of goodwill; and deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred income tax is determined using tax rates and laws that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

Deferred income tax assets are recognized only to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

O) EARNINGS PER SHARE

Basic earnings per share ("EPS") is calculated by dividing the net income (loss) for the period attributable to the shareholders of Air Canada by the weighted average number of ordinary shares outstanding during the period. Shares held in trust for employee share-based compensation awards are treated as treasury shares and excluded from basic shares outstanding in the calculation of basic EPS.

Diluted EPS is calculated by adjusting the weighted average number of ordinary shares outstanding for dilutive potential ordinary shares. The Corporation's potentially dilutive ordinary shares comprise stock options, warrants, and any shares held in trust for employee share-based compensation awards. The number of shares included with respect to time vesting options and warrants is computed using the treasury stock method unless they are anti-dilutive. Under this method, the proceeds from the exercise of such instruments are assumed to be used to purchase Class B Voting Shares at the average market price for the period and the difference between the number of shares issued upon exercise and the number of shares assumed to be purchased are included in the calculation. The number of shares included with respect to performance-based employee share options is treated as contingently issuable shares because their issue is contingent upon satisfying specified conditions in addition to the passage of time. If the specified conditions are met, then the number of shares included is also computed using the treasury stock method unless they are anti-dilutive.

P) CASH AND CASH EQUIVALENTS

Cash and cash equivalents include $186 pertaining to investments with original maturities of three months or less at December 31, 2013 ($218 as at December 31, 2012). Investments include bankers' acceptances and bankers' discount notes, which may be liquidated promptly and have original maturities of three months or less.

Q) SHORT-TERM INVESTMENTS

Short-term investments, comprised of bankers' acceptances and bankers' discount notes, have original maturities over three months, but not more than one year.

R) RESTRICTED CASH

The Corporation has recorded Restricted cash under Current assets representing funds held in trust by Air Canada Vacations in accordance with regulatory requirements governing advance ticket sales, as well as funds held in escrow accounts relating to Air Canada Vacations credit card booking transactions, recorded under Current liabilities, for certain travel related activities.

Restricted cash with maturities greater than one year from the balance sheet date is recorded in Deposits and other assets. This restricted cash relates to funds on deposit with various financial institutions as collateral for letters of credit and other items.

S) AIRCRAFT FUEL INVENTORY AND SPARE PARTS AND SUPPLIES INVENTORY

Inventories of aircraft fuel and spare parts, other than rotables, and supplies are measured at the lower of cost and net realizable value, with cost being determined using a weighted average formula.

The Corporation did not recognize any write-downs on inventories or reversals of any previous write-downs during the periods presented. Included in Aircraft maintenance is $48 related to spare parts and supplies consumed during the year (2012 – $43).

T) PROPERTY AND EQUIPMENT

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

The Corporation allocates the amount initially recognized in respect of an item of property and equipment to its significant components and depreciates separately each component. Property and equipment are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Aircraft and flight equipment are componentized into airframe, engine, and cabin interior equipment and modifications. Airframe and engines are depreciated over 20 to 25 years, with 10% to 20% estimated residual values. Cabin interior equipment and modifications are depreciated over the lesser of 5 years or the remaining useful life of the aircraft. Spare engines and related parts ("rotables") are depreciated over the average remaining useful life of the fleet to which they relate with 10% to 20% estimated residual values. Cabin interior equipment and modifications to aircraft on operating leases are amortized over the term of the lease. Major maintenance of airframes and engines, including replacement spares and parts, labour costs and/or third party maintenance service costs, are capitalized and amortized over the average expected life between major maintenance events. Major maintenance events typically consist of more complex inspections and servicing of the aircraft. All maintenance of fleet assets provided under power-by-the-hour contracts are charged to operating expenses in the income statement as incurred. Buildings are depreciated on a straight-line basis over their useful lives not exceeding 50 years or the term of any related lease, whichever is less. Leasehold improvements are amortized over the lesser of the lease term or 5 years. Ground and other equipment is depreciated over 3 to 25 years.

Residual values and useful lives are reviewed at least annually and depreciation rates are adjusted accordingly on a prospective basis. Gains and losses on disposals of property and equipment are determined by comparing the proceeds with the carrying amount of the asset and are included as part of non-operating gains and losses in the consolidated statement of operations.

U) INTEREST CAPITALIZED

Borrowing costs are expensed as incurred. For borrowing costs attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use, the costs are capitalized as part of the cost of that asset. Capitalization of borrowing costs commences when expenditures for the asset and borrowing costs are being incurred and the activities to prepare the asset for its intended use are in progress. Borrowing costs are capitalized up to the date when the project is completed and the related asset is available for its intended use.

To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization is determined at the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization is determined by applying a capitalization rate to the expenditures on that asset. The capitalization rate is the weighted average of the borrowing costs applicable to the borrowings of the Corporation that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

V) LEASES

Leases are classified as finance leases when the lease arrangement transfers substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases. Gains and losses on sale and operating leaseback transactions are recognized immediately in the consolidated statement of operations when it is clear that the transactions are established at fair value. If the sale price is below fair value, any loss is recognized immediately except that, if the loss is compensated for by future lease payments at below market price, it is deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the gain is deferred and amortized over the period for which the asset is expected to be used. In the context of sale and finance leaseback transactions, any gain on the sale is deferred and amortized over the lease term.

W) INTANGIBLE ASSETS

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

	Estimated Useful Life	Remaining amortization period as at December 31, 2013
International route rights and slots	Indefinite	not applicable
Marketing based trade names	Indefinite	not applicable
Contract and customer based	10 years	1 year
Technology based (internally developed)	5 years	1 to 5 years

Development costs that are directly attributable to the design, development and testing of identifiable software products are recognized as technology based intangible assets if certain criteria are met, including technical feasibility and intent and ability to develop and use the technology to generate probable future economic benefits; otherwise they are expensed as incurred. Directly attributable costs that are capitalized as part of the technology based intangible assets include software-related, employee and third party development costs and an appropriate portion of relevant overhead. Air Canada has international route and slot rights which enable the Corporation to provide services internationally. The value of the recorded intangible assets relates to the cost of route and slot rights at Tokyo's Narita International Airport, Washington's Reagan National Airport and London's Heathrow Airport. Air Canada expects to provide service to these international locations for an indefinite period.

Air Canada and certain of its subsidiaries have trade names, trademarks, and domain names (collectively, "Trade Names"). These items are marketing based intangible assets as they are primarily used in the selling and promotion of Air Canada's products and services. The Trade Names create brand recognition with customers and potential customers and are capable of contributing to cash flows for an indefinite period of time. Air Canada intends to continuously re-invest and market the Trade Names to support classification as indefinite life intangibles. If there were plans to cease using any of the Trade Names, the specific names would be classified as finite and amortized over the expected remaining useful life.

X) GOODWILL

Goodwill represents the excess of the cost of an acquisition over the fair value of the Corporation's share of the net identifiable assets of the acquired business at the date of acquisition. Goodwill is tested at least annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. For the purpose of impairment testing, goodwill is tested for impairment at the lowest level within the entity at which the goodwill is monitored for internal management purposes, being the operating segment level (Note DD). No impairment losses have been recorded against the value of goodwill since its acquisition.

Y) IMPAIRMENT OF LONG-LIVED ASSETS

Long-lived assets include property and equipment, finite lived intangible assets, indefinite lived intangible assets and goodwill. Assets that have an indefinite useful life, including goodwill are tested at least annually for impairment or when events or circumstances indicate that the carrying value may not be recoverable. Assets that are subject to depreciation or amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment test is performed by comparing the carrying amount of the asset or group of assets to their recoverable amount. Recoverable amount is calculated as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash inflows (cash-generating units or CGUs). Management has determined that the appropriate level for assessing impairments is at the North American (for narrowbody aircraft) and international (for widebody aircraft) fleet levels for aircraft and related assets supporting the operating fleet. Parked aircraft not used in operations and aircraft leased or subleased to third parties are assessed for impairment at the individual asset level. Value in use is calculated based upon a discounted cash flow analysis. An impairment loss is recognized for the amount by which the asset's or cash generating unit's carrying amount exceeds its recoverable amount.

Long-lived assets, other than goodwill, that suffered an impairment are reviewed for possible reversal of the impairment at each reporting date. Management assesses whether there is any indication that an impairment loss recognized in a prior period no longer exists or has decreased. In assessing whether there is a possible reversal of an impairment loss, management considers the indicators that gave rise to the impairment loss. If any such indicators exist that an impairment loss has reversed, management estimates the recoverable amount of the long-lived asset. An impairment loss recognized in prior periods for an asset other than goodwill shall be reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. The carrying amount of any individual asset in the CGU is not increased above the carrying value that would have been determined had the original impairment not occurred. A reversal of an impairment loss is recognized immediately in the consolidated statement of operations.

Z) NON-CURRENT ASSETS (OR DISPOSAL GROUPS) HELD FOR SALE

Non-current assets (or disposal groups) are classified as assets held for sale when their carrying amount is to be recovered principally through a sale transaction and a sale is considered highly probable. They are stated at the lower of carrying amount and fair value less costs to sell. There are currently no assets held for sale.

AA) PROVISIONS

Provisions are recognized when there is a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate can be made of the obligation. If the effect is significant, the expected cash flows are discounted using a rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognized as Interest expense within Other non-operating expense.

The Corporation records an asset and related provision for the costs associated with the retirement of long-lived tangible assets when a legal or constructive obligation to retire such assets exists. The provision recorded in Other long-term liabilities is measured as the best estimate of the expenditure required to settle the present obligation at each reporting period. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and then amortized in accordance with the accounting policy in Note 2T. In subsequent periods, the asset retirement provision is adjusted for the passage of time through charges to Interest expense. Any change in the amount of the underlying cash flows, due to changes in the discount rate or changes in the estimate of the expenditure required to settle the present obligation, adjusts both the asset retirement provision and the related asset.

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

Total aircraft operating lease rentals over the lease term are amortized to operating expense (aircraft rent) on a straight-line basis. Included in Deposits and other assets and Other long-term liabilities are the differences between the straight line aircraft rent expense and the payments as stipulated under the lease agreement.

CC) EXCEPTIONAL ITEMS

Exceptional items are those items that in management's view are required to be separately disclosed by virtue of their size or incidence to enable a full understanding of the Corporation's financial performance.

DD) SEGMENT REPORTING

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision maker. The chief operating decision maker, who is responsible for allocating resources and assessing performance of operations, has been identified as the Chief Executive Officer. Air Canada is managed as one operating segment based on how financial information is produced internally for the purposes of making operating decisions.

EE) ACCOUNTING STANDARDS ADOPTED ON JANUARY 1, 2013

In addition to the adoption of the accounting standard changes for IAS 19 – Employee Benefits and IFRS 13 – Fair Value Measurement described above in Note 2G and 2L, the Corporation adopted the following accounting standard changes effective January 1, 2013.

IFRS 11 – Joint Arrangements

IFRS 11 requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. Under previous IFRS, entities had the choice to proportionately consolidate or equity account for interests in joint ventures. IFRS 11 supersedes IAS 31, Interests in Joint Ventures, and SIC-13, Jointly Controlled Entities-Non-monetary Contributions by Venturers. There was no impact to the Corporation's financial statements upon adoption of this standard.

IFRS 12 – Disclosure of Interests in Other Entities

IFRS 12 establishes disclosure requirements for interests in other entities, such as joint arrangements, associates, special purpose vehicles and off balance sheet vehicles. The standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interests in other entities which have been included by the Corporation within the 2013 notes to the consolidated financial statements.

Amendments to IAS 1 – Financial Statement Presentation

The amendments to IAS 1 require entities to separate items presented in OCI into two groups, based on whether or not they may be recycled to profit or loss in the future. Items that will not be recycled such as remeasurements related to IAS 19 will be presented separately from items that may be recycled in the future, such as deferred gains and losses on cash flow hedges. Entities that choose to present OCI items before tax will be required to show the amount of tax related to the two groups separately.

The Corporation has adopted the amendments to IAS 1 effective January 1, 2013. These changes did not result in any adjustments as the components of OCI for 2013 and the comparative period only includes items relating to remeasurements on post-employment benefit plans which are not reclassified to net income.

Amendments to Other Standards

In addition, there have been amendments to other standards, including IFRS 7 Financial Instruments: Disclosure, IAS 27, Separate Financial Statements, and IAS 28, Investments in Associates and Joint Ventures. IFRS 7 amendments require disclosure about the effects of offsetting financial assets and financial liabilities and related arrangements on an entity's financial position. IAS 27 addresses accounting for subsidiaries, jointly controlled entities and associates in non-consolidated financial statements. IAS 28 has been amended to include joint ventures in its scope and to address the changes in IFRS 10 – 13. The Corporation has adopted these amendments effective January 1, 2013 and added disclosures to address the requirements within the 2013 notes to the consolidated financial statements.

FF) ACCOUNTING STANDARDS AND AMENDMENTS ISSUED BUT NOT YET ADOPTED

The following is an overview of accounting standard changes that the Corporation will be required to adopt in future years. The Corporation does not expect to adopt any of these standards before their effective dates. The Corporation continues to evaluate the impact of these standards on its consolidated financial statements.

IFRS 9 – Financial Instruments

IFRS 9 introduces new requirements for the classification and measurement of financial assets. IFRS 9 requires all recognized financial assets that are within the scope of IAS 39 Financial Instruments: Recognition and Measurement to be measured at amortized cost or fair value in subsequent accounting periods following initial recognition. Specifically, financial assets that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding are generally measured at amortized cost at the end of subsequent accounting periods. All other financial assets including equity investments are measured at their fair values at the end of subsequent accounting periods.

Requirements for classification and measurement of financial liabilities were added in October 2010 and they largely carried forward existing requirements in IAS 39, Financial Instruments – Recognition and Measurement, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss would generally be recorded in other comprehensive income.

IFRS 9 was amended in November 2013, to (i) include guidance on hedge accounting, (ii) allow entities to early adopt the requirement to recognize changes in fair value attributable to changes in an entity's own credit risk, from financial liabilities designated under the fair value option, in OCI, without having to adopt the remainder of IFRS 9, and to (iii) remove the previous mandatory effective date for adoption of January 1, 2015, although the standard is available for early adoption.

