AIR CANADA

2016

MANAGEMENT DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

February 17, 2017

A STAR ALLIANCE MEMBER

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1. HIGHLIGHTS

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

(Canadian dollars in millions, except where indicated)	Fourth Quarter			Full Year		
	2016	2015	$ Change	2016	2015	$ Change
Financial Performance Metrics						
Operating revenues	3,425	3,182	243	14,677	13,868	809
Operating income	18	158	(140)	1,345	1,496	(151)
Non-operating expense	(196)	(274)	78	(468)	(1,188)	720
Net income (loss)	(179)	(116)	(63)	876	308	568
Adjusted net income (1)	38	116	(78)	1,147	1,222	(75)
Operating margin %	0.5%	5.0%	(4.5 pp)	9.2%	10.8%	(1.6 pp)
EBITDAR (excluding special items) (1)	455	456	(1)	2,768	2,542	226
EBITDAR margin (excluding special items) % (1)	13.3%	14.3%	(1.0 pp)	18.9%	18.3%	0.6 pp
Unrestricted liquidity (2)	3,388	2,968	420	3,388	2,968	420
Net cash flows from operating activities	351	251	100	2,421	2,025	396
Free cash flow (1)	121	(363)	484	(149)	210	(359)
Adjusted net debt (1)	7,090	6,291	799	7,090	6,291	799
Return on invested capital ("ROIC") % (1)	14.7%	18.3%	(3.6 pp)	14.7%	18.3%	(3.6 pp)
Leverage ratio (1)	2.6	2.5	0.1	2.6	2.5	0.1
Diluted earnings per share	$ (0.66)	$ (0.41)	$ (0.25)	$ 3.10	$ 1.03	$ 2.07
Adjusted earnings per share – diluted (1)	$ 0.14	$ 0.40	$ (0.26)	$ 4.06	$ 4.18	$ (0.12)
Operating Statistics (3)			**% Change**			**% Change**
Revenue passenger miles ("RPM") (millions)	17,643	15,301	15.3	76,481	67,545	13.2
Available seat miles ("ASM") (millions)	22,091	18,869	17.1	92,726	80,871	14.7
Passenger load factor %	79.9%	81.1%	(1.2 pp)	82.5%	83.5%	(1.0 pp)
Passenger revenue per RPM ("Yield") (cents)	16.9	18.2	(7.2)	16.8	18.0	(6.6)
Passenger revenue per ASM ("PRASM") (cents)	13.5	14.7	(8.6)	13.9	15.1	(7.7)
Operating revenue per ASM (cents)	15.5	16.9	(8.1)	15.8	17.1	(7.7)
Operating expense per ASM ("CASM") (cents)	15.4	16.0	(3.8)	14.4	15.3	(6.0)
Adjusted CASM (cents) (1)	11.4	12.2	(6.1)	10.9	11.3	(2.9)
Average number of full-time equivalent ("FTE") employees (thousands) (4)	26.2	25.1	4.4	26.1	24.9	4.9
Aircraft in operating fleet at period-end	381	370	3.0	381	370	3.0
Average fleet utilization (hours per day)	9.5	9.4	1.4	10.2	10.0	1.6
Seats dispatched (thousands)	13,873	12,623	9.9	57,135	52,359	9.1
Aircraft frequencies (thousands)	137	136	0.3	566	567	(0.3)
Average stage length (miles) (5)	1,592	1,495	6.5	1,623	1,545	5.1
Fuel cost per litre (cents)	59.4	58.6	1.4	53.9	63.0	(14.5)
Fuel litres (millions)	1,160	1,035	12.1	4,837	4,478	8.0
Revenue passengers carried (thousands) (6)	10,719	9,686	10.7	44,849	41,126	9.1

(1) Adjusted net income, EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent), EBITDAR margin, leverage ratio, free cash flow, ROIC and adjusted CASM are each non-GAAP financial measures and adjusted net debt is an additional GAAP measure. Refer to sections 9 and 19 of this MD&A for descriptions of Air Canada's non-GAAP financial measures and additional GAAP measures. As referenced in the table above, special items are excluded from all of Air Canada's reported EBITDAR calculations. Refer to sections 6 and 7 of this MD&A for information on the special items.

(2) 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, 2016 unrestricted liquidity was comprised of cash and short-term investments of $2,979 million and undrawn lines of credit of $409 million. At December 31, 2015, unrestricted liquidity was comprised of cash and short-term investments of $2,672 million and undrawn lines of credit of $296 million.

(3) Except for the reference to average number of FTE employees, operating statistics in this table include third party carriers (such as Jazz Aviation LP ("Jazz"), Sky Regional Airlines Inc. ("Sky Regional"), Air Georgian Limited ("Air Georgian") and Exploits Valley Air Services Ltd. ("EVAS")) operating under capacity purchase agreements with Air Canada.

(4) Reflects FTE employees at Air Canada. Excludes FTE employees at third party carriers (such as Jazz, Sky Regional, Air Georgian and EVAS) operating under capacity purchase agreements with Air Canada.

(5) Average stage length is calculated by dividing the total number of available seat miles by the total number of seats dispatched.

(6) Revenue passengers are counted on a flight number basis (rather than by journey/itinerary or by leg) which is consistent with the IATA definition of revenue passengers carried.

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, doing business as Air Canada Vacations® ("Air Canada Vacations") and Air Canada Rouge LP, doing business under the brand name Air Canada Rouge® ("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 full year of 2016. This MD&A should be read in conjunction with Air Canada's audited consolidated financial statements and notes for 2016. Except as otherwise noted, 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 as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 20 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of February 16, 2017. Certain comparative figures have been reclassified to conform to the financial statement presentation adopted for 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 17 "Risk Factors" of this MD&A. Air Canada issued a news release dated February 17, 2017 reporting on its results for the fourth quarter and the full year 2016. 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, our ability to successfully achieve or sustain positive net profitability or to realize our initiatives and objectives, currency exchange, industry, market, credit, economic and geopolitical conditions, energy prices, competition, our ability to successfully implement appropriate strategic initiatives or reduce operating costs, our dependence on technology, cybersecurity risks, our ability to pay our indebtedness and secure financing, war, terrorist acts, epidemic diseases, our dependence on key suppliers including regional carriers and Aeroplan, casualty losses, employee and labour relations and costs, our ability to preserve and grow our brand, pension issues, environmental factors (including weather systems and other natural phenomena and factors arising from man-made sources), limitations due to restrictive covenants, insurance issues and costs, our dependence on the Star Alliance, interruptions of service, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties and our ability to attract and retain required personnel, as well as the factors identified throughout this MD&A and, in particular, those identified in section 17 "Risk Factors" of this MD&A. The forward-looking statements contained in this MD&A represent Air

Canada's expectations as of February 16, 2017 (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 relatively modest Canadian GDP growth for 2017 and 2018. Air Canada also assumes a continuing relationship between the price of jet fuel and the value of the Canadian dollar whereby increases and decreases in the cost of fuel continue to be respectively associated, to some degree, with increases and decreases in the value of the Canadian dollar. Air Canada also expects that the Canadian dollar will trade, on average, at C$1.32 per U.S. dollar in the first quarter of 2017 and C$1.31 per U.S. dollar for the full year 2017 and that the price of jet fuel (taking the impact of fuel hedging into account) will average 65 CAD cents per litre in the first quarter of 2017 and 66 CAD cents per litre for the full year 2017.

INTELLECTUAL PROPERTY

Air Canada owns or has rights to trademarks, service marks or trade names used in connection with the operation of its business. In addition, Air Canada's names, logos and website names and addresses are owned or licensed by Air Canada. Air Canada also owns or has the rights to copyrights that also protect the content of its products and/or services. Solely for convenience, the trademarks, service marks, trade names and copyrights referred to in this MD&A may be listed without the ©, ® and ™ symbols, but Air Canada reserves all rights to assert, to the fullest extent under applicable law, its rights or the rights of the applicable licensors to these trademarks, service marks, trade names and copyrights.

This MD&A may include trademarks, service marks or trade names of other parties. Air Canada's use or display of other parties' trademarks, service marks, trade names or products is not intended to, and does not imply a relationship with, or endorsement or sponsorship of Air Canada by, the trademark, service mark or trade name owners or licensees.

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 2016, Air Canada, together with Jazz Aviation LP ("Jazz") and other regional airlines operating flights on behalf of Air Canada under capacity purchase agreements, operated, on average, 1,570 daily scheduled flights to 206 direct destinations on six continents, comprised of 64 Canadian cities, 55 destinations in the United States and a total of 87 cities in Europe, Africa, the Middle East, Asia, Australia, the Caribbean, Mexico and South America. In 2016, Air Canada carried approximately 44.8 million passengers, an increase of 9.1% from 2015.

At December 31, 2016, Air Canada mainline operated a fleet of 168 aircraft, comprised of 75 Airbus narrow-body aircraft, 68 Boeing and Airbus wide-body aircraft and 25 Embraer 190 regional jets, while Air Canada Rouge operated a fleet of 45 aircraft, comprised of 20 Airbus A319 aircraft, five Airbus A321 aircraft and 20 Boeing 767-300 aircraft, for a total fleet of 213 aircraft.

The ongoing renewal and expansion of Air Canada's wide-body fleet remains a key element of its strategy to profitably develop its international network and to become a global champion. In 2016, Air Canada took delivery of nine Boeing 787 aircraft and, since December 31, 2016, Air Canada took delivery of three Boeing 787s (for a total of 24 deliveries out of 37 Boeing 787 aircraft on order). These aircraft, with their lower operating costs, mid-size capacity and longer range, are driving new opportunities for profitable growth at Air Canada and allow the airline to more efficiently operate routes previously operated with Boeing 767 aircraft and to serve new international destinations. Air Canada also has a firm order for 61 Boeing 737 MAX aircraft to replace the existing mainline fleet of Airbus narrow-body aircraft. Deliveries of Boeing 737 MAX aircraft are scheduled to begin in late 2017 with two aircraft, with the remaining firm order deliveries scheduled from 2018 to 2021. Furthermore, Air Canada has a firm order for 45 Bombardier C-Series CS300 aircraft. The first 25 aircraft on delivery are expected to replace Air Canada's existing mainline fleet of Embraer E190 aircraft, with the incremental aircraft supporting Air Canada's hub and network growth. Deliveries are scheduled to begin in late 2019 and extend to 2022.