Amendments to IAS 32 – Financial Instruments: Presentation

IAS 32 addresses inconsistencies when applying the offsetting requirements, and is effective for annual periods beginning on or after January 1, 2014.

3. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in these financial statements and accompanying notes. These estimates and associated assumptions are based on historical experience, future operating plans and various other factors believed to be reasonable under the circumstances, and the results of such estimates form the basis of judgments about carrying values of assets and liabilities. These underlying assumptions are reviewed on an ongoing basis. Actual results could differ materially from those estimates.

Significant estimates made in the preparation of these financial statements include, but are not limited to, the following areas, with further information contained in the applicable accounting policy or note:

- Employee future benefits
  - The cost and related liabilities of the Corporation's pensions, other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations involve assumptions including discount rates, future salary increases, mortality rates and future benefit increases. Also, due to the long-term nature of these programs, such estimates are subject to significant uncertainty. Refer to Note 9 for additional information.
- Depreciation and amortization period for long-lived assets
  - The Corporation makes estimates about the expected useful lives of long-lived assets and the expected residual values of the assets based on the estimated current fair value of the assets, the Corporation's fleet plans and the cash flows they generate. Changes to these estimates, which can be significant, could be caused by a variety of factors, including changes to maintenance programs, changes in jet fuel prices and other operating costs, changes in utilization of the aircraft, and changing market prices for new and used aircraft of the same or similar types. Estimates and assumptions are evaluated at least annually. Generally, these adjustments are accounted for on a prospective basis, through depreciation and amortization expense. For the purposes of sensitivity analysis on these estimates, a 50% reduction to residual values on aircraft with remaining useful lives greater than five years results in an increase of $22 to annual depreciation expense. For aircraft with shorter remaining useful lives, the residual values are not expected to change significantly.
- Impairment considerations on long-lived assets
  - An impairment test is performed by comparing the carrying amount of the asset or cash-generating unit to their recoverable amount, which is calculated as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. Value in use is calculated based upon a discounted cash flow analysis, which requires management to make a number of significant assumptions including assumptions relating to future operating plans, discount rates and future growth rates. Refer to Notes 5 and 6 for additional information.
- Maintenance provisions
  - The recording of maintenance provisions related to return conditions on aircraft leases requires management to make estimates of the future costs associated with the maintenance events required under the lease return condition and estimates of the expected future maintenance condition of the aircraft at the time of lease expiry. These estimates take into account current costs of these maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in maintenance expense in the period. The effect of any changes in estimates, including changes in discount rates, inflation assumptions, cost estimates or lease expiries, is also recognized in maintenance expense in the period. Refer to Note 10(a) for additional information.

4. PROPERTY AND EQUIPMENT

	Aircraft and flight equipment	Buildings, and leasehold improvements	Ground and other equipment	Purchase deposits, including capitalized interest	Total
Year ended December 31, 2012					
At January 1, 2012	$ 4,346	$ 356	$ 140	$ 96	$ 4,938
Additions	86	38	18	282	424
Reclassifications	30	24	–	(54)	–
Disposals	(22)	–	(1)	–	(23)
Depreciation	(571)	(33)	(24)	–	(628)
At December 31, 2012	$ 3,869	$ 385	$ 133	$ 324	$ 4,711
At December 31, 2012					
Cost	$ 5,991	$ 662	$ 311	$ 324	$ 7,288
Accumulated depreciation	(2,122)	(277)	(178)	–	(2,577)
	$ 3,869	**$ 385**	**$ 133**	**$ 324**	**$ 4,711**
Year ended December 31, 2013					
At January 1, 2013	$ 3,869	$ 385	$ 133	$ 324	$ 4,711
Additions	736	(4)	27	198	957
Reclassifications	143	3	20	(166)	–
Disposals	(65)	–	–	–	(65)
Depreciation	(445)	(32)	(23)	–	(500)
Impairment	(30)	–	–	–	(30)
At December 31, 2013	$ 4,208	$ 352	$ 157	$ 356	$ 5,073
At December 31, 2013					
Cost	$ 6,119	$ 660	$ 359	$ 356	$ 7,494
Accumulated depreciation	(1,911)	(308)	(202)	–	(2,421)
	$ 4,208	**$ 352**	**$ 157**	**$ 356**	**$ 5,073**

The Corporation took delivery of four Boeing 777 aircraft in 2013. These aircraft were financed through the proceeds from the private offering of enhanced equipment trust certificates as described in Note 8. In 2013, an impairment charge of $30 was recorded in Depreciation, amortization and impairment expense related mainly to four A340-300 aircraft (none of which were operated by Air Canada). The impairment charge was based upon the net proceeds expected upon the return or other disposition of these aircraft. In 2013, these four A340-300 aircraft were sold with proceeds approximating book value.

As at December 31, 2013, property and equipment included finance leased assets including 18 aircraft (2012 – 19) with a net book value of $150 (2012 – $177) and facilities with a net book value of $45 (2012 – $47).

Included in aircraft and flight equipment are 32 aircraft and 6 spare engines (2012 – 28 aircraft and 8 spare engines) which are leased to Sky Regional, Jazz (Note 16) and third parties with a cost of $481 (2012 – $371) less accumulated depreciation of $124 (2012 – $112) including accumulated impairment losses of $26 related to the fleet of A340-300 aircraft (2012 – $46) for a net book value of $357 (2012 – $259). Depreciation expense for 2013 for this aircraft and flight equipment amounted to $38 (2012 – $50).

Interest capitalized during 2013 amounted to $46 at an interest rate of 8.36% (2012 $18 at an interest rate of 10.85%) and is included in Purchase deposits and assets under development in the table above.

Certain property and equipment are pledged as collateral as further described under the applicable debt instrument in Note 8.

5. INTANGIBLE ASSETS

	International route rights and slots	Marketing based trade names	Contract and customer based	Technology based (internally developed)	Total
Year ended December 31, 2012					
At January 1, 2012	$ 97	$ 87	$ 12	$ 116	$ 312
Additions	–	1	–	35	36
Amortization	–	–	(5)	(29)	(34)
At December 31, 2012	$ 97	$ 88	$ 7	$ 122	$ 314
At December 31, 2012					
Cost	$ 97	$ 88	$ 20	$ 333	$ 538
Accumulated amortization	–	–	(13)	(211)	(224)
	$ 97	**$ 88**	**$ 7**	**$ 122**	**$ 314**
Year ended December 31, 2013					
At January 1, 2013	$ 97	$ 88	$ 7	$ 122	$ 314
Additions	–	–	–	30	30
Amortization	–	–	(4)	(36)	(40)
At December 31, 2013	$ 97	$ 88	$ 3	$ 116	$ 304
At December 31, 2013					
Cost	$ 97	$ 88	$ 20	$ 363	$ 568
Accumulated amortization	–	–	(17)	(247)	(264)
	$ 97	**$ 88**	**$ 3**	**$ 116**	**$ 304**

Certain international route rights and slots are pledged as security for senior secured notes as described in Note 8(b).

An annual impairment review is conducted on all intangible assets that have an indefinite life. International route rights and slots and marketing based trade names are considered to have an indefinite life. The impairment review is carried out at the level of a cash-generating unit. On this basis, an impairment review was performed at the North American and international fleet levels for aircraft and related assets supporting the operating fleet. A summary of the allocation of the indefinite lived intangible assets to the cash-generating units is presented below.

	2013	2012
North American	41	41
International	144	144
	$ 185	$ 185

The recoverable amount of the cash-generating units has been measured based on their value in use, using a discounted cash flow model. Cash flow projections are based on the annual business plan approved by the Board of Directors of Air Canada. In addition, management-developed projections are made covering a three-year period. These cash flows are management's best estimate of future events taking into account past experience and future economic assumptions, such as the forward curves for crude-oil and the exchange rates. Cash flows beyond the three-year period are projected to increase consistent with the long-term growth assumption of the airline considering various factors such as industry growth assumptions. The pre-tax discount rate applied to the cash flow projections is derived from the Corporation's weighted average cost of capital adjusted for taxes and specific risks associated with the CGU being tested.

For the annual 2013 impairment review, the most recent calculations from the 2011 period were carried forward as the calculation of the recoverable amount exceeded the carrying amount by a substantial margin, the assets and liabilities making up the CGU had not changed significantly and no events had occurred or circumstances had changed which would indicate that the likelihood of the recoverable asset not exceeding the carrying value was remote.

Key assumptions used for the value in use calculations in fiscal 2011 were as follows:

	2011
Pre-tax discount rate	15.6%
Long-term growth rate	2.5%
Jet fuel price range per barrel	$125 – $135

The recoverable amount of both cash-generating units based on value in use exceeded their respective carrying values by approximately $1,400. If the discount rate were increased by 380 basis points, the excess of recoverable amount over carrying value would be reduced to nil.

6. GOODWILL

Goodwill is tested at least annually for impairment. For the purpose of impairment testing, goodwill is tested for impairment using the fair value less cost to sell model at the operating segment level. Air Canada is managed as one operating segment based on how financial information is produced internally for the purposes of making operating decisions.

In assessing the goodwill for impairment, the Corporation compares the aggregate recoverable amount consisting of the sum of its quoted equity market capitalization and the fair value of its debt to the carrying value of its net assets excluding long term debt. An impairment charge is recognized to the extent that the carrying value exceeds the recoverable amount.

No impairment charges have arisen as a result of the reviews performed as at December 31, 2013 and 2012. Reasonably possible changes in key assumptions would not cause the recoverable amount of goodwill to fall below the carrying value.

7. DEPOSITS AND OTHER ASSETS

		2013	2012
Restricted cash	Note 2R	$ 190	$ 188
Aircraft related deposits (a)		84	105
Aircraft lease payments in excess of rent expense	Note 2BB	65	50
Prepayments under maintenance agreements	Note 2J	64	72
Share forward contracts	Note 17	36	10
Deposit related to the pension and benefits agreement	Note 9 & 19	9	29
Other deposits		29	25
Other		17	31
		$ 494	**$ 510**

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

8. LONG-TERM DEBT AND FINANCE LEASES

	Final Maturity	Weighted Average Interest Rate (%)	2013	2012
Aircraft financing (a)				
Fixed rate US dollar financing	2014 – 2025	6.52	$ 1,706	$ 1,278
Floating rate US dollar financing	2015 – 2021	2.39	609	650
Floating rate Japanese yen financing	2020	0.28	116	152
Senior secured notes – US dollar (b)	2019 – 2020	7.61	745	–
Senior secured notes – CDN dollar (b)	2019	7.63	300	–
Senior secured notes – US dollar (b)	2013	–	–	796
Senior secured notes – CDN dollar (b)	2013	–	–	300
Other secured financing – US dollar (b) and (c)	2014 – 2019	6.01	467	245
Other secured financing – CDN dollar (d)	2015	9.15	126	26
Long-term debt		**6.03**	**4,069**	**3,447**
Finance lease obligations (e)	2014-2033	10.12	328	363
Total debt and finance leases		**6.33**	**4,397**	**3,810**
Unamortized discount			–	(9)
Unamortized debt issuance costs			(64)	(43)
Current portion			(374)	(499)
Long-term debt and finance leases			**$ 3,959**	**$ 3,259**

The total weighted average interest rate presented above excludes the impact of interest rate swaps applicable to certain aircraft financing arrangements.

(a) Aircraft financing (US$2,177, and JPY11,476) is secured primarily by specific aircraft with a carrying value of $3,222 (2012 – $3,193). For the majority of the financing, principal and interest is repayable quarterly until maturity and can be repaid at any time with the payment of applicable fees. US$264 and JPY11,476 of the financing is supported by a loan guarantee by the Export-Import Bank of the United States (“EXIM”).

On May 9, 2013, in connection with the financing of five new Boeing 777-300ER aircraft, four of which were delivered in 2013, with the remaining aircraft scheduled for delivery in February 2014, Air Canada completed a private offering of three tranches of enhanced equipment trust certificates (“EETC”) with a combined aggregate face amount of US$715.

The private offering is comprised of Class A, Class B and Class C certificates.

- The Class A certificates, with a US$425 face amount, have an interest rate of 4.125% per annum and a final expected distribution date of May 15, 2025.
- The Class B certificates, with a US$182 face amount, have an interest rate of 5.375% per annum and a final expected distribution date of May 15, 2021.
- The Class C certificates, with US$108 face amount, will have an interest rate of 6.625% per annum and a final expected distribution date of May 15, 2018.

The trust certificates have a weighted average interest rate of approximately 4.7% per annum.

The trust certificates represent an interest in three separate pass through trusts. The trusts consist of a separate trust for each of the Class A, B and C certificates. The trusts use the proceeds from the offering to acquire equipment notes that are issued to finance the acquisition of each of the five new Boeing 777-300ER aircraft. The proceeds from the offering of the trust certificates are held in escrow until the delivery of the respective aircraft. Funds held in escrow by the depositary are not assets of Air Canada and are not reported as assets or debt on Air Canada’s consolidated statement of financial position. In connection with the acquisition of the first four aircraft, an amount of US$571 was drawn from the proceeds held in escrow in connection with the delivery and is included in Aircraft financing in the table above.

The equipment notes issued are secured by each of the five Boeing 777-300ER aircraft being acquired, and the security interest in each of the aircraft benefits from the protections of the Cape Town Convention on International Interests in Mobile Equipment and the Protocol thereto on Matters Specific to Aircraft Equipment, as enacted in Canada.

In respect of the Class A certificates and the Class B certificates, the trustee distributes all payments of principal, premium (if any) and interest received on the related equipment notes to the holders of the Class A certificates and Class B certificates, subject to the subordination provisions applicable to the certificates. Scheduled payments of principal and interest received by the trust on the related equipment notes are distributed to the holders of the Class A certificates and Class B certificates on the regular distribution dates of May 15 and November 15, which commenced on November 15, 2013.

In respect of the Class C certificates, the trustee distributes all payments of principal, premium (if any) and interest received on the related equipment notes to the holders of the Class C certificates, subject to the subordination provisions applicable to the certificates. Scheduled payments of interest made on the equipment notes are distributed to the holders of the Class C certificates on the regular distribution dates of May 15 and November 15, which commenced on November 15, 2013. The entire principal amount is scheduled to be paid on May 15, 2018.

Cash deposits with the trustee of $6 at December 31, 2013 are reported in Investing on the consolidated statement of cash flow. Financing fees paid in conjunction with the offering were $15 and are reported in Financing on the consolidated statement of cash flow.

(b) On September 26, 2013, the Corporation completed private offerings of senior secured notes, consisting of (i) US$400 principal amount of 6.750% senior secured first lien notes due 2019 and $300 principal amount of 7.625% senior secured first lien notes due 2019 (the "New Senior First Lien Notes") and (ii) US$300 principal amount of 8.750% senior secured second lien notes due 2020 (the "New Senior Second Lien Notes" and together with the New Senior First Lien Notes, the "New Senior Notes"). The Corporation also completed the closing of its US$400 new senior secured (first lien) credit facility, comprised of a US$300 term loan maturing in 2019 and a US$100 revolving credit facility (collectively, the "New Credit Facility"). The term loan is included in Other secured financing in the table above. As at December 31, 2013, the Corporation had not drawn on the revolving credit facility.

The Corporation received, in total, net proceeds of approximately $1,300 from the sale of the New Senior Notes and from term loan borrowings under the New Credit Facility (in each case, after deduction of the applicable transaction costs, fees and expenses). The Corporation applied a portion of such net proceeds and borrowings to purchase all of its outstanding 9.250% Senior Secured Notes due 2015, 10.125% Senior Secured Notes due 2015 and 12.000% Senior Second Lien Notes due 2016 (collectively, the "Existing Notes") that were validly tendered on or before the early tender deadline (which was September 18, 2013), in connection with the cash tender offers commenced by the Corporation on September 5, 2013. In October 2013, the Corporation used a portion of the remaining net proceeds and borrowings to redeem the remaining Existing Notes of $70 not tendered prior to the early tender deadline. The Corporation is using the remaining net proceeds for working capital and general corporate purposes.

In conjunction with the purchase of the Existing Notes, the premium costs paid, in the amount of $61, as well as the write off of existing transaction costs and discounts related to the Existing Notes, in the amount of $34, were recorded as an interest charge in 2013.

The New Senior Notes and the Corporation's obligations under the New Credit Facility are senior secured obligations of Air Canada, guaranteed on a senior secured basis by one or more of Air Canada's subsidiaries, and secured (on a first lien basis with respect to the New Senior First Lien Notes and Air Canada's obligations in the New Credit Facility, and on a second lien basis with respect to the New Senior Second Lien Notes), subject to certain permitted liens and exclusions, by certain accounts receivable, certain real estate interests, certain spare engines, ground service equipment, certain airport slots and gate leaseholds, and certain Pacific routes and the airport slots and gate leaseholds utilized in connection with those Pacific routes. The applicable margin with respect to loans under the revolving credit facility in the New Credit Facility is 4.50% with respect to LIBOR loans and banker's acceptances and 3.50% with respect to the Index Rate loans or Canadian Prime Rate loans. The applicable margin with respect to the term loans under the New Credit Facility is 4.50% with respect to LIBOR loans and 3.50% with respect to the Index Rate loans. All such applicable margins are subject to the adjustments and other terms provided for in the New Credit Facility.

(c) Other US dollar secured financings are fixed and floating rate financings that are secured by certain assets including assets described in b) above relating to the New Credit Facility. It also includes a revolving credit facility for the financing of jet fuel. Financial covenants under the revolving credit facility require the Corporation to maintain certain minimum operating results and cash balance tests. In 2012, this debt amount included spare engines financings of which an amount of US$44 was repaid in 2013.

(d) Other CDN dollar secured financing is a revolving credit facility for the financing of jet fuel. Financial covenants under the agreement require the Corporation to maintain certain minimum operating results and cash balance tests.

(e) Finance leases, related to facilities and aircraft, total $328 ($76 and US$237) (2012 – $363 ($78 and US$286)). During 2013, the Corporation recorded interest expense on finance lease obligations of $46 (2012 – $40). The carrying value of aircraft and facilities under finance leases amounted to $150 and $45 respectively (2012 – $177 and $47).

Air Canada has aircraft leasing transactions with a number of structured entities. Air Canada controls and consolidates leasing entities covering 23 aircraft as at December 31, 2013. This debt amount includes any guarantee by Air Canada in the residual value of the aircraft upon expiry of the lease. The related aircraft are charged as collateral against the debt by the owners thereof. The creditors under these leasing arrangements have recourse to Air Canada, as lessee, in the event of default or early termination of the lease.

Certain aircraft and other secured finance agreements contain collateral fair value tests. Under the tests, Air Canada may be required to provide additional collateral or prepay part of the financings. The maximum amount payable in 2014, assuming the collateral is worth nil, is $271 (US$257). The maximum amount payable declines over time in relation to the outstanding principal. Total collateral as at December 31, 2013 is $5 (US$5) (2012 – $20(US$20)) in the form of cash deposits, included in Deposits and other assets, has been provided under the fair value test for certain of these aircraft leases.

Cash interest paid on Long-term debt and finance leases in 2013 by the Corporation was $345 (2012 – $287).

Refer to Note 16 for the Corporation’s principal and interest repayment requirements as at December 31, 2013.

9. PENSIONS AND OTHER BENEFIT LIABILITIES

The Corporation maintains several defined benefit and defined contribution plans providing pension, other post-retirement and post-employment benefits to its employees, and to former employees for whom the related pension assets and liabilities have not yet been settled.

The Corporation is the administrator and sponsoring employer of ten Domestic Registered Plans ("Domestic Registered Plans") with defined benefit commitments registered under the Pension Benefits Standard Act, 1985 (Canada). The US plan, UK plan and Japan plan are international plans covering members in those countries. In addition, the Corporation maintains a number of supplementary pension plans which are not registered. The defined benefit pension plans provide benefits upon retirement, termination or death based on the member's years of service and final average earnings for a specified period. Under the terms of the domestic registered and supplementary plans, there is no indexation provided after January 1, 2007. Benefit payments are from trustee-administered funds, however there are also a number of unfunded plans where the Corporation meets the benefit payment obligation as it falls due. Plan assets held in trusts are governed by regulations. The governance of the plans, overseeing all aspects of the plans including investment decisions and contributions, lies primarily with the Corporation. The Pension Committee, a committee of the Board of Directors, assists in the monitoring and oversight of the plans to ensure pension liabilities are appropriately funded, pension assets are prudently invested, risk is managed at an acceptable level and retirement benefits are administered in a proper and effective manner.

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

Amendments to the Defined Benefit Pension Plans

In December 2013, amendments to the defined benefit pension plans, determined in accordance with new collective agreements during 2011 and 2012 and changes applicable to non-unionized employees as communicated to them in 2013, were approved by OSFI and became effective January 1, 2014. As a result of this approval, the Corporation has recorded a credit of $82 in Benefit plan amendments in 2013 related to the impact of those amendments on pension liabilities. By virtue of its size and incidence, this item is separately disclosed within the consolidated statement of operations.

In 2012, as a result of changes to retirement age in the collective agreement between Air Canada and the Air Canada Pilots Association, which were not subject to regulatory approval, the Corporation recorded a credit of $127 in Benefit plan amendments.

Pension Plan Cash Funding Obligations

As at January 1, 2013, the aggregate solvency deficit in the domestic registered pension plans was $3,700. The next required valuations to be made as at January 1, 2014, will be completed in the first half of 2014, but as described below, they will not increase the 2014 pension past service cost funding obligations. Based on preliminary estimates, in aggregate, the domestic registered pension plans are estimated to be in a small surplus position on a solvency basis as at January 1, 2014.

Pension funding obligations are generally dependent on a number of factors, including the assumptions used in the most recently filed actuarial valuation reports for current service (including the applicable discount rate used or assumed in the actuarial valuation), the plan demographics at the valuation date, the existing plan provisions, existing pension legislation and changes in economic conditions (mainly the return on fund assets and changes in interest rates). Actual contributions that are determined on the basis of future valuation reports filed annually may vary significantly from projections. In addition to changes in plan demographics and experience, actuarial assumptions and methods may be changed from one valuation to the next, including due to changes in plan experience, financial markets, future expectations, changes in legislation and other factors.

In July 2009, the Government of Canada adopted the *Air Canada 2009 Pension Regulations*. The Air Canada 2009 Pension Regulations relieved Air Canada from making any past service contributions (i.e. special payments to amortize the plan deficits) to its domestic defined benefit registered pension plans in respect of the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contribution was the lesser of (i) $150, $175, and $225 in respect of 2011, 2012, and 2013, respectively, on an accrued basis, and (ii) the maximum past service contribution permitted under the Canadian Income Tax Act. Current service contributions continued to be made in the normal course while the *Air Canada 2009 Pension Regulations* were in effect.

In December 2013, further to an agreement reached with Air Canada in March 2013, the Government of Canada formally approved the *Air Canada Pension Plan Funding Regulations, 2014* ("the "2014 Regulations") under the *Pension Benefits Standards Act, 1985* in respect of special payments under Air Canada's defined benefit plans applicable to the period between 2014 to 2020 inclusive, expiring December 31, 2020. According to the terms of the 2014 Regulations, Air Canada will be required to make payments of at least $150 annually with an average of $200 per year, to contribute an aggregate minimum of $1,400 over seven years in solvency deficit payments, in addition to its pension current service payments. Air Canada may elect to opt out of the regulations and have special payments in respect of all Air Canada pension plans, collectively, determined in accordance with normal funding rules.

Under the agreement with the Government of Canada, in respect of the plan years during which Air Canada funds its plan pursuant to the 2014 Regulations, Air Canada is subject to a series of covenants and undertakings, including a prohibition on dividends and share repurchases, as well as certain limitations on executive compensation arrangements. As requested by the Government of Canada, Air Canada has also agreed to use reasonable efforts, during the negotiations of the next collective agreements with Air Canada's Canadian-based unions, to seek to include in those collective agreements provisions which would have employees contribute fifty per cent of their pension plan normal costs, and has agreed not to implement pension plan benefit improvements without regulatory approval.

Giving effect to the Air Canada 2009 Pension Regulations as outlined above, total employer pension funding contributions during 2013 amounted to $475. After taking into account the effect of the 2014 Regulations, total employer contributions to defined benefit pension plans for 2014 are expected to be $439.

Pension and Benefits Agreement with Aveos

Air Canada and Aveos were parties to 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.

Following Aveos filing for court protection pursuant to the Companies' Creditors Arrangements Act ("CCAA") in March 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 were not transferred to Aveos' plans and remain under Air Canada's pension plans. Settlement of obligations under the other post-retirement and post-employment benefits plans pertaining to the transferred unionized employees were concluded in October 2013 with payment in trust to Aveos by Air Canada in the amount of $6, for distribution to Aveos eligible recipients. The letter of credit of $20 previously issued in favour of Aveos was returned to Air Canada.

Benefit Obligation and Plan Assets

These consolidated financial statements include all of the assets and liabilities of all Corporation-sponsored plans. The net benefit obligation is recorded in the statement of financial position as follows:

	2013	2012
Accrued benefit liabilities for		
Pension benefits obligation	$ 1,578	$ 3,528
Other employee future benefits	1,183	1,230
Net benefit obligation	**2,761**	**4,758**
Current portion	(74)	(72)
Pension and other benefit liabilities	**$ 2,687**	**$ 4,686**

The current portion of the net benefit obligation represents an estimate of other employee future benefits claims to be paid during 2014. The current portion is included in Accounts payable and accrued liabilities. The following table presents financial information related to the changes in the pension and other post-employment benefits plans:

	Pension Benefits		Other Employee Future Benefits	
	2013	2012	2013	2012
Change in benefit obligation				
Benefit obligation at beginning of year	$ 16,446	$ 14,461	$ 1,230	$ 1,116
Current service cost	264	215	60	62
Interest cost	704	737	53	55
Employees' contributions	71	71	–	–
Benefits paid	(850)	(775)	(50)	(51)
Remeasurements:				
Experience loss (gain)	30	(42)	(28)	(61)
Loss (gain) from change in demographic assumptions	764	79	32	2
Loss (gain) from change in financial assumptions	(1,245)	1,829	(101)	116
Plan amendments	(82)	(123)	–	(4)
Plan settlements	–	(9)	(26)	–
Foreign exchange (gain) loss	45	3	13	(5)
	16,147	16,446	1,183	1,230
Change in plan assets				
Fair value of plan assets at beginning of year	13,253	11,907	–	–
Return on plan assets, excluding amounts included in Net financing expense	1,199	1,021	–	–
Interest income	563	607	–	–
Employer contributions	475	433	50	51
Employees' contributions	71	71	–	–
Benefits paid	(850)	(775)	(50)	(51)
Plan settlements	–	(9)	–	–
Administrative expenses paid from plan assets	(7)	(7)	–	–
Foreign exchange gain (loss)	41	5	–	–
	14,745	13,253	–	–
Deficit at end of year	**1,402**	**3,193**	**1,183**	**1,230**
Additional minimum funding liability	176	335	–	–
Net benefit obligation	**$ 1,578**	**$ 3,528**	**$ 1,183**	**$ 1,230**

The actual return on plan assets was $1,762 (2012 – $1,628).

The net benefit obligation for pension benefits was $1,578 (2012 – $3,528). The decrease is mainly the result of the increase in plan assets and the reduction in accrued benefit obligation resulting from the increase in discount rates, partially offset by the impact of the change in mortality assumptions as further described below.

The weighted average duration of the defined benefit obligation is 13.3 years (2012 – 13.8 years).