The Air Canada Leisure Group, created in 2012, to improve profitability and competitiveness in leisure markets, represents a coordinated strategy which leverages the strengths of Air Canada, Air Canada Rouge, the airline's lower-cost leisure airline, and Air Canada Vacations. Through Air Canada Rouge, Air Canada is pursuing opportunities in new international leisure markets made viable by Air Canada Rouge's more competitive cost structure. Air Canada Vacations is a leading Canadian tour operator, developing, marketing and distributing vacation travel packages, operating in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, Central and South America, South Pacific, Australia and Asia) and also offering cruise packages in North America, Europe and the Caribbean.

Air Canada enhances its domestic and transborder network through capacity purchase agreements ("CPAs") with regional airlines, namely Jazz, Sky Regional Airlines Inc. ("Sky Regional"), Air Georgian Limited ("Air Georgian" and Exploits Valley Services Limited ("EVAS"), each of which operates flights on behalf of Air Canada. These carriers form an integral part of the airline's international network strategy, providing valuable traffic feed to Air Canada and Air Canada Rouge routes. At December 31, 2016, the Air Canada Express fleet was comprised of 43 Bombardier regional jets, 89 Bombardier Dash-8 turboprop aircraft and 20 Embraer 175 aircraft for a total of 152 aircraft. Air Georgian and EVAS also operate a total of 16 18-passenger Beech 1900 aircraft on behalf of Air Canada.

Air Canada is a founding member of the Star Alliance® network. Through the 28-member airline network, Air Canada offers its customers access to approximately 1,300 destinations in 190 countries, as well as reciprocal participation in frequent flyer programs and the use of airport lounges and other common airport facilities.

Air Canada is able to build customer loyalty through Air Canada Altitude®, its frequent flyer program and through the Aeroplan® loyalty program operated by Aimia Canada Inc. (formerly Aeroplan Canada Inc. and referred to as "Aeroplan" in this MD&A). Air Canada Altitude® recognizes and rewards Aeroplan® members with a range of premium travel privileges and benefits corresponding to their travel activity, such as priority check-in, complimentary checked baggage and upgrades to Business Class, as well as opportunities to earn Aeroplan® Miles on Air Canada flights and those of its other 27 Star Alliance® member airlines. Aeroplan is also Air Canada's single largest customer, purchasing Air Canada seats to be provided to Aeroplan® members who choose to redeem their Aeroplan® Miles for travel on Air Canada. Aeroplan® members also have opportunities to redeem their Aeroplan® Miles for travel with Star Alliance® member airlines.

Air Canada generates revenue from its cargo division, operating as Air Canada Cargo, Canada's largest provider of air cargo services as measured by cargo capacity. 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 cargo services are provided across the Air Canada network.

4. STRATEGY

Air Canada's principal objective is to be among the best global airlines, to continually improve customer experience and employee engagement, and to create value for its shareholders. Air Canada is pursuing its principal goal of becoming a global champion through its focus on four core strategies:

- Identifying and implementing cost reduction and revenue generating initiatives;
- Pursuing profitable international growth opportunities and leveraging competitive attributes to appropriately enhance margins, in large part by increasing connecting traffic through existing and new international gateways and expanding and competing effectively in the leisure market to and from Canada;
- Engaging customers by continually enhancing their travel experience and providing a consistently high level of customer service, with additional emphasis on premium and business passengers and products; and
- Fostering positive culture change through employee engagement programs. This includes meaningful investments in training and other tools that support delivering exceptional customer experiences and that also promote improved collaboration and an appreciation of how the airline and its talented employees can better work together in a supportive and enriching environment.

Revenue Enhancement and Cost Transformation

Margin improvement through the implementation of sustainable cost transformation and profitable revenue-generating initiatives remains a key priority at Air Canada. Air Canada continues to seek and implement measures to meaningfully reduce unit costs and enhance margins, including through fleet modernization and greater fleet productivity. Additionally, Air Canada seeks to improve its ability to generate incremental passenger and ancillary revenue.

Key achievements in 2016

- Recorded an EBITDAR margin of 18.9%, an increase of 0.6 percentage points when compared to 2015 and better than the 2016 EBITDAR margin of 15 to 18% forecast in Air Canada's news release dated November 7, 2016. Air Canada's better than projected 2016 EBITDAR margin performance was primarily driven by a December 2016 revenue environment that was more robust than anticipated.
- Reduced CASM by 6.0% from 2015. Adjusted CASM decreased 2.9% from 2015. Had the Canadian-U.S. dollar exchange rate remained at 2015 levels, adjusted CASM would have decreased 3.8% when compared to 2015.
- Continued to successfully expand Air Canada Rouge, the airline's leisure carrier, which has significantly lower operating costs. The Air Canada Rouge fleet is estimated to generate 25% lower CASM when compared to the same aircraft in the mainline fleet.
- Introduced an additional nine Boeing 787 aircraft into the mainline fleet, allowing the airline to more efficiently operate routes previously operated with Boeing 767 aircraft and to serve new international destinations.
- Introduced two higher-density Boeing 777 aircraft into the mainline fleet, deployed on select markets where there is a higher demand for economy travel.
- Converted 12 Boeing 777-300ER and six Boeing 777-200LR aircraft into a more cost effective and competitive configuration, adding a premium economy cabin and refurbishing the international business class cabin to the new Boeing 787 state-of-the-art standard.

- Concluded a purchase agreement with Bombardier Inc. ("Bombardier") which includes a firm order for 45 Bombardier C-Series CS300 aircraft and options for an additional 30 Bombardier C-Series CS300 aircraft. Air Canada estimates that the projected fuel burn and maintenance cost savings (on a per seat basis) of greater than 15% will reduce CASM by approximately 10% compared to the aircraft that will be replaced.

- Completed a private offering of senior secured notes and a new credit facility in connection with a C$1.25 billion refinancing transaction resulting in an improved balance sheet, a reduction in Air Canada weighted average cost of debt, an extension of its senior secured debt maturity, annualized interest expense savings, the release of collateral and generally increasing Air Canada's ability and flexibility to execute on strategic initiatives.

Ongoing Initiatives

Air Canada is taking tangible steps to pursue its strategy for sustained value creation and profitability through the execution of new and ongoing strategic initiatives. These include:

Air Canada Rouge

The strategic expansion of Air Canada Rouge in conjunction with Air Canada's mainline fleet growth continues. Since its first flight in July 2013, the leisure carrier has been deployed to a growing number of Caribbean destinations and select leisure destinations in the United States and in Canada, as well as in international leisure markets where demand is highly-elastic and responds positively to lower-priced, non-stop capacity. Air Canada Rouge offers competitive fares while leveraging such strengths of Air Canada as its brand, extensive network with enhanced connection options, operational expertise and leading loyalty programs. Air Canada Rouge may operate up to 50 aircraft (comprised of 25 narrow-body aircraft and 25 Boeing 767 aircraft). At December 31, 2016, Air Canada Rouge operated 45 aircraft and expects to have a total of 50 aircraft in its fleet by summer of 2018.

Air Canada Rouge operates with a long-term cost structure consistent with that of its leisure market competitors, effectively lowering CASM on leisure routes through increased seat density, lower wage rates, more efficient work standards, and reduced overhead costs. This is providing new opportunities for profitable growth in international leisure markets.

Fleet Improvement Initiatives

Continued Introduction of Fuel-Efficient Boeing 787 Aircraft

As of the date of this MD&A, Air Canada has taken delivery of 24 Boeing 787 Dreamliners (from its firm order for 37 Boeing 787 Dreamliners, comprised of eight Boeing 787-8 and 29 Boeing 787-9 aircraft). Air Canada plans to take delivery of the remaining 13 Boeing 787-9 aircraft on firm order by the end of 2019.

Reconfiguration of Airbus A330-300 Aircraft

Following the conversion, in 2016, of 12 Boeing 777-300ER and six Boeing 777-200LR aircraft into a more cost effective and competitive configuration, Air Canada began reconfiguring its fleet of eight Airbus A330-300 aircraft to allow the airline to compete more effectively and to offer customers the option of its new Premium Economy cabin. Conversion of the Airbus A330 aircraft started in the fourth quarter of 2016 and is expected to be completed during the first quarter of 2017.

Narrow-body Fleet Renewal Program

In 2014, Air Canada entered into agreements with The Boeing Company ("Boeing") for the acquisition of up to 109 Boeing 737 MAX narrow-body aircraft (61 firm orders, 18 purchase options and certain rights to purchase up to an additional 30 aircraft) to replace the existing mainline fleet of Airbus narrow-body aircraft. Deliveries are scheduled to begin in late 2017 with two aircraft, with the remaining firm aircraft deliveries scheduled from 2018 to 2021. Air Canada estimates that the projected fuel burn and maintenance cost savings on a per seat basis of greater than 20% will generate a CASM reduction of approximately 10% as compared to the airline's existing narrow-body fleet.

In June 2016, Air Canada and Bombardier finalized a purchase agreement for the acquisition of up to 75 Bombardier C-Series CS300 aircraft (45 firm orders plus options to purchase up to an additional 30 aircraft). Deliveries are scheduled to begin in late 2019 and extend to 2022. The first 25 aircraft on delivery are expected to replace Air Canada's existing mainline fleet of Embraer E190 aircraft, with the incremental aircraft supporting Air Canada's hub and network growth. The entry of the C-Series into Air Canada's fleet is expected to yield significant cost savings.

Revenue Optimization and Cost Reduction Initiatives

Air Canada is committed to fostering a culture of continuous cost transformation and revenue improvement across the organization. To this end, Air Canada continually drives initiatives through productivity enhancements, process reforms and other measures. Initiatives may entail revising business and operational processes, including supply chain and maintenance operations, improving employee productivity and asset utilization, and promoting workplace policies to add revenue and reduce costs. In 2017, Air Canada aims to increase its ancillary revenue per passenger through branded fares, and other "à la carte" services, such as those related to baggage, ticket changes, seat selection, preferred seating and upgrades. Air Canada is also generating revenues from its onboard offerings, including food, beverage, duty-free shopping and onboard Wi-Fi. To better monetize its ancillary offerings and increase related revenues, Air Canada is further developing its merchandising capabilities to customize, differentiate and combine its product offerings. In addition, Air Canada will also continue to undertake sales and distribution initiatives in an effort to increase revenues and reduce overall costs of sales.

International Growth

Air Canada remains focused on identifying new international growth opportunities to generate increased profit and diversify its network which also lowers its risk profile. Part of this strategy focuses on the development of additional synergies offered by alliances with foreign carriers. Consistent with 2016, in 2017, more than 90% of the airline's planned capacity growth is in international markets. International growth is being pursued on a lower-cost basis, primarily through the introduction of new Boeing 787 aircraft, increased seating on Boeing 777 and Airbus A330 aircraft, and by an increase in flights operated by Air Canada Rouge.

Key developments in 2016

- Introduced non-stop Air Canada service from Vancouver to Brisbane and Delhi, from Toronto to Seoul and from Montreal to Lyon.
- Introduced non-stop seasonal Air Canada Rouge service from Montreal to Casablanca, from Toronto to Glasgow, Gatwick, Budapest, Prague and Warsaw and from Vancouver to Dublin.
- Launched 12 transborder routes to the U.S., including Toronto-Washington-Dulles; Toronto-Jacksonville, Florida, Toronto-Portland, Oregon; Toronto-Salt Lake City; Toronto-Palm Springs; Vancouver-San Jose, Vancouver-San Diego; Vancouver–Chicago; Montreal-Philadelphia; Montreal-Denver; Montreal-Houston; and Calgary-San Francisco. In addition to solidifying Air Canada's position in the Canada-U.S. transborder market, these new routes serve to channel traffic to and from Air Canada's domestic and international networks through its major airport hubs.
- Introduced new codeshare agreements with EVA Air in support of its Narita and Incheon services and with Avianca Brasil in support of its Sao Paolo services. Air Canada also reinstated its codeshare relationship with Thai Airways.
- Increased meaningfully sixth freedom traffic (international-to-international, including U.S.) connecting at Air Canada's major Canadian hubs when compared to 2015.

In 2017, Air Canada plans to launch additional international services, including:

- Non-stop year-round Air Canada service from Toronto to Mumbai and from Vancouver to Taipei;

- Non-stop seasonal Air Canada Rouge service from Montreal to Algiers and Marseille; Vancouver to Nagoya; and Toronto to Berlin;

- Non-stop daily year-round Air Canada service from Montreal to Shanghai further deepening the airline's strong ties with China; and

- Non-stop seasonal Air Canada service from Montreal to Tel Aviv.

In addition, Air Canada plans to convert its Air Canada Rouge service from Montreal to Casablanca from a seasonal service to a year-round service. The airline also plans to launch six new non-stop U.S. services beginning in May 2017. Three of the routes, Toronto to San Antonio, Memphis and Savannah, bring new destinations into the airline's U.S. network while the addition of Montreal to Dallas-Fort Worth, Vancouver to Denver and the conversion of the Vancouver-Phoenix route to year-round operation will deepen Air Canada's transborder schedule.

Air Canada possesses tools, processes and other competitive attributes to profitably pursue international route opportunities. It has the ability to appreciably increase international-to-international traffic through its strategic international gateways in Toronto, Vancouver, Montreal and Calgary, and is broadening its network appeal through its membership in Star Alliance®, its trans-Atlantic revenue-sharing joint venture with United Airlines and Deutsche Lufthansa AG, referred to as A++, and through numerous codeshare and interline agreements. Furthermore, Air Canada has access to Canada's wide portfolio of international route rights, and Canada's multi-ethnic demographic profile provides the airline with further opportunities to profitably capture demand for international travel. These attributes combined with Air Canada's powerful brand franchise and industry-leading products and services, allow it to leverage its network and benefit from the higher margins generally available in international markets.

In 2017, Air Canada plans to selectively and profitably expand its international services by leveraging its new aircraft and improved cost structure, and by exploiting the following competitive attributes:

- A widely-recognized brand and a strong position in the market for trans-Atlantic and trans-Pacific travel to-and-from Canada and to-and-from North and South America via Canada.

- An extensive and expanding global network, enhanced by the airline's membership in Star Alliance, numerous codeshare agreements and participation in the A++ joint venture.

- A flexible fleet mix, including aircraft leases with staggered expiry dates over the next several years and aircraft that are owned and unencumbered which can be temporarily or permanently removed from the fleet, which enables the airline to redeploy or otherwise manage capacity to match changes in demand.

- Air Canada Altitude®, Air Canada's loyalty program, which recognizes 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 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) with excellent in-transit facilities, accentuating the advantages of flying Air Canada through an improved travel experience for customers travelling to or from the U.S. from or to Asia and Europe.

- Favourable slot times at busy airports, including Beijing, Shanghai, Hong Kong, Tokyo-Narita, Tokyo-Haneda, Paris-Charles de Gaulle, Frankfurt, London-Heathrow, New York-LaGuardia, and Washington-Ronald Reagan National Airport.

The airline believes that it has the potential to continue to grow sixth freedom traffic over the coming years, particularly from the U.S., with its award-winning products and services, geographically well-positioned Canadian hubs, extensive network and other competitive attributes. Toronto Pearson International Airport ("Toronto Pearson") offers a strategic advantage due to its proximity to densely populated major U.S. markets and serves a large number of business and leisure travelers to and from Toronto. Air Canada and its Star Alliance partners' operations are consolidated in one terminal at Toronto Pearson, which also has efficient in-transit facilities that allow passengers and their bags to move seamlessly between Canadian and U.S. Customs and Immigration. For several years, Air Canada has worked closely with the GTAA to transform Toronto Pearson into the leading North American airport and gain a greater share of the global sixth freedom market. Air Canada is growing its Vancouver hub into a premier gateway to Asia-Pacific markets and developing Montreal into a complementary and competitive trans-Atlantic hub. With the new flights being introduced between Vancouver and cities across North America, Air Canada is poised to offer some of the shortest elapsed travel time between continental North America and Pacific Asia, providing travelers with a better travel experience. The airline's Montreal hub not only links North America with key markets in France, but also positions Montreal as a premier gateway to the Atlantic. In Calgary, Air Canada has relocated its international and U.S. operations to the new state-of-the-art terminal which now includes connection processes comparable to Air Canada's other hubs. Given the improvements that are being made in Toronto, Vancouver, Montreal and Calgary, the airline is able to build its network from the U.S. to provide increased connection flows to its international flights.

The development of commercial alliances with major international carriers is another important element of Air Canada's business strategy. These arrangements provide Air Canada with an effective means to leverage expansion and broaden its network offerings. Air Canada also achieves this through its membership in Star Alliance which is comprised of 28 members and through its participation in a trans-Atlantic revenue sharing joint venture with United Airlines and the Lufthansa Group, referred to as A++. By coordinating pricing, scheduling and sales (under such joint venture), Air Canada is better able to serve customers by offering more travel options, while reducing travel times. It can also achieve greater critical mass and network scope through numerous codeshare and interline agreements.

Subject to agreement of terms and any requisite approvals by the relevant competition authorities, Air Canada and Air China intend to form a comprehensive revenue sharing joint venture in respect of all their flights between China and Canada.

Air Canada has 33 codeshare partners of which 24 are Star Alliance members. Air Canada also code shares with a number of carriers who are not members of Star Alliance. These include Aer Lingus, Central Mountain Air, Etihad, Eurowings, Germanwings, GOL Linhas Aéreas Inteligentes, Jet Airways, Middle East Airlines and SriLankan. In 2016, Air Canada introduced codeshare agreements with EVA Air in support of its Narita and Incheon services and with Avianca Brasil in support of its Sao Paolo services. Air Canada also reinstated its codeshare relationship with Thai Airways. Additionally, and in support of its international expansion, Air Canada expanded the scope of existing codeshare agreements, including with Singapore Airlines with the addition of Air Canada's marketing code to Singapore via Narita and Incheon; with Asiana Airlines with the addition of Air Canada's marketing code to Busan via Incheon and Asiana's code on Air Canada's new Toronto-Incheon operation; with Avianca/Taca Peru with the addition of Air Canada's marketing code beyond Lima to Cusco, Trujillo, Piura, Arequipa and Juliaca; and with Air India with the addition of Air Canada's marketing code to Kochi from both Delhi and Mumbai and timing adjustments for existing code on Air India's domestic network connecting to Air Canada's Delhi services. More specifically in support of its Atlantic growth, Air Canada expanded its codeshare relationship with its A++ partners United, Lufthansa, Swiss, Brussels airlines and Austrian. The codeshare expansion included the addition of Lufthansa's and/or United's code on Vancouver-Dublin, Toronto-Budapest, Toronto-Glasgow, Toronto-Prague, Toronto Warsaw, Montreal-Lyon, Montreal-Casablanca and Toronto-Gatwick, Montreal-Marseille and Toronto-Berlin, Vancouver-Gatwick and Vancouver-Frankfurt. Lufthansa Group carriers, Swiss, Austrian and Brussels Airlines also expanded code on Air Canada on several transatlantic and domestic Canada points. Air Canada is assessing new strategic partnerships in 2017 in support of its business plan and international growth strategy.

In December 2016, Air Canada concluded a strategic cooperation agreement with Cathay Pacific that enhances travel services for customers travelling via Hong Kong to Southeast Asian countries, including the Philippines, Malaysia, Vietnam and Thailand. Air Canada offers codeshare services to an additional eight cities in Southeast Asia on flights operated by Cathay Pacific and Cathay Dragon connecting with Air Canada's double daily service to Hong Kong from Toronto and Vancouver. Air Canada has placed its code on Cathay Pacific and Cathay Dragon flights to Manila, Cebu, Kuala Lumpur, Ho Chi Minh City, Hanoi, Bangkok, Phuket and Chiang Mai. Air Canada has also signed a memorandum of understanding for a strategic cooperation agreement with Virgin Australia, simplifying Canadians' travel throughout Australia and New Zealand and providing Australians with more options for travel to Canada. The first stage of the codeshare agreement is scheduled to be implemented in early 2017 when Air Canada customers will be able to book travel on a single ticket to an additional 10 cities throughout Australia and New Zealand on Virgin Australia-operated flights for connecting with Air Canada's daily year-round service to Sydney and Brisbane. Subject to obtaining the necessary regulatory approvals, Air Canada will place its code on Virgin Australia flights to Adelaide, Canberra, Cairns, Melbourne and Perth as well as to Christchurch and Auckland, New Zealand. Customers will also be able to travel on Virgin Australia flights from Sydney to Brisbane, Sydney to the Gold Coast and Brisbane to Wellington, New Zealand.