Pension and Other Employee Future Benefit Expense

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

	Pension Benefits		Other Employee Future Benefits	
	2013	2012	2013	2012
Consolidated Statement of Operations				
Components of cost				
Current service cost	$ 264	$ 215	$ 60	$ 62
Past service cost from plan amendments	(82)	(123)	–	(4)
Administrative and other expenses	7	6	–	–
Actuarial (gains) losses	–	–	(16)	(12)
Total cost recognized in Wages, salaries and benefits	**$ 189**	**$ 98**	**$ 44**	**$ 46**
Net financing expense relating to employee benefits	**$ 155**	**$ 233**	**$ 53**	**$ 55**
Total cost recognized in statement of operations	**$ 344**	**$ 331**	**$ 97**	**$ 101**
Consolidated Other Comprehensive (Income) Loss				
Remeasurements:				
Experience loss (gain), including foreign exchange	35	(44)	(23)	(53)
Loss (gain) from change in demographic assumptions	764	79	32	2
Loss (gain) from change in financial assumptions	(1,245)	1,829	(98)	114
Return on plan assets	(1,199)	(1,021)	–	–
Minimum funding liability	(174)	(1,732)	–	–
Total cost recognized in OCI	**$ (1,819)**	**$ (889)**	**$ (89)**	**$ 63**

Composition of Pension Plan Assets

Domestic Registered Plans

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

	2013	2012	Target Allocation(1)
Non-matched assets (mainly equities)	52.8%	54.9%	53.0%
Matched assets (mainly Canadian bonds)	47.2%	45.1%	47.0%
	100.0%	**100.0%**	**100.0%**

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

All invested assets within the Master Trust are comprised of the following asset categories:

	2013	2012
Bonds	47%	51%
Equities	21%	22%
Privately held entities	21%	19%
Cash and cash equivalents	11%	8%
	100%	**100%**

For the Master Trust Fund, approximately 79% of assets as of December 31, 2013 have a quoted market price in an active market (81% as of December 31, 2012). Assets that do not have a quoted market price in an active market are mainly investments in privately held entities.

Included in plan assets, for determining the net benefit obligation for accounting purposes, are 17,647,059 Class B Voting Shares of Air Canada with a fair value of $131 (2012 – $31) which were issued in 2009 in connection with pension funding agreements reached with all of the Corporation's Canadian-based unions. All future net proceeds of sale of such shares, when realised, are to be contributed to the pension plans.

For the Domestic Registered Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Funds, as amended during 2013. The investment return objective is to achieve a total annualized rate of return that exceeds by a minimum of 1.0% before investment fees on average over the long term (i.e. 10 years) the total annualized return that could have been earned by passively managing the Liability Benchmark. The Liability Benchmark, which is referenced to widely used Canadian fixed income performance benchmarks (DEX), is composed of a mix of the DEX Universe Provincial Bond Index, DEX Long Term Provincial Bond Index and DEX Real Return Bond Index that closely matches the characteristics of the pension liabilities.

Recognizing the importance of surplus risk management, Air Canada manages the Domestic Registered Plans in an effort to optimally minimize surplus risk (defined as the difference between asset value and pension liability value), which is considered to be the key risk to be minimized and monitored. In addition, the objective of the investment strategy is to invest the assets of the Master Trust in a prudent and diversified manner to minimize the risk of price fluctuation of asset classes and individual investments within those asset classes and to combine those asset classes and individual investments in an effort to reduce overall risk.

In addition to the broad asset allocation, as summarized in the asset allocation section above, the following policies apply to individual asset classes invested within the Master Trust Fund:

- Non-matched assets are mainly equities, and are required to be diversified among industries and economic sectors. Foreign equities can comprise 25% to 39% of the total market value of the invested assets of the Master Trust Fund. Limitations are placed on the overall allocation to any individual security. Foreign equities at December 31, 2013 were 19% of assets of the Master Trust Fund. Investments in alternative investments are allowed up to 20% of the total market value of the invested assets of the Master Trust Fund. Alternative investments are investments in non-publicly traded securities and in non-traditional asset classes. They may comprise, but are not limited to investments in real estate, agriculture, timber, private equity, venture capital, infrastructure, emerging markets debt, high yield bonds and commodity futures.

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

Derivatives are permitted provided that they are used for managing a particular risk (including interest rate risk related to pension liabilities) or to create exposures to given markets and currencies and that counterparties have a minimum credit rating of A. As of December 31, 2013, a 21% derivatives exposure to matched assets is in place to hedge interest rate risk related to pension liabilities.

The trusts for the supplemental plans are invested 50% in indexed equity investments, in accordance with their investment policies, with the remaining 50% held by the Canada Revenue Agency as a refundable tax, in accordance with tax legislation.

Risks

Through its defined benefit pension plans, the Corporation is exposed to a number of risks, the most significant of which are detailed below:

Asset risk

Non-matched assets are subject to market and equity price risks. Investments in equity and other investments are subject to changes in price which may not be offset by changes in the value of plan liabilities. The plan liabilities are calculated using a discount rate set with reference to corporate bond yields. If plan assets underperform this yield, this will create a deficit. Certain plan assets are invested in foreign equities, which are also subject to foreign exchange risk.

Interest rate risk

A decrease in corporate and/or government bond yields will increase plan liabilities, which will be partially offset by an increase in the value of the plans' bond holdings.

Funding risk

Adverse changes in the value of plan assets or in interest rates could have a significant impact on pension plan solvency valuations and cash funding requirements. Refer to discussion above with respect to past service funding obligations while the 2014 Regulations are in effect.

Life expectancy

The majority of the plans' obligations are to provide benefits for the life of the member, so increases in life expectancy will result in an increase in the plans' liabilities.

Assumptions

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

Financial assumptions

Discount Rate

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

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

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

	Pension Benefits		Other Employee Future Benefits	
	2013	2012	2013	2012
Discount rate used to determine:				
Accrued benefit cost for the year ended December 31	4.30%	5.20%	4.17%	4.90%
Accrued benefit liability as at December 31	4.90%	4.30%	4.80%	4.17%
Rate of future increases in compensation used to determine:				
Accrued benefit cost for the year ended December 31	2.50%	2.50%	not applicable	not applicable
Accrued benefit obligation as at December 31	2.50%	2.50%	not applicable	not applicable

Actuarial assumptions

Mortality rates

The cost and related liabilities of the Corporation's pension plans, and other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations include several economic and demographic assumptions including mortality rates. For the December 31, 2013 accounting valuations, the mortality assumption has been updated to reflect the results of a mortality study specific to Air Canada pension plan membership which was completed in the fourth quarter of 2013. The change in mortality rate assumptions resulted in an actuarial remeasurement of the accounting liabilities with the impact being recorded in other comprehensive income. The improvements in assumed mortality rates are consistent with those presented by the Canadian Institute of Actuaries ("CIA") which issued a draft report during the third quarter of 2013 proposing new mortality tables for use in the valuation of Canadian pension and benefit plans. The CIA is expected to issue further guidance for mortality rate assumptions by early 2014, and Air Canada's experience will be remeasured against the revised CIA tables.

Sensitivity Analysis

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

Sensitivity analysis on 2013 pension expense and net financing expense relating to pension benefit liabilities, based on different actuarial assumptions with respect to discount rate is set out below. The effects on each pension plan of a change in an assumption are weighted proportionately to the total plan obligation to determine the total impact for each assumption presented.

	0.25 Percentage Point	
	Decrease	Increase
Discount rate on obligation assumption		
Pension expense	$ 15	$ (14)
Net financing expense relating to pension benefit liabilities	4	8
	$ 19	**$ (6)**
Increase (decrease) in pension obligation	**$ 530**	**$ (537)**

An increase of one year in the mortality rate assumption would increase the pension benefit obligation by $394.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 6% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2013 (2012 – 6.75%). The rate is assumed to decrease gradually to 5% by 2015. A one percentage point increase in assumed health care trend rates would have increased the total of current service and interest costs by $4 and the obligation by $55. A one percentage point decrease in assumed health care trend rates would have decreased the total of current service and interest costs by $4 and the obligation by $53.

A 0.25 percentage point decrease in discount rate would have increased the total of current and interest costs by less than $1 and the obligation by $42. A 0.25 percentage point increase in discount rate would have decreased the total of current and interest costs by less than $1 and the obligation by $36.

Defined Contribution Pension Plans

The Corporation's management, administrative and certain unionized employees may participate in defined contribution pension plans or multi-employer plans which are accounted for as defined contribution plans. Contributions range from 3% to 6% of annual pay for those employees in Canada and 3% to 7% of annual pay for those participants in the United Kingdom. The Corporation contributes an amount expressed as a percentage of employees' contributions with such percentage varying by group and based on the number of years of service.

The Corporation's expense for defined contribution pension plans amounted to $5 for the year ended December 31, 2013 (2012 – $3). Expected total employer contributions to defined contribution pension plans for 2014 are $6.

10. PROVISIONS FOR OTHER LIABILITIES

The following table provides a continuity schedule of all recorded provisions. Refer to Note 18 for additional information on Litigation provisions. Current provisions are recorded in Accounts payable and accrued liabilities.

	Maintenance (a)	Asset retirement (b)	Litigation	Other (c)	Total provisions
At December 31, 2012					
Current	$ 14	$ –	$ 29	$ 18	$ 61
Non-current	571	19	–	–	590
	$ 585	**$ 19**	**$ 29**	**$ 18**	**$ 651**
Provisions arising during the year	$ 72	$ –	$ 2	$ –	$ 74
Amounts disbursed	(9)	–	(2)	(17)	(28)
Changes in estimated costs	(40)	(2)	–	(1)	(43)
Accretion expense	6	–	–	–	6
Foreign exchange gain	42	–	–	–	42
At December 31, 2013	$ 656	$ 17	$ 29	$ –	$ 702
Current	$ –	$ –	$ 29	$ –	$ 29
Non-current	656	17	–	–	673
	$ 656	$ 17	$ 29	$ –	$ 702

(a) Maintenance provisions relate to the provision for the costs to meet the contractual return conditions on aircraft under operating leases. The provision relates to leases with expiry dates ranging from 2014 to 2024 with the average remaining lease term of approximately four years. The maintenance provisions take into account current costs of maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Assuming the aggregate cost for return conditions increases by 5%, holding all other factors constant, there would be a cumulative balance sheet adjustment to increase the provision by $32 at December 31, 2013 and an increase to maintenance expense in 2014 of approximately $4. If the discount rates were to increase by 1%, holding all other factors constant, there would be a cumulative balance sheet adjustment to decrease the provision by $15 at December 31, 2013. Due to low market rates of interest, a 1% decrease in discount rates was not considered a reasonable scenario.

(b) Under the terms of certain land and facilities leases, the Corporation has an obligation to restore the land to vacant condition at the end of the lease and to rectify any environmental damage for which it is responsible. The related leases expire over terms ranging from 2014 to 2041. These provisions are based on numerous assumptions including the overall cost of decommissioning and remediation and the selection of alternative decommissioning and remediation approaches. The non-current provision is recorded in Other long-term liabilities.

(c) A liability of $18 was recorded in Wages, salaries and benefits related to employee profit sharing payments. The liability was an estimate based upon a number of assumptions and the Corporation's assessment as to the expected outcome related to this matter. During 2013, the provision was settled resulting in a cash payment in the amount of $17.

11. OTHER LONG-TERM LIABILITIES

		2013	2012
Proceeds from contractual commitments (a)		$ 107	$ 107
Deferred income tax	Note 12	49	49
Collateral held in leasing arrangements and other deposits		29	46
Aircraft rent in excess of lease payments	Note 2BB	27	33
Long-term employee liabilities		25	28
Other	Note 10(b)	138	156
		$ 375	$ 419

(a) Proceeds from contractual commitments represent non-refundable proceeds received, net of related costs and deposits, in consideration of various contractual commitments and will be recognized as reductions in the cost of those contractual commitments when incurred.

12. INCOME TAXES

Income Tax Expense

	2013	2012
Current income tax recovery in respect of prior years	$ (8)	$ –
Deferred income tax expense	–	1
Income tax expense (recovery)	**$ (8)**	**$ 1**

The income tax expense (recovery) differs from the amount that would have resulted from applying the statutory income tax rate to income before income tax expense as follows:

	2013	2012
Income (loss) before income taxes	$ 2	$ (135)
Statutory income tax rate based on combined federal and provincial rates	26.57%	26.49%
Income tax expense (recovery) based on statutory tax rates	1	(36)
Effects of:		
Non-taxable portion of capital gains	(3)	(4)
Non-deductible expenses	11	12
Tax rate changes on deferred income taxes	(6)	(17)
Recognition of previously unrecognized deferred income tax assets	(9)	–
Unrecognized deferred income tax assets	–	39
Adjustment in respect of current income tax of prior years	(8)	–
Other	6	7
Income tax expense (recovery)	**$ (8)**	**$ 1**

The applicable statutory tax rate is 26.57% (2012 – 26.49%). The Corporation's applicable tax rate is the Canadian combined rates applicable in the jurisdictions in which the Corporation operates.

The income tax expense relating to components of Other comprehensive income is as follows:

	2013	2012
Net gain on remeasurements on employee benefit liabilities	$ 521	$ 213
Recognition of previously unrecognized deferred income tax assets	(525)	(213)
Tax rate changes on deferred income taxes	4	–
Income tax expense in Other comprehensive income	**$ –**	**$ –**

Deferred Income Tax

Certain intangible assets with nominal tax cost and a carrying value of $185 have indefinite lives and accordingly, the associated deferred income tax liability of $49 (2012 – $49) is not expected to reverse until the assets are disposed of, become impaired or amortizable. In addition, the Corporation has other deferred income tax liabilities in the amount of $41, against which a deferred income tax asset of similar amount has been recognized. The recognized net deferred income tax liability of $49 is included in Other long-term liabilities.

Deferred income tax assets are recognized to the extent that the realization of the related tax benefit is probable. The Corporation has unrecognized tax loss carryforwards of $1,404 and temporary differences of $5,290 for which no deferred income tax assets could be recognized. However, the future tax deductions underlying these deferred income tax assets remain available for use in the future to reduce taxable income. The following are the Federal non-capital tax loss expiry dates:

	Tax Losses
2026	$ 2
2027	9
2028	962
2029	409
2030	11
2031	6
2032	1
2033	2
	$ 1,402

There are net capital losses as at December 31, 2013 of $2 (2012 – $2).

Cash income taxes recovered in 2013 by the Corporation were $5 (2012 – $1 paid).