Customer Engagement

Providing a consistently high level of customer experience and growing the airline's premium customer base are very important aspects of Air Canada's business strategy. Air Canada continually strives to improve customer loyalty and generate positive referrals to new customers. The airline recognizes that its ongoing success is dependent on consistently delivering superior value and innovative products, providing the highest levels of customer service and anticipating the changing needs of customers.

Air Canada is the only international network carrier in North America to receive a Four-Star ranking from Skytrax, placing it among a select group of carriers worldwide to have earned the distinction. In addition, in 2016, according to a report on Canadian brands published by Brand Finance, an independent brand valuation firm, Air Canada's brand value increased 88% to $1.8 billion over 2015 placing it among the Top 50 most valuable Canadian brands. Air Canada was cited by Brand Finance as the fastest growing Canadian brand among Canada's largest corporations, and the only Canadian airline to rank among the Top 50.

In late 2016, Air Canada was named "Best North American Airline for International Travel" by the readers of Business Traveler, an independent publication which bills itself as the leading magazine for frequent business travelers. According to Business Traveler, winners were selected by its readers as representing top value and superlative service across geographic regions of the world.

Investing in products and services remains pivotal to Air Canada's commitment to customer engagement. The 787 Dreamliner, with its newly designed cabins and next generation in-flight entertainment, has been enthusiastically received and Air Canada has introduced the 787's three-cabin international product and seating standard on all of its 25 Boeing 777 aircraft. The airline's modern fleet, along with other attributes, such as its expansive global network, International Business Class service, Maple Leaf Lounges, concierge service, and Aeroplan and Altitude loyalty programs, are designed to further boost Air Canada's leading position as the carrier of choice among Canadian business travelers.

Air Canada Altitude is designed to enhance the travel experiences of its most frequent flyers. Program members benefit from a wide range of privileges, including priority travel services, upgrades to Business and Premium Economy cabins and recognition across the Star Alliance network. New for 2017, Air Canada aims to optimize the effectiveness of the program by implementing minimum spend requirements, as well as streamlined benefits and policies to better recognize customers' needs, such as granting Altitude status extensions to members who have decreased travel during periods of parental leave.

Altitude members benefit from Air Canada's partnership with the Aeroplan program, which provides a wide range of ways to earn and redeem Aeroplan Miles, including flights and upgrades to over 1,200 destinations worldwide. In the coming year, Air Canada will work with Aeroplan to offer new ways to earn miles, and additional options for members to use their miles for rewards with Air Canada.

In 2016, Air Canada created a more exclusive airport check-in experience for select Altitude members and business class customers with the launch of Business Class Check-in at Toronto Pearson and introduced new concierge offices at Toronto Pearson and Vancouver. To further improve the customer experience for its Altitude Super Elite 100K members and customers travelling in International Business Class, the airline added concierge services in Brisbane, Rome and Lyon and plans to open two new concierge stations in

Taipei and Mumbai in 2017. A new concierge office, similar in design to Toronto Pearson, is underway for the Montreal concierge office in 2017 and is planned for Calgary and Ottawa. Additionally, Premium Agent service was launched in most Canadian hubs, offering an elevated level of personalized service at key customer touch points. Air Canada also introduced enhanced self-service bag drop for passengers with checked baggage at Calgary, with planned expansion to Montreal, Toronto and Vancouver, and continues to expand the availability of electronic boarding passes at more destinations.

For the comfort and convenience of premium and business customers, Air Canada operates 22 Maple Leaf Lounges, including three lounges in Europe (London-Heathrow, Paris-Charles de Gaulle and Frankfurt), three lounges in the United States (Los Angeles International Airport, New York LaGuardia and Newark Liberty International) and 16 lounges across Canada. In 2016, Air Canada upgraded several of its international departures lounges (Calgary International Airport, Los Angeles International Airport, Montreal Trudeau and Paris-Charles de Gaulle) and plans to refurbish several more in 2017. Air Canada also plans to open a lounge at Saskatoon Diefenbaker Airport.

Another program, entitled "Air Canada Corporate Rewards", is designed to help businesses of all sizes save on business travel while earning rewards and benefiting from special offers. Members are eligible for flight discounts and can take advantage of exclusive services such as eUpgrade credits, access to Air Canada's Maple Leaf Lounges and preferred seat selection. The program also offers an intuitive online tool to easily book business travel, reserve cars, manage and share itineraries and keep track of both travel expenses and program rewards.

For customers in the U.S., Air Canada has made electronic boarding passes available through mobile devices at all U.S. airports. Air Canada also offers TSA Pre-check, allowing eligible customers to experience expedited, more efficient security screening for flights out of U.S. airports where the service is available.

Air Canada has preferred seats available on its entire mainline fleet and has made it easier for customers to conveniently purchase these seats when booking or at any time prior to boarding, including through its website, its airport kiosks or mobile devices. Most preferred seats are located near the front of the aircraft, enabling customers to disembark more quickly at their destination.

Air Canada offers Wi-Fi connectivity on its mainline narrow-body aircraft and is planning for Wi-Fi connectivity on its mainline wide-body fleet as well as on its Air Canada Rouge narrow-body and wide-body fleets.

To remain competitive within the digital ecosystem, in 2016, Air Canada strengthened its online presence to offer a responsive design experience for traditional web users, while also meeting the increased demands from tablet and mobile device users. Customers, regardless of device and screen size, can seamlessly interact with Air Canada and access its products and services. In 2017, Air Canada will further enhance the digital experience by providing its customers the ability to find the airline's lowest available fares within a 270-day period on its website. Customers will be able to import mobile bookings made via mobile app to make changes to their itinerary on Air Canada's website. Customers will also be able to receive personalized offers and communications throughout the booking flow based on previous purchase history and preferences.

In 2016, Air Canada started leveraging its new customer relationship management system to gain valuable customer insights on travel patterns and preferences and to deliver a more personalized and satisfying customer experience. This new system is allowing Air Canada to more effectively target its product offerings to stimulate traffic, increase yields and improve customer loyalty.

Culture Change

A healthy and dynamic corporate culture is a competitive attribute that can significantly affect Air Canada's long-term performance. A cornerstone of Air Canada's business strategy is the transformation of its corporate culture to one that embraces leadership and accountability. Air Canada is fostering positive culture change by promoting entrepreneurship, engagement, empowerment and pay-for-performance. It seeks to create a sense of purpose, shared values and common goals among employees and regularly communicates through multiple channels the rationale behind its strategic initiatives and the importance of adapting to changing market conditions. Recently this includes an increased focus on executive led town hall meetings with employees across the network and through social media. This is reinforced by continual and consistent emphasis on the four corporate priorities at every opportunity since their adoption in 2009.

Air Canada's cultural evolution entails continuous improvement, learning and empowerment, all geared towards ensuring employees feel valued and have a sense of purpose. Employees are more likely to embrace the new culture if they take an active part in Air Canada's evolution. As such, Air Canada encourages employee feedback and ideas as they are in an optimal position to identify improvements and changes necessary for success.

Participation in employee recognition programs such as Shine has increased to almost 90% company-wide. The Shine program offers options for employees to publicly recognize colleagues online and/or offer award points which can be exchanged for merchandise and e-gifts. In addition to Shine, Air Canada's long-established Award of Excellence recognition program honours outstanding employees annually. Employees are nominated by their peers for their outstanding work and community involvement.

Results from employee surveys continue to demonstrate a pronounced improvement in both employee engagement and a sense of pride in working at Air Canada. Air Canada has made substantial progress in 2016 – suggesting a dramatic increase in levels of confidence that the organization is doing well financially, that the culture is moving in the right direction across all employee groups, and that employees feel well informed about changes that impact their work. Staff increasingly view that levels of communication have improved, as have team work and cooperation among departments, and there is a growing sense of community. Perceptions are such that a higher proportion of employees agree strongly that Air Canada is on the right track towards stability and sustainability. Employees' perceptions toward senior management have improved significantly since 2014, indicating that senior management actively listens and demonstrates care and concern for employees. This is particularly evident amongst pilots, flight attendants and maintenance workers. A very high proportion of employees feel confident about their skills to do their job. Employees and managers see improvements in their ability to provide direction and support – some of which has been attributed to the expanded training programs – and indications are that they are eager to receive more training and development in the future.

The cross-functional approach of Air Canada's operational excellence team is also driving employee engagement while increasing customer satisfaction levels. Air Canada has initiatives in place to ensure that all employees understand how to work together to deliver on the customer promise. These include a comprehensive employee on-boarding experience, integrated management practices, as well as development programs intended to cultivate Air Canada's leadership behaviours and values. Customer-facing, management and emerging leaders are targeted for various programs – all designed around the principles of customer orientation, innovation and promoting the importance of brand loyalty.

In 2016, key customer service employee training programs were initiated across the system, including virtual classroom technology and racing pit crew-type training in support of improving aircraft turnaround times, safety and process efficiencies. Air Canada expanded both interpersonal skills and technical training to targeted audiences such as concierge and cabin crew**.** In 2016, Air Canada hired over 1,000 new flight attendants who received additional innovative customer service training. This will be offered to an additional 800 flights attendants in 2017. The airline will also be continuing its training program for premium agents in additional stations, including internationally.

In 2016, Air Canada was named one of the 50 Most Engaged Workplaces in North America for its commitment to employee engagement by Achievers, an employee social recognition company. Achievers reported to have been selected companies for their work in setting the benchmark for standards in employee engagement.

In 2016, Air Canada also received the following important awards which further demonstrate that positive culture change is occurring at Air Canada:

- One of "Canada's 10 most admired corporate cultures" by Waterstone Human Capital

- One of "Canada's Top 100 Employers" for the fourth consecutive year in an annual employer survey by Mediacorp Canada Inc.
- One of "Montreal's Top Employers" for the third consecutive year by MediaCorp Canada
- Canada's third "Most Attractive Employer" by Randstad Canada
- One of Canada's 15 "Top Employers for Canadians Over 40" by MediaCorp Canada
- One of "Canada's Best Diversity Employers" by Mediacorp Canada Inc.
- Fastest Growing Brand Among Canada's Largest Corporations according to a report on Canadian brands published by Brand Finance

In addition, in recognition of the ongoing significant evolution underway at Air Canada, as announced in the National Post, Air Canada's President and Chief Executive Officer, Calin Rovinescu, was named as Canada's Outstanding CEO of the Year for 2016. Calin Rovinescu, was also named one of Glassdoor's 20 Highest Rated CEOs for 2016 in Canada and Air Canada as one of Canada's "Best Places to Work" based on employee feedback. Glassdoor reports gathering ratings through its online company review survey which seeks to gain current and former employee sentiment about job and company satisfaction, culture and work environment.