13. SHARE CAPITAL

	Number of shares	Value
At January 1, 2012	277,371,493	$ 840
Shares purchased and cancelled under issuer bid	(3,019,600)	(9)
Expiration of warrants	–	(18)
Shares in trust for employee recognition award	91,910	–
At December 31, 2012	**274,443,803**	**813**
Shares issued on the exercise of stock options	2,064,264	4
Shares issued on the exercise of warrants	7,916,667	12
Repurchase of warrants	–	(2)
Shares in trust for employee recognition award	107,705	–
At December 31, 2013	**284,532,439**	**$ 827**

The issued and outstanding ordinary shares of Air Canada, along with the potential ordinary shares, were as follows:

		2013	2012
Issued and outstanding			
Class A variable voting shares		26,577,512	33,006,104
Class B voting shares		257,954,927	241,437,699
Total issued and outstanding		**284,532,439**	**274,443,803**
Potential ordinary shares			
Warrants		–	10,000,000
Shares held in trust	Note 14	1,337,377	1,445,082
Stock options	Note 14	10,079,694	8,410,403
Total potential ordinary shares		**11,417,071**	**19,855,485**

Ordinary Shares

As at December 31, 2013, the ordinary shares issuable by Air Canada consist of an unlimited number of Class A Variable Voting Shares ("Variable Voting Shares") and an unlimited number of Class B Voting Shares ("Voting Shares"). The two classes of ordinary shares have equivalent rights as common shareholders except for voting rights. Holders of Variable Voting Shares are entitled to one vote per share unless (i) the number of Variable Voting Shares outstanding, as a percentage of the total number of voting shares of Air Canada exceeds 25% or (ii) the total number of votes cast by or on behalf of holders of Variable Voting Shares at any meeting exceeds 25% of the total number of votes that may be cast at such meeting. If either of the above noted thresholds would otherwise be surpassed at any time, the vote attached to each Variable Voting Share will decrease proportionately such that (i) the Variable Voting Shares as a class do not carry more than 25% of the aggregate votes attached to all issued and outstanding voting shares of Air Canada and (ii) the total number of votes cast by or on behalf of holders of Variable Voting Shares at any meeting do not exceed 25% of the votes that may be cast at such meeting.

Variable Voting Shares may only be held, beneficially owned or controlled, directly or indirectly, by persons who are not Canadians (within the meaning of the *Canada Transportation Act*). An issued and outstanding Variable Voting Share shall be converted into one Voting Share automatically and without any further act of Air Canada or the holder, if such Variable Voting Share becomes held, beneficially owned and controlled, directly or indirectly, otherwise than by way of security only, by a Canadian, as defined in the *Canada Transportation Act*.

Voting Shares may only be held, beneficially owned and controlled, directly or indirectly, by Canadians. An issued and outstanding Voting Share shall be converted into one Variable Voting Share automatically and without any further act of Air Canada or the holder, if such Voting Share becomes held, beneficially owned or controlled, directly or indirectly, otherwise than by way of security only, by a person who is not a Canadian.

Warrants

In 2013, the Corporation purchased for cancellation 2,083,333 warrants expiring July 30, 2013 for an aggregate purchase price of $2, representing the average trading price, at the time of purchase, of Air Canada shares on the Toronto Stock Exchange less the exercise price of $1.51 of each warrant. In addition, the outstanding number of ordinary shares increased by 7,916,667 upon exercise of warrants with proceeds to Air Canada of $12.

In 2012, 79,430,300 warrants with an exercise price of $2.20 expired. Upon expiry, the value ascribed to the Share capital related to the warrants of $18 was reclassified to the Deficit. No warrants were exercised during 2012.

The Corporation has no warrants left outstanding.

Normal Course Issuer Bid

In 2011, Air Canada received approval from the Toronto Stock Exchange ("TSX") to implement a normal course issuer bid to purchase, for cancellation, up to 24,737,753 Class A Variable Voting Shares and/or Class B Voting Shares (the "Shares"), representing, at that time, 10% of the total public float of the Shares. The repurchase program, which commenced on December 12, 2011 and ended December 11, 2012, was conducted through the facilities of the TSX.

During 2012, the Corporation purchased and cancelled 3,019,600 shares for cash at an average cost of $1.67 per share.

Shareholder Rights Plan

In 2012, the shareholders of Air Canada approved amendments to the shareholder rights plan agreement (the "Rights Plan") which provide that, subject to certain exceptions identified in the Rights Plan, the Rights Plan, as last amended, would be triggered in the event of an offer to acquire 20% or more of the outstanding Class A variable voting shares and Class B voting shares of Air Canada calculated on a combined basis, instead of 20% or more of either the outstanding Class A variable voting shares or the Class B voting shares calculated on a per class basis as was the case under the Rights Plan prior to the amendments that came into effect in 2012.

The amendments to the Rights Plan were proposed and implemented in order to render effective a decision issued by Canadian securities regulatory authorities (pursuant to an application of Air Canada) that effectively treats Air Canada's Class A variable voting shares and Class B voting shares as a single class for the purposes of applicable take-over bid requirements and early warning reporting requirements contained under Canadian securities laws.

Under the terms of the Rights Plan, one right (a "Right") has been issued with respect to each Class B Voting Share and each Class A Variable Voting Share (each a "Share") of Air Canada issued and outstanding as of the close of business on March 30, 2011 or subsequently issued. These Rights would become exercisable only when a person, including any party related to it, acquires or announces its intention to acquire 20% or more of the outstanding Class A Variable Voting Shares and Class B Voting Shares of Air Canada calculated on a combined basis, without complying with the "Permitted Bid" provisions of the Rights Plan or, in certain cases, without the approval of the Board. Until such time, the Rights are not separable from the shares, are not exercisable and no separate rights certificates are issued. To qualify as a "Permitted Bid" under the Rights Plan, a bid must, among other things: (i) be made to all holders of Shares, (ii) remain open for a period of not less than 60 days, (iii) provide that no Shares shall be taken up unless more than 50% of the then outstanding Class A Variable Voting Shares and Class B Voting Shares, on a combined basis, other than the Shares held by the person pursuing the acquisition and parties related to it, have been tendered and not withdrawn, and (iv) provide that if such 50% condition is satisfied, the bid will be extended for at least 10 business days to allow other shareholders to tender.

Following the occurrence of an event which triggers the right to exercise the Rights and subject to the terms and conditions of the Rights Plan, each Right would entitle the holders thereof, other than the acquiring person or any related persons, to exercise their Rights and purchase from Air Canada two hundred dollars worth of Class A Variable Voting Shares or Class B Voting Shares for one hundred dollars (i.e. at a 50% discount to the market price at that time). Upon such exercise, holders of rights beneficially owned and controlled by Qualified Canadians would receive Class B Voting Shares and holders of rights beneficially owned or controlled by persons who are not Qualified Canadians would receive Class A Variable Voting Shares.

The Rights Plan is scheduled to expire at the close of business on the date immediately following the date of Air Canada's annual meeting of shareholders to be held in 2014, unless terminated earlier in accordance with the terms of the Rights Plan. The Rights Plan may be renewed or extended with shareholders' approval.

14. SHARE-BASED COMPENSATION

Air Canada Long-Term Incentive Plan

Certain of the Corporation's employees participate in the Air Canada Long-term Incentive Plan (the "Long-term Incentive Plan"). The Long-term Incentive Plan provides for the grant of options and performance share units to senior management and officers of Air Canada. 19,470,294 shares are authorized for issuance under the Long-term Incentive Plan in respect of either of stock options or performance share units.

Stock Options

The options to purchase shares granted under the Long-term Incentive Plan have a maximum term of seven years and an exercise price based on the fair market value of the shares at the time of the grant of the options. Fifty percent of options are time-based and vest over four years. The remaining options will vest based upon performance conditions. The performance vesting conditions are based on operating margin (operating income over operating revenues) targets established by the Air Canada Board over the same time period. Each option entitles the employee to purchase one ordinary share at the stated exercise price. The terms of the Long-term Incentive Plan specify that following retirement an employee may exercise options granted with the rights to exercise continuing for the three years after the retirement date.

The number of Air Canada stock options granted to employees, the related compensation expense recorded and the assumptions used to determine stock-based compensation expense, using the Black-Scholes option valuation model are as follows:

	2013	2012
Compensation expense ($ millions)	$ 3	$ 2
Number of stock options granted to Air Canada employees	4,052,085	2,922,043
Weighted average fair value per option granted ($)	$ 1.29	$ 0.44
Aggregated fair value of options granted ($ millions)	$ 5	$ 1
Weighted average assumptions:		
Share price	$ 2.95	$ 0.96
Risk-free interest rate	1.20%-2.21%	1.22%-1.89%
Expected volatility	48.8%-74.2%	50.9%-77.7%
Dividend yield	0%	0%
Expected option life (years)	5.25	5.25

Expected volatility was determined at the time of grant using the Air Canada share price on a historical basis. It reflects the assumption that the historical volatility is indicative of future trends, which may not necessarily be the actual outcome.

A summary of the Long-term Incentive Plan option activity is as follows:

	2013		2012	
	Options	Weighted Average Exercise Price/Share	Options	Weighted Average Exercise Price/Share
Beginning of year	8,410,403	$ 2.68	6,581,242	$ 4.07
Granted	4,052,085	2.95	2,922,043	0.98
Exercised	(2,064,264)	1.44	–	–
Expired	(311,655)	21.00	(100,315)	2.54
Forfeited	(6,875)	12.18	(992,567)	6.91
Outstanding options, end of year	**10,079,694**	**$ 2.47**	**8,410,403**	**$ 2.68**
Options exercisable, end of year	**1,609,601**	**$ 3.61**	**2,657,585**	**$ 5.01**

The weighted average share price on the date of exercise for options exercised in 2013 was $6.56. There were no options exercised in 2012.

		2013 Outstanding Options			2013 Exercisable Options	
Range of Exercise Prices	Expiry Dates	Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	Number of Exercisable Options	Weighted Average Exercise Price/Share
$11.08 – $18.60	2014	237,661	1	$ 14.71	237,661	$ 14.71
$8.51	2015	5,500	2	8.51	5,500	8.51
$0.97 – $1.59	2016	442,500	3	1.30	442,500	1.30
$1.78 – $1.91	2017	31,250	4	1.85	–	–
$2.34	2018	2,612,356	5	2.34	577,828	2.34
$0.96 – $1.28	2019	2,698,342	6	0.98	346,112	1.00
$2.49 – $5.69	2020	4,052,085	7	2.95	–	–
		10,079,694		**$ 2.47**	**1,609,601**	**$ 3.61**

		2012 Outstanding Options			2012 Exercisable Options	
Range of Exercise Prices	Expiry Dates	Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	Number of Exercisable Options	Weighted Average Exercise Price/Share
$21.00	2013	315,405	1	$ 21.00	315,405	$ 21.00
$11.08 – $18.60	2014	237,661	2	14.71	237,661	14.71
$8.51	2015	5,500	3	8.51	5,500	8.51
$0.97 – $1.59	2016	2,110,625	4	1.30	1,722,344	1.32
$1.78 – $1.91	2017	50,000	5	1.85	12,500	1.85
$2.34	2018	2,913,400	6	2.34	364,175	2.34
$0.96 – $1.28	2019	2,777,812	7	0.98	–	–
		8,410,403		**$ 2.68**	**2,657,585**	**$ 5.01**

Performance Share Units

The Long-term Incentive Plan also includes performance share units ("PSUs"), which are accounted for as equity settled instruments. The vesting term of PSUs is three years and generally includes time based vesting features as well as performance based vesting features, which are based upon achievement of earnings targets established over the vesting period. The terms of the plan specify that upon the retirement of an employee, the number of PSUs that vest are prorated based on the total number of completed months of active service during the PSU vesting term. The PSUs granted may only be redeemed for Air Canada shares purchased on the secondary market and/or equivalent cash at the discretion of the Board of Directors.

The compensation expense related to PSUs in 2013 was $12 (2012 –$6).

A summary of the Long-term Incentive Plan performance share unit activity is as follows:

	2013	2012
Beginning of year	7,255,711	6,115,840
Granted	4,047,136	2,712,230
Settled	(1,661,624)	(1,095,422)
Forfeited	(203,253)	(476,937)
Outstanding PSUs, end of year[(1)]	**9,437,970**	**7,255,711**

(1) 1,299,533 PSUs were eligible for vesting as at December 31, 2013, of which all were vested in accordance with the terms of the program. These PSUs which vested in 2013 are planned to be settled in 2014.

Refer to Note 17 for a description of derivative instruments used by the Corporation to mitigate the cash flow exposure to the PSUs granted.

Employee Recognition Award

In 2011, Air Canada's Board of Directors approved a special one-time Employee Recognition Award in the form of Air Canada shares granted to all eligible unionized and certain non-unionized employees worldwide, where permitted. Under the award, eligible employees were granted an aggregate of approximately 3.3 million shares with a grant date fair value of $11. Half of these shares vested immediately upon issuance and the other half vest at the end of three years. Pursuant to the award, the Corporation purchased approximately 3.3 million shares for $11, of which half were distributed to the eligible employees and the other half are held in trust over the vesting period. The shares held in trust were recorded at cost of $6 and are reported net against Share capital. Compensation expense for these shares will be recognized over the vesting period. The compensation expense recorded in 2013 was $2 (2012 – $2). Refer to Note 13 for the number of remaining shares held in trust as at period end which will vest in the first quarter of 2014.

Employee Share Purchase Plan

Eligible employees can participate in the employee share purchase plan under which employees can invest up to 6% of their base salary for the purchase of shares on the secondary market. Air Canada will match 33.3% of the investments made by the employee during the first year of participation in the program, with a 50% match after 12 months of continuous participation in the program. During 2013, the Corporation recorded compensation expense of $1 (2012 – less than $1).

15. EARNINGS PER SHARE

The following table outlines the calculation of basic and diluted earnings per share:

(in millions, except per share amounts)	2013	2012
Numerator:		
Numerator for basic and diluted earnings per share:		
Net income (loss) attributable to shareholders of Air Canada from continuing operations	$ 6	$ (85)
Net loss attributable to shareholders of Air Canada from discontinued operations	–	(55)
Net income (loss) attributable to shareholders of Air Canada	$ 6	$ (140)
Denominator:		
Weighted-average shares	277	276
Effect of potential dilutive securities:		
Warrants	2	–
Stock options	4	1
Shares held in Trust for employee share-based compensation award	1	1
	7	2
Add back anti-dilutive impact	–	(2)
Adjusted denominator for diluted earnings per share	**284**	**276**
Basic earnings (loss) per share from continuing operations	**$ 0.02**	**$ (0.31)**
Diluted earnings (loss) per share from continuing operations	**$ 0.02**	**$ (0.31)**
Basic and diluted earnings (loss) per share from discontinued operations	**$ –**	**$ (0.20)**
Diluted earnings (loss) per share	**$ 0.02**	**$ (0.51)**

The calculation of earnings per share is based on whole dollars and not on rounded millions. As a result, the above amounts may not be recalculated to the per share amount disclosed above.

Basic EPS is calculated based on the weighted average number of ordinary shares outstanding after deducting shares held in trust for the purposes of the Employee Recognition Award.

Excluded from the 2013 calculation of diluted earnings per share were 7,027,000 (2012 – 7,865,000) outstanding options where the options' exercise prices were greater than the average market price of the ordinary shares for the year. In 2012, 9,638,190 warrants were excluded from the calculation of diluted earnings per share as the warrants' exercise prices were greater than the average market price of the ordinary shares for the year. All warrants were exercised or settled in 2013.

16. COMMITMENTS

Boeing

As at December 31, 2013, the Corporation has outstanding purchase commitments with The Boeing Company ("Boeing") for the acquisition of 37 Boeing 787 aircraft. The first six deliveries are scheduled for 2014 and the remaining 31 between 2015 and 2019. The Corporation also has purchase options for 13 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing and delivery positions), and purchase rights for 10 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on Boeing's then current pricing).

The Corporation has financing commitments covering 31 of the 37 Boeing 787 firm aircraft orders. The financing terms for 28 out of the 31 covered aircraft is for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments. For the remaining 3 out of the 31 covered aircraft, the financing under the commitment covers up to 90% of the capital expenditure and the term to maturity is 15 years with principal payments made on a mortgage style basis resulting in equal installment payments of principal and interest over the term to maturity.

In addition, the Corporation has an outstanding purchase commitment for the acquisition of one Boeing 777 aircraft, scheduled for delivery in February 2014. This aircraft, together with four Boeing 777 aircraft which were delivered in 2013, is financed through the proceeds from the private offering of enhanced equipment trust certificates as described in Note 8. The Corporation also has purchase rights for 13 Boeing 777 (entitling Air Canada to purchase aircraft based on previously determined pricing).

In December 2013, as part of the narrowbody fleet renewal plan, the Corporation announced an agreement with Boeing, which is subject to conclusion of final documentation and other conditions, which includes firm orders for 33 737 MAX 8 and 28 737 MAX 9 aircraft with substitution rights between them as well as for the 737 MAX 7 aircraft. It also provides for options for 18 aircraft and certain rights to purchase an additional 30. Deliveries are scheduled to begin in 2017 with 2 aircraft, and with the remaining deliveries between 2018 to 2021, subject to deferral and acceleration rights. These Boeing 737 aircraft orders are not included in the capital commitments disclosure until such time as final documentation and other conditions are met.

Operating Lease and Capital Commitments

The estimated aggregate cost of the future firm Boeing 787 aircraft deliveries and other capital purchase commitments as at December 31, 2013 approximates $4,986 (of which $3,392 is subject to committed financing, subject to the fulfillment of certain terms and conditions). US dollar amounts are converted using the December 31, 2013 closing rate of CDN$1.0636. The estimated aggregate cost of aircraft is based on delivery prices that include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day US LIBOR rate at December 31, 2013.

	2014	2015	2016	2017	2018	Thereafter	Total
Capital commitments	$ 916	$ 727	$ 1,067	$ 1,378	$ 643	$ 255	**$ 4,986**

As at December 31, 2013 the future minimum lease payments under existing operating leases of aircraft and other property amount to $1,744 using year end exchange rates.

	2014	2015	2016	2017	2018	Thereafter	Total
Aircraft	$ 313	$ 263	$ 223	$ 195	$ 169	$ 266	**$ 1,429**
Other property	46	43	27	24	22	153	**315**
Total	**$ 359**	**$ 306**	**$ 250**	**$ 219**	**$ 191**	**$ 419**	**$ 1,744**

Non-cancellable Sublease Receipts

The Corporation leases or subleases to third parties 12 aircraft and 6 spare engines which have final maturities ranging from 2014 to 2016 and the future minimum rentals receivable under such leases and subleases amount to $24 using year end exchange rates.

	2014	2015	2016	2017	2018	Thereafter	Total
Subleases	$ 16	$ 6	$ 2	$ –	$ –	$ –	**$ 24**

For accounting purposes, the Corporation acts as an agent and subleases certain aircraft to Jazz on a flow-through basis, which are reported net on the consolidated statement of operations. These subleases relate to 25 Bombardier CRJ-200 aircraft and 15 Bombardier CRJ-705 aircraft which have final maturities ranging from 2015 to 2024. The sublease revenue and lease expense related to these aircraft each amounted to $78 in 2013 (2012 – $76). The operating lease commitments under these aircraft, which are recovered from Jazz, are not included in the aircraft operating lease commitments or non-cancellable lease and sublease receipt tables above but are summarized as follows:

	2014	2015	2016	2017	2018	Thereafter	Total
Jazz flow – through leases	$ 81	$ 79	$ 73	$ 67	$ 64	$ 277	**$ 641**

The subleases with Jazz have the same terms and maturity as the Corporation's corresponding lease commitments to the lessors.

The Corporation leases and subleases certain aircraft to Sky Regional, which are charged back to Air Canada through the CPA with Sky Regional. These are reported net on the consolidated statement of operations. The leases and subleases relate to 5 Bombardier Q400 aircraft and 15 Embraer 175 aircraft. The leases and sublease revenue and expense related to these aircraft each amount to $27 in 2013 and are not included in the non-cancellable lease and sublease receipts above.

The future minimum non-cancellable commitment for the next 12 months under the Jazz CPA is approximately $801 and under the capacity purchase agreements with other regional carriers is $109. The rates and mark-up under the Jazz CPA are subject to change based upon, amongst other things, changes in Jazz's costs and the level of flying contracted by Air Canada.

Maturity Analysis

Principal and interest repayment requirements as at December 31, 2013 on Long-term debt and finance lease obligations are as follows:

Principal	2014	2015	2016	2017	2018	Thereafter	Total
Long-term debt obligations	$ 312	$ 613	$ 317	$ 426	$ 309	$ 2,092	**$ 4,069**
Finance lease obligations	62	61	26	27	30	122	**328**
	$ 374	**$ 674**	**$ 343**	**$ 453**	**$ 339**	**$ 2,214**	**$ 4,397**

Interest	2014	2015	2016	2017	2018	Thereafter	Total
Long-term debt obligations	$ 229	$ 192	$ 172	$ 180	$ 137	$ 176	**$ 1,086**
Finance lease obligations	30	23	19	16	13	37	**138**
	$ 259	**$ 215**	**$ 191**	**$ 196**	**$ 150**	**$ 213**	**$ 1,224**

Principal repayments in the table above exclude transaction costs of $64 which are offset against Long-term debt and finance leases in the consolidated statement of financial position.

The following is a maturity analysis, based on contractual undiscounted cash flows, for financial liabilities. The analysis includes both the principal and interest component of the payment obligations on long-term debt and is based on interest rates and the applicable foreign exchange rate effective as at December 31, 2013.

	2014	2015	2016	2017	2018	Thereafter	Total
Long-term debt obligations	$ 541	$ 805	$ 489	$ 606	$ 446	$ 2,268	**$ 5,155**
Finance lease obligations	92	84	45	43	43	159	**466**
Accounts payable and accrued liabilities	1,129	–	–	–	–	–	**1,129**
	$ 1,762	$ 889	$ 534	$ 649	$ 489	$ 2,427	**$ 6,750**

Minimum Committed Purchase of Aeroplan Miles

The CPSA between the Corporation and Aeroplan outlines a requirement for the Corporation to purchase a minimum number of Aeroplan Miles® from Aeroplan. The estimated minimum requirement for 2014 is $218. The annual commitment is based on 85% of the average total Aeroplan Miles® actually issued in respect of Air Canada flights or Air Canada airline affiliate products and services in the three preceding calendar years. During 2013, the Corporation purchased $242 of Aeroplan Miles® from Aeroplan.

17. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Summary of Financial Instruments

	Carrying Amounts				
	December 31, 2013				December 31, 2012
	Financial instruments classification				
	Held for trading	Loans and receivables	Liabilities at amortized cost	Total	
Financial Assets					
Cash and cash equivalents	$ 750	$ –	$ –	$ 750	$ 754
Short-term investments	1,458	–	–	1,458	1,219
Restricted cash	92	–	–	92	96
Accounts receivable	–	589	–	589	550
Deposits and other assets					
Restricted cash	190	–	–	190	188
Aircraft related and other deposits	–	122	–	122	159
Prepayment option on senior secured notes	2	–	–	2	15
Derivative instruments					
Fuel derivatives	20	–	–	20	16
Share forward contracts	56	–	–	56	10
Foreign exchange derivatives	13	–	–	13	–
Interest rate swaps	10	–	–	10	13
	$ 2,591	$ 711	$ –	$ 3,302	$ 3,020
Financial Liabilities					
Accounts payable	$ –	$ –	$ 1,026	$ 1,026	$ 1,028
Current portion of long-term debt and finance leases	–	–	374	374	499
Long-term debt and finance leases	–	–	3,959	3,959	3,259
	$ –	$ –	$ 5,359	$ 5,359	$ 4,786

There have been no changes in classification of financial instruments since December 31, 2012.

For cash flow purposes, the Corporation may settle, from time to time, certain cash equivalents and short-term investments prior to their original maturity. For this reason, these financial instruments do not meet the criteria of held to maturity and are therefore designated as held for trading. They are recorded at fair value with changes in fair value recorded in Interest income.

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

	2013	2012
Fuel derivatives	$ (6)	$ (43)
Share forward contracts	42	5
Prepayment option on senior secured notes	2	15
Interest rate swaps	(1)	(1)
Other	–	4
Gain (loss) on financial instruments recorded at fair value	$ 37	$ (20)

Risk Management

Under its risk management policy, the Corporation manages its interest rate risk, foreign exchange risk, share-based compensation risk and market risk (e.g. fuel price risk) through the use of various interest rate, foreign exchange, fuel and other derivative financial instruments. The Corporation uses derivative financial instruments only for risk management purposes, not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be offset by changes in cash flows related to the risk being hedged.

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

Interest Rate Risk

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

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

The ratio of fixed to floating rate obligations outstanding is designed to maintain flexibility in the Corporation's capital structure and is based upon a long term objective of 60% fixed and 40% floating but allows flexibility in the short-term to adjust to prevailing market conditions. The ratio at December 31, 2013 is 74% fixed and 26% floating, including the effects of interest rate swap positions (71% and 29%, respectively as at December 31, 2012). The following are the current derivatives employed in interest rate risk management activities and the adjustments recorded during 2013:

- As at December 31, 2013, the Corporation had two interest rate swap agreements in place with terms to July 2022 and January 2024 relating to two Boeing 767 aircraft financing agreements with an aggregate notional value of $62 (US$58) (2012 – $65 (US$66)). These swaps convert the lease payments on the two aircraft leases from fixed to floating rates. The fair value of these contracts as at December 31, 2013 was $10 in favour of the Corporation (2012 – $13 in favour of the Corporation). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During 2013, a loss of $1 was recorded in Gain on financial instruments recorded at fair value related to these derivatives (2012 – $2 gain).

Interest income includes $29 (2012 – $33) related to Cash and cash equivalents and Short-term investments, which are classified as held for trading. Interest expense reflected on the consolidated statement of operations relates to financial liabilities recorded at amortized cost.

Foreign Exchange Risk

The Corporation's financial results are reported in Canadian dollars, while a large portion of its revenues, expenses, debt obligations and capital commitments are in foreign currencies, primarily in US dollars. Foreign exchange risk is the risk that fluctuations in foreign exchange rates will adversely impact operating results and cash flows.

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

The Corporation's cash inflows are primarily in Canadian dollars, while a large portion of its outflows are in US dollars. This unbalanced mix results in an annual US dollar shortfall from operations. In order to mitigate this imbalance, the Corporation has adopted a number of risk management strategies, which include:

- The practice of converting excess revenues from offshore currencies into US dollars. In 2013, this conversion generated coverage for approximately 25% of the imbalance.
- Holding US cash reserves as an economic hedge against changes in the value of the US dollar. US dollar cash and short-term investment balances as at December 31, 2013 amount to $791(US$743) ($581 (US$584) as at December 31, 2012).
- Locking in the foreign exchange rate through the use of a variety of foreign exchange derivatives which have maturity dates corresponding to the forecasted dates of US dollar shortfalls.

The target coverage of the above strategies is to cover 50% of the net US dollar exposure on a rolling 12 month basis. The level of foreign exchange derivatives entered into and their related maturity dates are dependent upon a number of factors, which include the amount of foreign revenue conversion available, US dollar net cash flows, as well as the amount attributed to aircraft and debt payments. Based on the notional amount of currency derivatives outstanding at December 31, 2013, as further described below, and the value of US cash reserves, approximately 50% of net US cash outflows are hedged in 2014.

As at December 31, 2013, the Corporation had outstanding foreign currency options and swap agreements to purchase US dollars and Euros against Canadian dollars on $1,645 (US$1,547) and $72 (EUR $34, GBP $16) which mature in 2014 and 2015 at a weighted average rate of $1.0341 per $1.00 US dollar (2012 – $1,289 (US$1,296) which matured in 2013). The fair value of these foreign currency contracts as at December 31, 2013 was $13 in favour of the Corporation (2012 – less than $1 in favour of the Corporation). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During 2013, a gain of $68 was recorded in Foreign exchange gain (loss) related to these derivatives (2012 – $20 gain).

Share-based Compensation Risk

The Corporation issues share-based compensation to its employees in the form of stock options and PSUs as described in Note 14. Each PSU entitles the employees to receive a payment in the form of one Air Canada ordinary share, cash in the amount equal to market value of one ordinary share, or a combination thereof, at the discretion of the Board of Directors.