In 2017, Air Canada will continue to expand on employee engagement and leadership development though an enhanced suite of learning initiatives designed to support brand and customer loyalty. This will include various levels of management and customer-facing employees, with a particular focus on leadership, accountability and revitalization of the customer experience. Other improvements are being made to the overall Human Resources experience for employees and managers through developing and implementing client-facing strategies, enabling web and mobile-based technology, and adopting best practice policies and processes.

To encourage the development of a corporate culture, which is focused on transformation and performance, Air Canada has a profit sharing program that rewards eligible employees for their contributions, sharing the financial success of the airline.

As at December 31, 2016, in aggregate, 24,293,473 shares or 8.9% of total issued and outstanding shares of Air Canada were held by Air Canada employees and unions, including 17,647,059 shares held under a trust arrangement in connection with pension arrangements concluded in 2009.

Labour

Starting in 2014, Air Canada entered into multiple long-term labour agreements with unions representing its unionized workforce, a concrete indication of the collaborative partnership supporting its transformation into a global champion. These agreements include the following:

- Unifor (Customer Service and Sales Agents) - In the second quarter of 2015, Air Canada and Unifor, representing the airline's approximately 4,000 customer service and sales agents concluded a contract providing collective agreement terms for five years, ending February 28, 2020.
- CUPE (Flight Attendants) - In the fourth quarter of 2015, Air Canada and CUPE, representing over 7,000 flight attendants, concluded a contract providing collective agreement terms for 10 years, ending March 31, 2025, subject to certain renegotiation provisions over this period.
- IAMAW (Maintenance, Operations and Baggage) - In the first quarter of 2016, Air Canada and the IAMAW, representing approximately 7,500 technical maintenance, operational support and airport baggage handlers, concluded a contract providing collective agreement terms for 10 years, ending April 1, 2026, subject to certain renegotiation provisions over this period.

- ACPA (Pilots) - In the fourth quarter of 2014, Air Canada and ACPA, representing approximately 3,000 pilots, concluded a contract providing collective agreement terms for 10 years, ending September 29, 2024, subject to certain renegotiation provisions and benchmarks over this period.

- CALDA (Dispatchers) - In the first quarter of 2016, Air Canada and CALDA, representing flight dispatchers, concluded a contract providing collective agreement terms for 12 years, ending February 29, 2028, subject to certain renegotiation provisions over this period.

Corporate Sustainability Report

In 2016, Air Canada released Citizens of the World, the airline's fifth corporate sustainability report (“CSR”), providing an update on Air Canada's performance during 2015 in four key areas of sustainability: safety, the environment, employee well-being, and the airline's community involvement. In early 2017, Air Canada was recognized by the Finance and Sustainability Initiative (FSI) with the "2017 Award for Best Corporate Sustainability Report - Transportation" in Canada. FSI reports that this annual competition aims to promote excellence in sustainable development reporting among Canadian public companies.

5. OVERVIEW

In 2016, Air Canada generated operating income of $1,345 million and net income of $876 million or $3.10 per diluted share. In 2016, Air Canada recorded adjusted net income of $1,147 million or $4.06 per diluted share and generated record EBITDAR of $2,768 million. EBITDAR, adjusted net income and adjusted earnings per diluted share are non-GAAP financial measures. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

In the fourth quarter of 2016, Air Canada generated operating income of $18 million and a net loss of $179 million or $0.66 per diluted share. In the fourth quarter of 2016, Air Canada recorded adjusted net income of $38 million or $0.14 per diluted share and EBITDAR of $455 million.

Full Year 2016 Financial Summary

The following is an overview of Air Canada's results of operations and financial position for the full year 2016 compared to the full year 2015.

- Record operating revenues of $14,677 million, an increase of $809 million or 6% from 2015. On capacity growth of 14.7%, record passenger revenues of $13,148 million increased $728 million or 5.9% from 2015.

- Operating expenses of $13,332 million, an increase of $960 million or 8% from 2015. Special items, described in section 6 of this MD&A, increased operating expenses by $91 million in 2016 while special items increased operating expenses by $8 million in 2015. In 2016, CASM declined 6.0% from 2015. On an adjusted basis, CASM decreased 2.9% from 2015, in line with the 2.75% to 3.75% decrease forecast in Air Canada's news release dated November 7, 2016. Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

- Operating income of $1,345 million in 2016 compared to operating income of $1,496 million in 2015.

- Record EBITDAR of $2,768 million in 2016 compared to EBITDAR of $2,542 million in 2015, an increase of $226 million or 8.9% and better than the 6% to 8% increase projected in Air Canada's news release dated November 7, 2016. Air Canada's better than projected 2016 EBITDAR performance was primarily driven by a December 2016 revenue environment that was more robust than anticipated, lower than expected expenses related to lease maintenance return provisions and the airline's success in achieving additional cost reductions. Special items are excluded from all of Air Canada's reported EBITDAR calculations. Refer to sections 6 and 7 of this MD&A for information on the special items.

- Net income of $876 million or $3.10 per diluted share in 2016 versus net income of $308 million or $1.03 per diluted share in 2015.

- Adjusted net income of $1,147 million or $4.06 per diluted share in 2016 compared to adjusted net income of $1,222 million or $4.18 per diluted share in 2015, a decrease of $75 million or $0.12 per diluted share.

- Adjusted net debt of $7,090 million at December 31, 2016, an increase of $799 million from December 31, 2015. Adjusted net debt is an additional GAAP financial measure. Refer to section 9.3 "Adjusted Net Debt" of this MD&A for additional information. The airline's leverage ratio (adjusted net debt to trailing 12-month EBITDAR ratio was 2.6 at December 31, 2016 versus a ratio of 2.5 at December 31, 2015. Leverage ratio is a non-GAAP financial measure. Refer to section 9.3 "Adjusted Net Debt" and section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

- Net cash flows from operating activities of $2,421 million in 2016, an improvement of $396 million from 2015. Negative free cash flow of $149 million in 2016 represented a decrease in free cash flow of $359 million from 2015. Refer to section 9.5 "Consolidated Cash Flow Movements" of this MD&A for additional information. Free cash flow is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

- Return on invested capital ("ROIC") for the 12 months ended December 31, 2016 of 14.7% (versus 18.3% for the 12 months ended December 31, 2015), in line with Air Canada's 2016 ROIC target of 13% to 16% forecast in its November 7, 2016 news release. ROIC is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

Fourth Quarter 2016 Financial Summary

The following is an overview of Air Canada's results of operations and financial position for the fourth quarter of 2016 compared to the fourth quarter of 2015.

- Record operating revenues of $3,425 million in the fourth quarter of 2016, an increase of $243 million or 8% from the fourth quarter of 2015. On capacity growth of 17.1%, record passenger revenues of $3,035 million in the fourth quarter of 2016 increased $199 million or 7.0% from the fourth quarter of 2015.

- Operating expenses of $3,407 million in the fourth quarter of 2016, an increase of $383 million or 13% from the fourth quarter of 2015. Special items, described in section 7 of this MD&A, increased operating expenses by $91 million in the fourth quarter of 2016 while special items increased operating expenses by $31 million in the fourth quarter of 2015. CASM declined 3.8% from the fourth quarter of 2015. On an adjusted basis, CASM decreased 6.1% from the fourth quarter of 2015, slightly better than the 5.0% to 6.0% decrease forecast in Air Canada's news release dated November 7, 2016.

- Operating income of $18 million in the fourth quarter of 2016 compared to operating income of $158 million in the fourth quarter of 2015.

- EBITDAR of $455 million in the fourth quarter of 2016 compared to EBITDAR of $456 million in the fourth quarter of 2015, a decrease of $1 million.

- A net loss of $179 million or $0.66 per diluted share in the fourth quarter of 2016 versus a net loss of $116 million or $0.41 per diluted share in the fourth quarter of 2015.

- Adjusted net income of $38 million or $0.14 per diluted share in the fourth quarter of 2016 compared to adjusted net income of $116 million or $0.40 per diluted share in fourth quarter of 2015, a decrease of $78 million or $0.26 per diluted share.

- Net cash flows from operating activities of $351 million in the fourth quarter of 2016, an improvement of $100 million when compared to the fourth quarter of 2015. Free cash flow of $121 million in the fourth quarter of 2016 represented an increase in free cash flow of $484 million from the same quarter in 2015. Refer to section 9.5 "Consolidated Cash Flow Movements" of this MD&A for additional information.

6. RESULTS OF OPERATIONS – FULL YEAR 2016 VERSUS FULL YEAR 2015

The following table and discussion compares results of Air Canada for 2016 versus 2015.

(Canadian dollars in millions, except per share figures)	Full Year 2016	Full Year 2015	Change $	Change %
Operating revenues				
Passenger	$ 13,148	$ 12,420	$ 728	6
Cargo	512	506	6	1
Other	1,017	942	75	8
Total revenues	**14,677**	**13,868**	**809**	**6**
Operating expenses				
Aircraft fuel	2,279	2,464	(185)	(8)
Regional airlines expense				
Aircraft fuel	327	359	(32)	(9)
Other	2,081	1,920	161	8
Wages, salaries and benefits	2,510	2,324	186	8
Airport and navigation fees	859	802	57	7
Aircraft maintenance	880	773	107	14
Depreciation, amortization and impairment	816	655	161	25
Sales and distribution costs	703	608	95	16
Ground package costs	489	415	74	18
Aircraft rent	462	353	109	31
Food, beverages and supplies	349	314	35	11
Communications and information technology	242	211	31	15
Special items	91	8	83	1,038
Other	1,244	1,166	78	7
Total operating expenses	**13,332**	**12,372**	**960**	**8**
Operating income	**1,345**	**1,496**	**(151)**	
Non-operating income (expense)				
Foreign exchange loss	(38)	(762)	724	
Interest income	48	46	2	
Interest expense	(374)	(389)	15	
Interest capitalized	58	70	(12)	
Net financing expense relating to employee benefits	(76)	(105)	29	
Gain (loss) on financial instruments recorded at fair value	4	(17)	21	
Gain on sale and leaseback of assets	19	-	19	
Loss on debt settlements	(89)	(13)	(76)	
Other	(20)	(18)	(2)	
Total non-operating expense	**(468)**	**(1,188)**	**720**	
Income before income taxes	**877**	**308**	**569**	
Income taxes	(1)	-	(1)	
Net income	**$ 876**	**$ 308**	**$ 568**	
Diluted earnings per share	**$ 3.10**	**$ 1.03**	**$ 2.07**	
EBITDAR [(1)]	**$ 2,768**	**$ 2,542**	**$ 226**	
Adjusted net income [(1)]	**$ 1,147**	**$ 1,222**	**$ (75)**	
Adjusted earnings per share – diluted [(1)]	**$ 4.06**	**$ 4.18**	**$ (0.12)**	

(1) EBITDAR, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

System passenger revenues

In 2016, system passenger revenues of $13,148 million increased $728 million or 5.9% from 2015 on traffic growth of 13.2% partly offset by a yield decline of 6.6%. Business cabin system revenues increased $113 million or 4.7% on traffic growth of 8.0% partly offset by a yield decline of 3.0%.