Share-based compensation risk refers to the risk that future cash flows to settle the PSUs will fluctuate because of changes in the Corporation's share price. To hedge the exposure to outstanding PSUs, the Corporation entered into share forward contracts to hedge PSUs that may vest between 2014 and 2016, subject to the terms of vesting including realization of performance vesting criteria. The contracts were prepaid by the Corporation. The forward dates for the share forward contracts coincide with the vesting terms and planned settlement dates of 7,523,112 PSUs from 2014 to 2016. These contracts were not designated as hedging instruments for accounting purposes. Accordingly, changes in the fair value of these contracts are recorded in Gain (loss) on financial instruments recorded at fair value in the period in which they arise. During 2013, a gain of $42 was recorded (2012 – gain of $5). As at December 31, 2013, the fair value of the share forward contracts is $56 in favour of the Corporation (2012 – $10 in favour of the Corporation), with those contracts maturing in 2014 of $20 recorded in Prepaid expenses and other current assets and the remainder of $36 is recorded in Deposits and other assets.

Liquidity risk

Liquidity risk is the risk that the Corporation will encounter difficulty in meeting obligations associated with its financial liabilities and other contractual obligations, including pension funding obligations as described in Note 9 and covenants in credit card agreements as described below. The Corporation monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as 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. The Corporation's principal objective in managing liquidity risk is to maintain a minimum unrestricted liquidity level of $1,700. This minimum target level was determined in conjunction with Air Canada's liquidity risk management strategy and replaces the previous target of maintaining at least 15% of 12 month trailing revenues. At December 31, 2013, unrestricted liquidity was $2,364 comprised of Cash and cash equivalents and Short-term investments of $2,208 and undrawn lines of credit of $156.

A maturity analysis of the Corporation's financial liabilities, other fixed operating commitments and capital commitments is set out in Note 16.

Market Risks

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

Sensitivity Analysis

The following table is a sensitivity analysis for each type of market risk relevant to the significant financial instruments recorded by the Corporation as at December 31, 2013. The sensitivity analysis is based on a reasonably possible movement in the relevant risk factor. These assumptions may not be representative of actual movements in these risks and should not be relied upon. Given potential volatility in the financial and commodity markets, the actual percentage changes may differ significantly from the percentage changes outlined below. Changes in income generally cannot be extrapolated because the relationship of the change in assumption to the change in income may not be linear. Each risk is contemplated independent of other risks. In reality, changes in one factor may result in changes in another, which may magnify or counteract the sensitivities.

The sensitivity analysis related to derivative contracts is based on the estimated fair value change applicable to the derivative as at December 31, 2013 considering a number of variables including the remaining term to maturity and does not consider the fair value change that would be applicable to the derivative assuming the market risk change was applicable to the maturity date of the derivative contract.

	Interest rate risk(1)	Foreign exchange rate risk(2)		Other price risk(3)	
	Income	Income		Income	
	1% increase	5% increase	5% decrease	10% increase	10% decrease
Cash and cash equivalents	$ 7	$ (4)	$ 4	$ –	$ –
Short-term investments	$ 15	$ (29)	$ 29	$ –	$ –
Aircraft related deposits	$ –	$ (3)	$ 3	$ –	$ –
Long-term debt and finance leases	$ (10)	$ 195	$ (195)	$ –	$ –
Fuel derivatives	$ –	$ –	$ –	$ 32	$ (17)
Share forward contracts	–	–	–	6	(6)
Foreign exchange derivatives	$ –	$ (22)	$ 24	$ –	$ –
Interest rate swaps	$ (3)	$ –	$ –	$ –	$ –

(1) Due Due to currently low market rates of interest, a 1% decrease in interest rates was not considered a reasonable scenario within the forecast period, being one year.

(2) Increase (decrease) in foreign exchange relates to a strengthening (weakening) of the Canadian dollar versus the U.S. dollar. The impact on long-term debt and finance leases includes $6 related to the Canadian dollar versus the Japanese yen. The impact of changes in other currencies is not significant to the Corporation's financial instruments.

(3) The sensitivity analysis for fuel derivatives is based upon a 10% increase or decrease in the price of the underlying commodity. The sensitivity analysis for share forward contracts is based upon a 10% increase or decrease in the Air Canada share price.

Covenants in Credit Card Agreements

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

The terms of the Corporation's principal credit card processing agreements for credit card processing services in North America are in effect for another four years each, and the agreements contain triggering events upon which the Corporation is required to provide the credit card processor with cash deposits. The obligation to provide cash deposits and the required amount of deposits are each based upon a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio for the Corporation and the unrestricted cash and short-term investments of the Corporation. In 2013, the Corporation made no cash deposits under these agreements (nil in 2012).

Credit Risk

Credit risk is the risk of loss due to a counterparty's inability to meet its obligations. As at December 31, 2013, the Corporation's credit risk exposure consists mainly of the carrying amounts of Cash and cash equivalents, Short-term investments and Accounts receivable. Cash and cash equivalents and Short-term investments are in place with major financial institutions, the Canadian government, and major corporations. Accounts receivable are generally the result of sales of tickets to individuals, often through the use of major credit cards, through geographically dispersed travel agents, corporate outlets, or other airlines. Credit rating guidelines are used in determining counterparties for fuel hedging. In order to manage its exposure to credit risk and assess credit quality, the Corporation reviews counterparty credit ratings on a regular basis and sets credit limits when deemed necessary.

Fuel Price Risk

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

During 2013:

- The Corporation recorded a loss of $6 in Loss on financial instruments recorded at fair value related to fuel derivatives ($43 loss in 2012).

- The Corporation purchased crude-oil and refined products-based call options and call spreads covering a portion of 2013 and 2014 fuel exposure. The cash premium related to these contracts was $39 ($51 in 2012 for 2012 and 2013 exposures).

- Fuel derivative contracts cash settled with a fair value of $29 in favour of the Corporation ($3 in favour of the Corporation in 2012).

As of December 31, 2013, approximately 20% of the Corporation's anticipated purchases of jet fuel for 2014 are hedged at an average West Texas Intermediate ("WTI") equivalent capped price of US$100 per barrel. The Corporation's contracts to hedge anticipated jet fuel purchases over the 2014 period are comprised of call options with notional volumes of 5,136,000 barrels. The fair value of the fuel derivatives portfolio at December 31, 2013 is $20 in favour of the Corporation ($16 in favour of the Corporation in 2012) and is recorded within Prepaid expenses and other current assets.

Financial Instrument Fair Values in the Consolidated Statement of Financial Position

The carrying amounts reported in the consolidated statement of financial position for short term financial assets and liabilities, which includes Accounts receivable and Accounts payable and accrued liabilities, approximate fair values due to the immediate or short-term maturities of these financial instruments. Cash equivalents and Short-term investments are classified as held for trading and therefore are recorded at fair value.

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

Management estimated the fair value of its long-term debt based on valuation techniques taking into account market rates of interest, the condition of any related collateral, the current conditions in credit markets and the current estimated credit margins applicable to the Corporation based on recent transactions. Based on significant observable inputs (Level 2 in the fair value hierarchy), the estimated fair value of debt approximates its carrying value of $4,333.

Following is a classification of fair value measurements recognized in the consolidated statement of financial position using a fair value hierarchy that reflects the significance of the inputs used in making the measurements.

		Fair value measurements at reporting date using:		
Recurring measurements	**December 31, 2013**	**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**
Financial Assets				
Held-for-trading securities				
Cash equivalents	$ 186	$ –	$ 186	$ –
Short-term investments	1,458	–	1,458	–
Deposits and other assets				
Prepayment option on senior secured notes	2	–	–	2
Derivative instruments				
Fuel derivatives	20	–	20	–
Share forward contracts	56	–	56	–
Foreign exchange derivatives	13	–	13	–
Interest rate swaps	10	–	10	–
Total	**$ 1,745**	**$ –**	**$ 1,743**	**$ 2**

Financial assets held by financial institutions in the form of cash and restricted cash have been excluded from the fair value measurement classification table above as they are not valued using a valuation technique.

The Corporation's policy is to recognize transfers into and transfers out of fair value hierarchy levels as of the date of the event or change in circumstances that caused the transfer. There were no transfers within the fair value hierarchy during 2013.

In measuring the fair value of the prepayment option on the New Senior Notes issued in September 2013, which is categorized as Level 3 in the fair value hierarchy, the Corporation takes into account various factors including the prepayment terms in the notes, market rates of interest, the current conditions in credit markets and the current estimated credit margin applicable to the Corporation.

The change in Level 3 assets in 2013 related to a loss of $15 recorded in Interest expense for the fair value of the prepayment option within the senior secured notes which were extinguished in September 2013, upon refinancing with the issuance of New Senior Notes. The fair value of the prepayment option on the New Senior Notes that were issued is $2. The Corporation's credit margin is considered a Level 3 input and an increase of 1% to the credit margin would result in a decrease of $1 to the prepayment option asset, and a decrease of 1% to the credit margin would result in a $2 increase to the prepayment option asset.

Offsetting of Financial Instruments in the Consolidated Statement of Financial Position

Financial assets and liabilities are offset and the net amount reported in the consolidated statement of financial position where the Corporation has a legally enforceable right to set-off the recognized amounts and there is an intention to settle on a net basis or realize the asset and settle the liability simultaneously. In the normal course of business, the Corporation enters into various master netting arrangements or other similar arrangements that do not meet the criteria for offsetting in the consolidated statement of financial position but still allow for the related amounts to be set off in certain circumstances, such as the termination of the contracts or in the event of bankruptcy or default of either party to the agreement.

Air Canada participates in industry clearing house arrangements whereby certain accounts receivable balances related to passenger, cargo and other billings are settled on a net basis with the counterparty through the clearing house. These billings are mainly the result of interline agreements with other airlines, which are commercial agreements that enable the sale and settlement of travel and related services between the carriers. Billed and work in process interline receivables are presented on a gross basis and amount to $61 as at December 31, 2013. These balances will be settled at a net value at a later date; however such net settlement amount is unknown until the settlement date.

The following table presents the recognized financial instruments that are offset, or subject to enforceable master netting arrangements or other similar arrangements but not offset, as at December 31, 2013 and 2012, and shows in the Net column what the net impact would be on the consolidated statement of financial position if all set-off rights were exercised.

	Amounts offset			Amounts not offset	Net
Financial assets	Gross assets	Gross liabilities offset	Net amounts presented	Financial instruments	
December 31, 2013					
Derivative assets	$ 99	$ –	$ 99	$ –	$ 99
Accounts receivable	96	(48)	48	(36)	12
	$ 195	**$ (48)**	**$ 147**	**$ (36)**	**$ 111**
December 31, 2012					
Derivative assets	$ 39	$ –	$ 39	$ –	$ 39
Accounts receivable	154	(91)	63	(39)	24
	$ 193	**$ (91)**	**$ 102**	**$ (39)**	**$ 63**

	Amounts offset			Amounts not offset	Net
Financial liabilities	Gross liabilities	Gross assets offset	Net amounts presented	Financial instruments	
December 31, 2013					
Accounts payable	$ 118	$ (48)	$ 70	$ (36)	$ 34
December 31, 2012					
Accounts payable	$ 161	$ (91)	$ 70	$ (39)	$ 31

18. CONTINGENCIES, GUARANTEES AND INDEMNITIES

Contingencies and Litigation Provisions

Investigations by Competition Authorities Relating to Cargo

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

In 2010, the European Commissions rendered a decision finding that 12 air cargo carriers (including groups of related carriers) had infringed European Union competition law in the setting of certain cargo charges and rates for various periods between 1999 and 2006. Air Canada was among the carriers subject to the decision and a fine of 21 Euros (approximately C$29) was imposed on Air Canada. Air Canada is appealing this decision and filed an application for appeal before the European General Court. In 2011, Air Canada paid the fine, as required, pending the outcome of its appeal.

As at December 31, 2013, Air Canada has a provision of $27 relating to outstanding claims in this matter, which is recorded in Accounts payable and accrued liabilities. This provision is an estimate based upon the status of investigations and proceedings at this time and Air Canada's assessment as to the potential outcome for certain of them. The provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Air Canada has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings and investigations. As stated above, Air Canada is appealing the decision issued by the European Commission and, if and as appropriate, based on the outcome of any updates regarding this appeal as well as developments regarding proceedings and investigations in other jurisdictions, may adjust the provision in its results for subsequent periods as required.

Mandatory Retirement

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

Other Contingencies

Various other lawsuits and claims, including claims filed by various labour groups of Air Canada are pending by and against the Corporation and provisions have been recorded where appropriate. It is the opinion of management that final determination of these claims will not have a material adverse effect on the financial position or the results of the Corporation.

With respect to 12 aircraft leases, the difference between the reduced rents as a result of the implementation of the Plan of Reorganization, Compromise and Arrangement under the *Companies' Creditors Arrangement Act* ("CCAA") on September 30, 2004 and amounts which would have been due under the original lease contracts will be forgiven at the expiry date of the leases if no material default has occurred by such date. In the event of a material default which does not include any cross defaults to other unrelated agreements (including unrelated agreements with the counterparties to these aircraft leases), this difference plus interest will become due and payable and all future rent will be based on the original contracted rates. Rent expense is being recorded on the renegotiated lease agreements and any additional liability would be recorded only at the time management believes the amount is likely to be incurred.

Refer to Note 10 for a continuity schedule of litigation provisions.

Guarantees

Guarantees in Fuel Facilities Arrangements

The Corporation participates in fuel facility arrangements operated through eight Fuel Facility Corporations, along with other airlines that contract for fuel services at various major airports in Canada. The Fuel Facility Corporations operate on a cost recovery basis. The purpose of the Fuel Facility Corporations is to own and finance the system that distributes the fuel to the contracting airlines, including leasing the land rights under the land leases. The aggregate debt of the eight Fuel Facility Corporations in Canada that have not been consolidated by the Corporation under IFRS 10 Consolidated Financial Statements is approximately $394 as at December 31, 2013 (December 31, 2012 – $390), which is the Corporation's maximum exposure to loss before taking into consideration the value of the assets that secure the obligations and any cost sharing that would occur amongst the other contracting airlines. The Corporation views this loss potential as remote. Each contracting airline participating in a Fuel Facility Corporation shares pro rata, based on system usage, in the guarantee of this debt. The maturities of these debt arrangements vary but generally extend beyond five years.