The table below provides passenger revenue by geographic region for 2016 versus 2015.

Passenger Revenue (Canadian dollars in millions)	**Full Year 2016**	**Full Year 2015**	**$ Change**	**% Change**
Canada	$ 4,426	$ 4,379	$ 47	1.1
U.S. transborder	2,879	2,685	194	7.2
Atlantic	3,026	2,775	251	9.0
Pacific	1,985	1,762	223	12.7
Other	832	819	13	1.6
System	**$ 13,148**	**$ 12,420**	**$ 728**	**5.9**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for 2016 versus 2015.

Full Year 2016 versus Full Year 2015	**Passenger Revenue % Change**	**Capacity (ASMs) % Change**	**Traffic (RPMs) % Change**	**Passenger Load Factor pp Change**	**Yield % Change**	**PRASM % Change**
Canada	1.1	5.7	5.8	0.1	(4.6)	(4.5)
U.S. transborder	7.2	13.9	13.0	(0.7)	(5.2)	(6.0)
Atlantic	9.0	21.1	17.4	(2.5)	(7.1)	(9.9)
Pacific	12.7	21.1	18.8	(1.6)	(5.1)	(6.9)
Other	1.6	9.6	11.0	1.1	(8.8)	(7.6)
System	**5.9**	**14.7**	**13.2**	**(1.0)**	**(6.6)**	**(7.7)**

A system ASM capacity increase of 14.7% in 2016, when compared to 2015, reflected capacity growth in all markets. The capacity increase was primarily driven by additional Boeing 787 and Boeing 777 aircraft in the mainline fleet, the growth of Air Canada Rouge and additional seats on Boeing 777 aircraft.

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

- The 13.2% traffic increase which reflected traffic growth in all markets. Consistent with the airline's objective of increasing global international-to-international connecting traffic through its major Canadian hubs (sixth freedom traffic), the traffic growth in 2016 reflected an increase in connecting traffic via Canada to international destinations.

- The 6.6% yield decrease, which is consistent with the anticipated yield impact stemming from the implementation of Air Canada's strategic plan, reflected:

    - an increase in average stage length of 5.1%, due to long-haul international expansion, which had the effect of reducing system yield by 2.8 percentage points;

    - a higher proportion of seats into long-haul leisure markets led by an increase in lower-cost flights operated by Air Canada Rouge;

- a reduction in carrier surcharges relating to lower fuel prices, especially where carrier surcharges are regulated;
- a higher proportional growth of connecting traffic via Canada to international destinations in support of the airline's international expansion strategy;
- increased industry capacity and competitive pricing activities affecting certain European and Pacific services; and
- in the first half of 2016, the impact of increased industry capacity and competitive pricing activities affecting certain domestic markets as well as a decline in higher-yielding oil market-related traffic.

A favourable currency impact of $193 million was a partly offsetting factor.

Domestic passenger revenues

In 2016, domestic passenger revenues of $4,426 million increased $47 million or 1.1% from 2015.

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

- The 5.8% traffic increase which reflected traffic growth on all major domestic services, including gains in premium cabin traffic. The domestic traffic increase also included incremental connecting traffic to U.S. and international destinations via Canada.
- The 4.6% yield decrease which reflected:
  - higher proportional growth of lower-yielding international and U.S. transborder passenger flows connecting to Air Canada's routes in the domestic market in support of the airline's international expansion strategy;
  - a 1.7% longer average stage length, which had the effect of reducing domestic yield by 1.0 percentage point in 2016;
  - The impact of increased industry capacity and competitive pricing activities affecting certain domestic markets; and
  - A decline in higher-yielding oil market-related traffic, particularly in the first half of 2016.

  A favourable currency impact of $26 million was a partly offsetting factor.

U.S. transborder passenger revenues

In 2016, U.S. transborder passenger revenues of $2,879 million increased $194 million or 7.2% from 2015.

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

- The 13.0% traffic increase which reflected traffic growth on all major U.S. transborder services. The year-over-year increase in traffic was due to strong passenger demand between Canada and the U.S. as well as growth of international-to-international passenger flows from the U.S.
- The 5.2% yield decline which mainly reflected the impact of increased competition and capacity on U.S. short-haul routes, competitive pricing activities on lower-cost Air Canada Rouge-operated U.S. sun routes and on services to California, and growth in international-to-international passenger flows from the U.S. A stronger premium cabin performance and a favourable currency impact of $56 million were partly offsetting factors.

Atlantic passenger revenues

In 2016, Atlantic passenger revenues of $3,026 million increased $251 million or 9.0% from 2015.

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

- The 17.4% traffic increase which reflected traffic growth from local and sixth freedom markets to and from Europe, India, Africa and the Middle East, including on Air Canada's and Air Canada Rouge's new and returning seasonal services. Traffic grew across all three cabins: Business, Premium Economy/Premium Rouge and Economy. This growth was partly offset by traffic declines on certain services, such as Belgium, Istanbul and Germany. Travel concerns in 2016, following terrorist attacks in France, Belgium and Turkey, were contributing factors to the passenger load factor decline.

- The 7.1% yield decline which reflected an increase in average stage length of 3.0%, which had the effect of reducing Atlantic yield by 1.7 percentage points. Increased industry capacity to and from Canada and the U.S., competitive pricing activities affecting certain European services, as well as a higher proportion of seats offered into long-haul leisure markets were also contributing factors to the yield decline. A favourable currency impact of $36 million was a partly offsetting factor.

Pacific passenger revenues

In 2016, Pacific passenger revenues of $1,985 million increased $223 million or 12.7% from 2015.

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

- The 18.8% traffic increase which reflected traffic growth on all major Pacific services with the exception of services to Hong Kong where traffic remained essentially at 2015 levels. The overall traffic increase versus 2015 was largely driven by the launch, in June 2016, of services to Seoul from Toronto and to Brisbane from Vancouver. In addition, Air Canada operated larger aircraft on routes to China and Japan and increased aircraft frequencies on its Vancouver–Osaka route (from five flights per week to six flights per week).

- The 5.1% yield decrease which mainly reflected the impact of increased industry capacity and competitive pricing activities, particularly on routes to China and Australia, as well as a reduction in carrier surcharges relating to lower fuel prices, especially where carrier surcharges are regulated. A favourable currency impact of $60 million was a partly offsetting factor.

Other passenger revenues

In 2016, Other passenger revenues of $832 million increased $13 million or 1.6% from 2015.

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

- The 11.0% traffic increase which reflected traffic growth on all major services, led by lower-cost Air Canada Rouge flying and growth in traffic to and from Brazil relating to the 2016 Summer Olympic Games. Consistent with Air Canada's strategy of growing international-to-international traffic through its Canadian hubs, international connections to and from South America also increased versus 2015.

- The 8.8% yield decrease which mainly reflected the impact of competitive pricing activities, driven by increased industry capacity on services to the Caribbean and Mexico while services to South America were impacted by a weaker economy, particularly in Brazil. A favourable currency impact of $15 million was a partly offsetting factor.

Cargo revenues

In 2016, cargo revenues of $512 million increased $6 million or 1.1% from 2015, reflecting traffic growth of 15.0% largely offset by a yield decline of 12.1%. Traffic increases were recorded in all markets on higher capacity. The overall yield decrease was primarily driven by increased industry capacity, particularly in the first half of 2016, and was partly offset by a favourable foreign currency impact of $12 million.

The table below provides cargo revenue by geographic region for 2016 versus 2015.

Cargo Revenue (Canadian dollars in millions)	**Full Year 2016**	**Full Year 2015**	**$ Change**	**% Change**
Canada	$ 63	$ 67	$ (4)	(7.0)
U.S. transborder	29	24	5	18.3
Atlantic	187	188	(1)	(0.5)
Pacific	193	188	5	3.0
Other	40	39	1	3.2
System	**$ 512**	**$ 506**	**$ 6**	**1.1**

Other revenues

In 2016, other revenues of $1,017 million increased $75 million or 8% from 2015, reflecting, in large part, an increase in ground package revenues at Air Canada Vacations, the result of higher passenger volumes, and growth in passenger and airline-related fees.

CASM and Adjusted CASM

In 2016, CASM and adjusted CASM decreased 6.0% and 2.9%, respectively, when compared to 2015. Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

The following table compares Air Canada's CASM and Adjusted CASM for 2016 versus 2015.

	Full Year		Change	
(cents per ASM)	**2016**	**2015**	**cents**	**%**
Aircraft fuel	2.46	3.05	(0.59)	(19.3)
Regional airlines expense				
Aircraft fuel	0.35	0.44	(0.09)	(20.5)
Other	2.25	2.38	(0.13)	(5.5)
Wages and salaries	2.09	2.21	(0.12)	(5.4)
Benefits	0.62	0.66	(0.04)	(6.1)
Airport and navigation fees	0.93	0.99	(0.06)	(6.1)
Aircraft maintenance	0.95	0.96	(0.01)	(1.0)
Depreciation, amortization and impairment	0.88	0.81	0.07	8.6
Sales and distribution costs	0.76	0.75	0.01	1.3
Ground package costs	0.53	0.51	0.02	3.9
Aircraft rent	0.50	0.44	0.06	13.6
Food, beverages and supplies	0.38	0.39	(0.01)	(2.6)
Communications and information technology	0.26	0.26	-	-
Special items	0.10	0.01	0.09	900.0
Other	1.32	1.44	(0.12)	(0.1)
CASM	**14.38**	**15.30**	**(0.92)**	**(6.0)**
Remove:				
Aircraft fuel expense (1), ground package costs at Air Canada Vacations and special items	(3.44)	(4.03)	0.59	14.6
Adjusted CASM (2)	**10.94**	**11.27**	**(0.33)**	**(2.9)**

(1) Includes aircraft fuel expense related to regional airline operations.
(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating expenses

In 2016, operating expenses of $13,332 million increased $960 million or 8% from 2015. This increase was mainly driven by the 14.7% capacity growth and the impact of a weaker Canadian dollar on foreign currency denominated operating expenses which increased operating expenses by $228 million in 2016 (comprised of $71 million related to aircraft fuel expense and $157 million related to non-fuel operating expenses). These increases were partly offset by the impact of lower jet fuel prices (before the impact of foreign exchange).

Aircraft fuel expense

In 2016, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to $2,606 million, a decrease of $217 million or 8% from 2015, reflecting the impact of lower base jet fuel prices (before the impact of foreign exchange) year-over-year, which accounted for a reduction of $519 million. Partly offsetting this decrease were the impact of a higher volume of fuel litres consumed, which accounted for an increase of $219 million, and an unfavourable currency impact of $71 million.

Regional airlines expense

In 2016, regional airlines expense of $2,408 million increased $129 million or 6% from 2015, reflecting the impact of increased flying, which was the result of fleet expansion initiatives in the Air Canada Express fleet operated by Sky Regional and Air Georgian, an unfavourable currency impact of $40 million and an increase in expenses related to end of lease maintenance provisions. Partly offsetting these increases were the impact of lower jet fuel prices year-over-year and lower rates associated with the Jazz CPA.

Wages, salaries and benefits expense

In 2016, wages, salaries and benefits expense of $2,510 million increased $186 million or 8% from 2015.

In 2016, wages and salaries expense of $1,936 million increased $148 million or 8% from 2015. This increase was largely due to a higher number of full-time equivalent (FTE) employees when compared to 2015. On the capacity growth of 14.7%, the average number of FTE employees increased 4.9% year-over-year.

In 2016, employee benefits expense of $574 million increased $38 million or 7% from 2015, in large part due to Air Canada having recorded a credit of $19 million in 2015 which pertained to benefit plan amendments in U.S. post-retirement health plans. This increase in employee benefits expense was higher than the $20 million increase projected in Air Canada's news release dated November 7, 2016, mainly due to the impact of Air Canada having recorded a current service cost expense of $6 million related to its collective agreement with the pilot union, higher defined contribution plan expenses than forecast and other factors.

Airport and navigation fees

In 2016, airport and navigation fees of $859 million increased $57 million or 7% from 2015, reflecting growth in wide-body and international flying and an unfavourable currency impact of $7 million. The favourable impact of Air Canada's agreement with the Greater Toronto Airport Authority, which is allowing the airline to increase international connecting traffic at Toronto Pearson International Airport on a more cost effective basis, and the impact of a 6% Nav Canada rate reduction, which was effective September 1, 2016, were partly offsetting factors.

Aircraft maintenance expense

In 2016, aircraft maintenance expense of $880 million increased $107 million or 14% from 2015, reflecting an increase in expenses related to end of lease maintenance provisions when compared to 2015, an unfavourable currency impact of $49 million and the effect of having additional Boeing 787 and 777 aircraft in the fleet which have engines under power-by-the-hour arrangements. The increase in end of lease maintenance provisions was mainly due to Air Canada having recorded credits in 2015 due to lease extensions. Partly offsetting these increases was the impact of cost reduction initiatives.

The year-over-year $107 million increase in aircraft maintenance expense was lower than the $120 million increase projected in Air Canada's news release dated November 7, 2016. This improvement was mainly due to lower than expected lease maintenance return provisions.

The following table provides a breakdown of the more significant items included in maintenance expense for the periods indicated:

(Canadian dollars in millions)	Full Year 2016	Full Year 2015	Change $	Change %
Technical maintenance	$ 727	$ 715	$ 12	2
Maintenance provision (1)	133	27	106	393
Other	20	31	(11)	(35)
Total aircraft maintenance expense	**$ 880**	**$ 773**	**$ 107**	**14**

(1) Maintenance provisions relate to return conditions on aircraft leases which are recorded over the term of the lease.

Depreciation, amortization and impairment expense

In 2016, depreciation, amortization and impairment expense of $816 million increased $161 million or 25% from 2015, reflecting, in large part, the addition of Boeing 787 aircraft to Air Canada's mainline fleet and the airline's aircraft refurbishment programs. The year-over-year increase in depreciation, amortization and impairment expense was essentially in line with the $160 million increase projected in Air Canada's news release dated November 7, 2016.

Sales and distribution costs

In 2016, sales and distribution costs of $703 million increased $95 million or 16% from 2015, reflecting higher commission expenses, in part due to new and enhanced competitive incentive programs, a higher volume of ticket sales, and a higher proportion of sales through international points-of-sales which generally result in higher transaction costs. An increase in credit card expenses (in line with sales and revenue growth) and an unfavourable currency impact of $14 million were also contributing factors to the increase in sales and distribution costs versus 2015.

Ground package costs

In 2016, ground package costs of $489 million increased $74 million or 18% from 2015, reflecting higher passenger volumes year-over-year and an unfavourable currency impact of $26 million.

Aircraft rent

In 2016, aircraft rent expense of $462 million increased $109 million or 31% from 2015, reflecting a greater number of leased aircraft year-over-year, primarily Airbus A321 and Boeing 787 aircraft, the reclassification of certain finance leases to operating leases, and an unfavourable currency impact of $18 million.

Special items

In 2016, a past service cost expense of $91 million was recorded as a special item to reflect the estimated cost of pension increases applicable to members of the Air Canada Pilots Association ("ACPA") who participate in a defined benefit plan. Certain pension plan amendments (related to maximum annual pension per year of service) are conditional on meeting defined business plan targets tied to the number of operating aircraft in the fleet by 2017, 2020 and as of 2023. The past service cost expense of $91 million represents the out-of-period expense associated with benefits granted upon signing of the ACPA collective agreement in 2014 based on management's best estimate of the probability of meeting the defined business plan targets tied to the number of operating aircraft at the respective dates. The special charge does not impact any of the Corporation's prior or current incentive compensation.

In 2015, special items increased operating expenses by $8 million. These special items included:

- One-time payments totaling $26 million related to Air Canada's contract on collective agreement terms with CUPE;

- One-time payments totaling $36 million related to Air Canada's contract on collective agreement terms with the IAMAW;

- A $30 million recovery related to cargo investigations and proceedings which had been previously paid; and

- Favourable tax-related provision adjustments of $23 million.

Other expenses

In 2016, other expenses of $1,244 million increased $78 million or 7% from 2015, reflecting, in large part, the capacity growth, the impact of Air Canada's international expansion strategy and an unfavourable currency impact.

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

	Full Year		Change	
(Canadian dollars in millions)	**2016**	**2015**	**$**	**%**
Terminal handling	$ 237	$ 227	$ 10	4
Crew cycle	177	149	28	19
Building rent and maintenance	154	145	9	6
Miscellaneous fees and services	141	137	4	3
Remaining other expenses	535	508	27	5
Total other expenses	**$ 1,244**	**$ 1,166**	**$ 78**	**7**

Non-operating expense

In 2016, non-operating expense of $468 million in 2016 decreased $720 million from 2015.

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

	Full Year		
(Canadian dollars in millions)	**2016**	**2015**	**$ Change**
Foreign exchange loss	$ (38)	$ (762)	$ 724
Interest expense, net	(268)	(273)	5
Net financing expense relating to employee benefits	(76)	(105)	29
Gain (loss) on financial instruments recorded at fair value	4	(17)	21
Gain on sale and leaseback of assets	19	-	19
Loss on debt settlements	(89)	(13)	(76)
Other	(20)	(18)	(2)
Total non-operating expense	**$ (468)**	**$ (1,188)**	**$ 720**

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

- In 2016, losses on foreign exchange amounted to $38 million compared to losses on foreign exchange of $762 million in 2015. In 2016, foreign exchange losses on foreign currency derivatives of $136 million were partly offset by foreign exchange gains on U.S. denominated long-term debt and finance leases of $126 million. The foreign exchange gains on U.S. denominated long-term debt were attributable to a stronger Canadian dollar at December 31, 2016 when compared to December 31, 2015. The December 31, 2016 closing exchange rate was US$1 = C$1.3427 while the December 31, 2015 closing exchange rate was US$1 = C$1.3840. In 2015, foreign exchange losses on U.S. denominated long-term debt of $876 million were attributable to a weaker Canadian dollar at December 31, 2015 when compared to the December 31, 2014 closing rate of US$1 = C$1.1601. Partially offsetting these losses were gains of $164 million on foreign currency derivatives.

- In 2016, net financing expense relating to employee benefits decreased $29 million which mainly reflected the impact of the lower net defined pension benefit obligation.

- In 2016, Air Canada recorded a gain of $19 million on the sale and operating leaseback of two Boeing 787-9 aircraft. No such gain was recorded in 2015.

- In 2016, Air Canada recorded a loss on debt settlements amounting to $89 million of which $82 million was related to the C$1.25 billion refinancing transaction concluded on October 6, 2016 and further described in section 9.8 "Contractual Obligations" of this MD&A and $7 million was related to the prepayment of debt associated with the disposal of Embraer 190 aircraft. In 2015, Air Canada recorded a loss on debt settlements of $13 million related to the prepayment of debt associated with the disposal of Embraer 190 aircraft.

7. RESULTS OF OPERATIONS – FOURTH QUARTER 2016 VS FOURTH QUARTER 2015

The following table and discussion compares results of Air Canada for the fourth quarter 2016 versus the fourth quarter of 2015.