Indemnification Agreements

In the ordinary course of the Corporation's business, the Corporation enters into a variety of agreements, some of which may provide for indemnifications to counterparties that may require the Corporation to pay for costs and/or losses incurred by such counterparties. The Corporation cannot reasonably estimate the potential amount, if any, it could be required to pay under such indemnifications. Such amount would also depend on the outcome of future events and conditions, which cannot be predicted. While certain agreements specify a maximum potential exposure, certain others do not specify a maximum amount or a limited period. Historically, the Corporation has not made any significant payments under these indemnifications.

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

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

When the Corporation, as a customer, enters into technical service agreements with service providers, primarily service providers who operate an airline as their main business, the Corporation has from time to time agreed to indemnify the service provider against certain liabilities that arise from third party claims, which may relate to services performed by the service provider.

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

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

19. INVESTMENTS IN AVEOS

In 2012, as a result of Aveos Fleet Performance Inc. ("Aveos") ceasing operations and filing for court protection pursuant to the *Companies' Creditors Arrangements Act* ("CCAA"), 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 in Non-operating expense. In addition, Air Canada recorded a liability of $55, which was charged to Discontinued Operations, related to Air Canada's commitment under a separation program. For the twelve months ended December 31, 2013, a cash outflow of $29 was generated in relation to this separation program ($26 in 2012).

A settlement and termination agreement pertaining to operating amounts owing between Air Canada and Aveos, including disputed invoices, was concluded during 2013. This agreement resulted in the set-off, settlement and release of all outstanding invoices between Air Canada and Aveos. Settlement of the Pension and Benefits Agreement was concluded in October 2013 with payment in trust to Aveos, for distribution to identified Aveos eligible recipients. The letter of credit of $20 previously issued in favour of Aveos was returned to Air Canada. Following this, obligations under the other post-retirement and post-employment benefit plans pertaining to transferred unionized Aveos employees are no longer included in the Corporation's consolidated financial statements as at December 31, 2013. In 2012, OSFI ordered the termination of Aveos' defined benefit pension plan and, as a result, the assets and liabilities accruing prior to July 14, 2011 in respect of transferred Aveos employees could not be transferred to Aveos' plans and remain under Air Canada's pension plans.

20. GEOGRAPHIC INFORMATION

A reconciliation of the total amounts reported by geographic region for Passenger revenues and Cargo revenues on the Consolidated Statement of Operations is as follows:

Passenger Revenues	2013	2012
Canada	$ 4,237	$ 4,178
US Transborder	2,176	2,130
Atlantic	2,263	2,114
Pacific	1,618	1,568
Other	727	747
	$ 11,021	**$ 10,737**

Cargo Revenues	2013	2012
Canada	$ 63	$ 68
US Transborder	18	17
Atlantic	171	177
Pacific	185	184
Other	37	42
	$ 474	**$ 488**

Passenger and cargo revenues are based on the actual flown revenue for flights with an origin and destination in a specific country or region. Atlantic refers to flights that cross the Atlantic Ocean with origins and destinations principally in Europe. Pacific refers to flights that cross the Pacific Ocean with origins and destinations principally in Asia and Australia. Other passenger and cargo revenues refer to flights with origins and destinations principally in South America and the Caribbean.

Other operating revenues are principally derived from customers located in Canada and consist primarily of revenues from the sale of the ground portion of vacation packages, ground handling services, and other airline-related services, as well as revenues related to the lease or sublease of aircraft to third parties.

21. CAPITAL DISCLOSURES

The Corporation views capital as the sum of Long-term debt and finance leases, capitalized operating leases, Non-controlling interests, and the market value of the Corporation's outstanding shares ("market capitalization"). The Corporation includes capitalized operating leases, which is a measure commonly used in the industry ascribing a value to obligations under operating leases. The value is based on annualized aircraft rent expense multiplied by 7.0, which is a factor commonly used in the airline industry. The measure used may not necessarily reflect the fair value or net present value related to the future minimum lease payments as the measure is not based on the remaining contractual payments and the factor may not recognize discount rates implicit in the actual leases or current rates for similar obligations with similar terms and risks. Market capitalization is based on the closing price of Air Canada's shares multiplied by the number of outstanding shares. This definition of capital is used by management and may not be comparable to measures presented by other public companies.

The Corporation also monitors its adjusted net debt. Adjusted net debt is calculated as the sum of Long-term debt and finance lease obligations and capitalized operating leases less Cash and cash equivalents and Short-term investments.

The Corporation's main objectives when managing capital are:

- To structure repayment obligations in line with the expected life of the Corporation's principal revenue generating assets;
- To ensure the Corporation has access to capital to fund contractual obligations as they become due and to ensure adequate cash levels to withstand deteriorating economic conditions;
- To maintain an appropriate balance between debt supplied capital versus investor supplied capital; and
- To monitor the Corporation's credit ratings to facilitate access to capital markets at competitive interest rates.

In order to maintain or adjust the capital structure, the Corporation may adjust the type of capital utilized, including purchase versus lease decisions, defer or cancel aircraft expenditures by not exercising available options or selling current aircraft options, issuing debt or equity securities, and repurchasing outstanding shares, all subject to market conditions and the terms of the underlying agreements or other legal restrictions.

The total capital and adjusted net debt as at December 31 is calculated as follows:

	2013	2012
Long-term debt and finance leases	$ 3,959	$ 3,259
Current portion of long-term debt and finance leases	374	499
	4,333	3,758
Capitalized operating leases	2,226	2,352
Adjusted debt	6,559	6,110
Non-controlling interests	63	59
Market capitalization	2,108	480
Total Capital	**$ 8,730**	**$ 6,649**
Adjusted debt	$ 6,559	$ 6,110
Less Cash and cash equivalents and Short-term investments	(2,208)	(1,973)
Adjusted net debt	**$ 4,351**	**$ 4,137**

Total capital has increased by $2,081, which reflects an increase in market capitalization due to a higher Air Canada share price.

22. RELATED PARTY TRANSACTIONS

Compensation of Key Management

Compensation of key management is reported on the accrual basis of accounting consistent with the amounts recognized on the consolidated statement of operations. Key management includes Air Canada's Board of Directors, President and Chief Executive Officer, Executive Vice-President and Chief Operating Officer, Executive Vice-President and Chief Financial Officer, and Executive Vice-President and Chief Commercial Officer. Compensation awarded to key management is summarized as follows:

	2013	2012
Salaries and other benefits	$ 8	$ 8
Post-employment benefits	1	2
Other long-term benefits	-	-
Share-based compensation	7	4
	$ 16	$ 14

OFFICERS

David I. Richardson	Chairman of the Board
Calin Rovinescu	President and Chief Executive Officer
Klaus Goersch	Executive Vice President and Chief Operating Officer
Michael Rousseau	Executive Vice President and Chief Financial Officer
Benjamin M. Smith	Executive Vice President and Chief Commercial Officer
Lise Fournel	Senior Vice President and Chief Information Officer
Kevin C. Howlett	Senior Vice President, Regional Markets
David J. Shapiro	Senior Vice President and Chief Legal Officer
Alan D. Butterfield	Vice President, Air Canada Maintenance and Engineering
Nick Careen	Vice President, Airports, Call Centres and Customer Relations
Yves Dufresne	Vice President, Alliances and Regulatory Affairs
Marcel Forget	Vice President, Network Planning
Michael Friisdahl	President and Chief Executive Officer, Leisure Group
Zeina Gedeon	Vice President, Sales Canada and Product Distribution
Lucie Guillemette	Vice President, Revenue Management and International Sales
Carolyn M. Hadrovic	Corporate Secretary
Chris Isford	Vice President and Controller
Amos Kazzaz	Vice President, Financial Planning and Analysis
Craig Landry	Vice President, Marketing
Priscille LeBlanc	Vice President, Corporate Communications
Arielle Meloul-Wechsler	Vice President, Human Resources
Scott Morey	Vice President, Labour Relations
Jim Tabor	Vice President, System Operations Control
Lise-Marie Turpin	Vice President, Cargo
Derek Vanstone	Vice President, Corporate Strategy, Industry and Government Affairs

DIRECTORS

David I. Richardson	Corporate Director and Chairman of the Board, Air Canada, Grafton, Ontario
Thomas Birks	President, Birinco Inc., Montreal, Quebec
Christie J.B. Clark	Corporate Director, Toronto, Ontario
Michael M. Green	Chief Executive Officer and Managing Director, Tenex Capital Management, Radnor, Pennsylvania
Jean Marc Huot	Partner, Stikeman Elliott LLP, Montreal, Quebec
Joseph B. Leonard	Corporate Director, Minneapolis, Minnesota
Roy J. Romanow	Senior Fellow, Public Policy, University of Saskatchewan, Saskatoon, Saskatchewan
Calin Rovinescu	President and Chief Executive Officer, Air Canada, Montreal, Quebec
Vagn Sørensen	Corporate Director, London, United Kingdom
Annette Verschuren	Chair and Chief Executive Officer, NRstor Inc., Toronto, Ontario

Investor and Shareholder Information

Price Range and Trading Volume of Air Canada Variable Voting Shares (AC.A)

2013	High	Low	Volume Traded
1st Quarter	$ 3.16	$ 1.70	3,761,970
2nd Quarter	$ 3.39	$ 1.96	5,494,997
3rd Quarter	$ 3.73	$ 2.08	7,523,963
4th Quarter	$ 8.00	$ 3.43	13,472,545
			30,253,475

Price Range and Trading Volume of Air Canada Voting Shares (AC.B)

2013	High	Low	Volume Traded
1st Quarter	$ 3.13	$ 1.75	82,141,435
2nd Quarter	$ 3.40	$ 1.96	157,040,018
3rd Quarter	$ 3.72	$ 2.07	130,185,811
4th Quarter	$ 8.00	$ 3.45	210,816,041
			580,183,305

Restrictions on Voting Securities

Currently, the *Air Canada Public Participation Act* (ACPPA) limits ownership of Air Canada's voting interests by non-residents of Canada to a maximum of 25%. The *Canada Transportation Act* (CTA) also requires that Canadians own and control at least 75% of the voting interests of licensed Canadian carriers. Accordingly, Air Canada's articles contain restrictions to ensure that it remains "Canadian" as defined under the CTA. The restrictions provide that non-Canadians can only hold variable voting shares of Air Canada, that such variable voting shares will not carry more than 25% (or any higher percentage that the Governor in Council may by regulation specify) of the aggregate votes attached to all issued and outstanding voting shares and that the total number of votes cast by the holders of such variable voting shares at any meeting of shareholders will not exceed 25% (or any such higher percentage) of the votes that may be cast at such meeting.

The Government of Canada's Bill C-10, the *Budget Implementation Act 2009*, contains provisions whereby the restrictions on voting securities in the ACPPA would be repealed and the CTA would be amended to provide the Governor in Council with flexibility to increase the foreign ownership limit from the existing 25% level to a maximum of 49%. These provisions will come into force on a date to be fixed by order of the Governor in Council made on the recommendation of the Minister of Finance, in the case of the ACPPA, and on the recommendation of the Minister of Transport, in the case of the CTA.

For Further Information

Shareholder Relations
Telephone: 514-422-6644
Facsimile: 514-422-0296
shareholders.actionnaires@aircanada.ca

Investor Relations
Telephone: 514-422-7849
Facsimile: 514-422-7877
investors.investisseurs@aircanada.ca

Head Office
Air Canada Centre
7373 Côte-Vertu Boulevard West
Saint-Laurent, Quebec H4S 1Z3

Internet
aircanada.com

Air Canada complies with the rules adopted by the Toronto Stock Exchange.

Transfer Agent and Registrar
CST Trust Company
Telephone: 1-800-387-0825

Duplicate Communication
Shareholders receiving more than one copy are requested to call 1-800-387-0825 or write to the Transfer Agent and Registrar at the following address:
2001 University Street, Suite 1600,
Montreal, Quebec H3A 2A6

Inquiries may also be submitted by email to inquiries@canstockta.com

Ce rapport annuel est publié dans les deux langues officielles du Canada. Pour en recevoir un exemplaire en français, veuillez communiquer avec les Relations avec les actionnaires.

Designed and produced in-house by the Air Canada Multimedia Centre
Printing: RR Donnelley

ENGLISH OR FRENCH, IT'S THE CLIENT'S CHOICE

Official Languages at Air Canada

For Air Canada, offering service in the language chosen by its customers is essential. Verbal exchanges with clients, public-address announcements at the airport and on board as well as briefing of passengers with special needs all constitute the very heart of customer service and call upon our employees linguistic skills at all times. Our consideration to bilingualism not only makes good sense customer-wise, but also supports our legal obligations to serve the public in the two official languages of Canada.

Air Canada puts great efforts to better serve clients in the language of their choice. It is through reach-out activities with the minority language communities as well as ongoing employee awareness and training that we can face the daily challenges, whether it is the growing difficulty to recruit bilingual candidates outside the province of Quebec and the national capital region, or for our employees to maintain their language skills with very little opportunities to practice the acquired language in some regions of the country.

Corporate Profile

Air Canada is Canada's largest airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market and in the international market to and from Canada. In 2013, Air Canada, together with its Air Canada Express regional partners operated on average 1,498 daily scheduled flights to 181 direct destinations on five continents, comprised of 60 Canadian cities, 54 destinations in the United States and a total of 67 cities in Europe, the Middle East, Asia, Australia, the Caribbean, Mexico and South America. In 2013, Air Canada carried 35.8 million passengers.

Air Canada is a founding member of the Star Alliance® network. Through Star Alliance® network's 28 member airlines, Air Canada offers customers access to approximately 1,328 destinations in 195 countries, as well as reciprocal participation in frequent flyer programs and use of over 1,000 airport lounges worldwide for eligible members.

Air Canada is the only international network carrier in North America to receive a Four-Star ranking according to independent U.K. research firm Skytrax that ranked Air Canada in a worldwide survey of more than 18 million airline passengers as Best Airline in North America in 2013 for the fourth consecutive year.

For more information, visit aircanada.com, follow @AirCanada on Twitter and join Air Canada on Facebook.

AIR CANADA