(Canadian dollars in millions, except per share figures)	Fourth Quarter 2016	Fourth Quarter 2015	Change $	Change %
Operating revenues				
Passenger	$ 3,035	$ 2,836	$ 199	7
Cargo	155	135	20	15
Other	235	211	24	11
Total revenues	**3,425**	**3,182**	**243**	**8**
Operating expenses				
Aircraft fuel	598	527	71	13
Regional airlines expense				
Aircraft fuel	90	81	9	11
Other	532	468	64	14
Wages, salaries and benefits	633	590	43	7
Airport and navigation fees	203	193	10	5
Aircraft maintenance	197	203	(6)	(3)
Depreciation, amortization and impairment	212	160	52	33
Sales and distribution costs	172	145	27	19
Ground package costs	101	87	14	16
Aircraft rent	120	98	22	22
Food, beverages and supplies	82	81	1	1
Communications and information technology	60	50	10	20
Special items	91	31	60	194
Other	316	310	6	2
Total operating expenses	**3,407**	**3,024**	**383**	**13**
Operating income	**18**	**158**	**(140)**	
Non-operating income (expense)				
Foreign exchange loss	(29)	(159)	130	
Interest income	13	13	-	
Interest expense	(83)	(99)	16	
Interest capitalized	8	20	(12)	
Net financing expense relating to employee benefits	(24)	(27)	3	
Gain (loss) on financial instruments recorded at fair value	9	(3)	12	
Loss on debt settlements	(82)	(13)	(69)	
Other	(8)	(6)	(2)	
Total non-operating expense	**(196)**	**(274)**	**78**	
Loss before income taxes	**(178)**	**(116)**	**(62)**	
Income taxes	(1)	-	(1)	
Net loss	**$ (179)**	**$ (116)**	**$ (63)**	
Diluted loss per share	**$ (0.66)**	**$ (0.41)**	**$ (0.25)**	
EBITDAR (1)	**$ 455**	**$ 456**	**$ (1)**	
Adjusted net income (1)	**$ 38**	**$ 116**	**$ (78)**	
Adjusted earnings per share – diluted (1)	**$ 0.14**	**$ 0.40**	**$ (0.26)**	

(1) EBITDAR, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

System passenger revenues

In the fourth quarter of 2016, system passenger revenues of $3,035 million increased $199 million or 7.0% from the fourth quarter of 2015 on traffic growth of 15.3% partly offset by a yield decline of 7.2%. Business cabin system revenues increased $49 million or 8.4% on traffic growth of 13.4% partly offset by a yield decline of 4.5%.

The table below provides passenger revenue by geographic region for the fourth quarter of 2016 versus the fourth quarter of 2015.

Passenger Revenue (Canadian dollars in millions)	**Fourth Quarter 2016**	**Fourth Quarter 2015**	**$ Change**	**% Change**
Canada	$ 1,079	$ 1,053	$ 26	2.5
U.S. transborder	697	632	65	10.1
Atlantic	619	572	47	8.3
Pacific	442	394	48	12.1
Other	198	185	13	7.3
System	**$ 3,035**	**$ 2,836**	**$ 199**	**7.0**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the fourth quarter of 2016 versus the fourth quarter of 2015.

Fourth Quarter 2016 versus Fourth Quarter 2015	**Passenger Revenue % Change**	**Capacity (ASMs) % Change**	**Traffic (RPMs) % Change**	**Passenger Load Factor pp Change**	**Yield % Change**	**PRASM % Change**
Canada	2.5	5.5	5.7	0.1	(3.1)	(2.9)
U.S. transborder	10.1	14.1	15.0	0.6	(4.3)	(3.6)
Atlantic	8.3	21.5	19.3	(1.4)	(9.2)	(10.9)
Pacific	12.1	31.9	23.7	(5.3)	(9.3)	(15.0)
Other	7.3	13.2	15.7	1.8	(7.6)	(5.5)
System	**7.0**	**17.1**	**15.3**	**(1.2)**	**(7.2)**	**(8.6)**

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters.

System	**Year-over-Year by Quarter (% Change)**				
	Q4'15	**Q1'16**	**Q2'16**	**Q3'16**	**Q4'16**
Passenger revenues	3.0	2.8	2.0	10.5	7.0
Capacity (ASMs)	8.4	8.2	11.0	20.9	17.1
Traffic (RPMs)	8.6	7.7	9.3	18.9	15.3
Passenger load factor (pp change)	0.1	(0.3)	(1.2)	(1.5)	(1.2)
Yield	(5.5)	(4.7)	(6.8)	(7.0)	(7.2)
PRASM	(5.3)	(5.1)	(8.2)	(8.6)	(8.6)

A system ASM capacity increase of 17.1% in the fourth quarter of 2016, when compared to the fourth quarter of 2015, reflected capacity growth in all markets. The capacity increase was primarily driven by additional Boeing 787 and Boeing 777 aircraft in the mainline fleet, the growth of Air Canada Rouge and additional seats on Boeing 777 aircraft.

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

- The 15.3% traffic increase which reflected traffic growth in all markets. Consistent with the airline's objective of increasing global international-to-international connecting traffic through its major Canadian hubs (sixth freedom traffic), the traffic growth in the fourth quarter of 2016 reflected an increase in connecting traffic via Canada to international destinations.

- The 7.2% yield decrease which reflected:

    - an increase in average stage length of 6.5%, due to long-haul international expansion, which had the effect of reducing system yield by 3.6 percentage points;

    - a higher proportion of seats into long-haul leisure markets led by an increase in lower-cost flights operated by Air Canada Rouge;

    - a reduction in carrier surcharges relating to lower fuel prices, especially where carrier surcharges are regulated; and

    - a higher proportional growth of connecting traffic via Canada to international destinations in support of the airline's international expansion strategy.

Domestic passenger revenues

In the fourth quarter of 2016, domestic passenger revenues of $1,079 million increased $26 million or 2.5% from the fourth quarter of 2015.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters.

Canada	Year-over-Year by Quarter (% Change)				
	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16
Passenger revenues	(4.1)	(2.3)	(1.6)	4.8	2.5
Capacity (ASMs)	4.0	6.3	4.5	6.3	5.5
Traffic (RPMs)	2.4	4.1	4.2	8.2	5.7
Passenger load factor (pp change)	(1.2)	(1.7)	(0.2)	1.5	0.1
Yield	(7.3)	(6.5)	(5.8)	(3.1)	(3.1)
PRASM	(8.7)	(8.4)	(6.1)	(1.4)	(2.9)

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

- The 5.7% traffic increase which reflected traffic growth on all major domestic services and included gains in premium cabin traffic. The domestic traffic increase also included incremental connecting traffic to U.S. and international destinations via Canada.

- The 3.1% yield decrease which reflected:

    - a 1.4% longer average stage length, which had the effect of reducing domestic yield by 0.8 percentage points in the fourth quarter of 2016;

- higher proportional growth of lower-yielding international and U.S. transborder passenger flows connecting to Air Canada's routes in the domestic market in support of the airline's international expansion strategy; and

- Increased competition on regional routes, particularly in eastern Canada.

U.S. transborder passenger revenues

In the fourth quarter of 2016, U.S. transborder passenger revenues of $697 million increased $65 million or 10.1% from the fourth quarter of 2015.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters.

U.S. transborder	Year-over-Year by Quarter (% Change)				
	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16
Passenger revenues	10.5	2.5	2.3	14.0	10.1
Capacity (ASMs)	11.9	10.2	12.3	19.3	14.1
Traffic (RPMs)	11.6	5.8	10.8	20.8	15.0
Passenger load factor (pp change)	(0.2)	(3.3)	(1.1)	1.0	0.6
Yield	(0.9)	(3.3)	(7.9)	(5.6)	(4.3)
PRASM	(1.1)	(7.1)	(9.1)	(4.5)	(3.6)

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

- The 15.0% traffic increase which reflected traffic growth on all major U.S. transborder services. The year-over-year increase in traffic was due to strong passenger demand between Canada and the U.S. as well as growth of international-to-international passenger flows from the U.S.

- The 4.3% yield decline which mainly reflected the impact of increased competition and capacity on U.S. short-haul routes, competitive pricing activities on lower-cost Air Canada Rouge-operated U.S. sun routes, and growth in international-to-international passenger flows from the U.S. A stronger premium cabin performance was a partly offsetting factor.

Atlantic passenger revenues

In the fourth quarter of 2016, Atlantic passenger revenues of $619 million increased $47 million or 8.3% from the fourth quarter of 2015.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters.

Atlantic	Year-over-Year by Quarter (% Change)				
	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16
Passenger revenues	9.1	12.9	5.0	10.7	8.3
Capacity (ASMs)	15.3	13.6	16.6	28.1	21.5
Traffic (RPMs)	14.2	15.8	10.9	21.8	19.3
Passenger load factor (pp change)	(0.7)	1.5	(4.0)	(4.4)	(1.4)
Yield	(4.5)	(2.5)	(5.4)	(9.1)	(9.2)
PRASM	(5.4)	(0.6)	(9.9)	(13.6)	(10.9)

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

- The 19.3% traffic increase which reflected traffic growth on all major Atlantic services, led by strong growth on Air Canada's services to Delhi and Dubai, along with the airline's extended services to Spain. Traffic grew across all three cabins: Business, Premium Economy/Premium Rouge and Economy. The uncertainty following the United Kingdom's referendum vote to withdraw from the European Union had a negative effect on traffic originating from the United Kingdom which continued through the fourth quarter of 2016.

- The 9.2% yield decline which reflected an increase in average stage length of 3.2%, which had the effect of reducing Atlantic yield by 1.8 percentage points. Increased industry capacity to and from Canada and the U.S., an unfavourable currency impact of $10 million, aggressive competitive pricing activities affecting certain European services, as well as a higher proportion of seats offered into long-haul leisure markets were also contributing factors to the yield decline.

Pacific passenger revenues

In the fourth quarter of 2016, Pacific passenger revenues of $442 million increased $48 million or 12.1% from the fourth quarter of 2015.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters.

Pacific	Year-over-Year by Quarter (% Change)				
	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16
Passenger revenues	4.7	7.7	8.8	19.2	12.1
Capacity (ASMs)	3.4	3.1	12.4	34.8	31.9
Traffic (RPMs)	7.9	6.3	13.7	29.0	23.7
Passenger load factor (pp change)	3.6	2.6	1.0	(3.9)	(5.3)
Yield	(2.9)	1.4	(4.2)	(7.6)	(9.3)
PRASM	1.3	4.6	(3.1)	(11.6)	(15.0)

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

- The 23.7% traffic increase which reflected traffic growth on all major Pacific services with the exception of services to Hong Kong where capacity was reduced year-over-year. The traffic increase versus the same quarter in 2015 was largely driven by the launch, in June 2016, of services to Seoul from Toronto and to Brisbane from Vancouver. In addition, Air Canada operated larger aircraft on routes to China and Japan and increased aircraft frequencies on its Vancouver–Osaka route (from five flights per week to six flights per week).

- The 9.3% yield decrease which mainly reflected the impact of increased industry capacity and competitive pricing activities on most major Pacific services as well as a reduction in carrier surcharges relating to lower fuel prices, especially where carrier surcharges are regulated. A favourable currency impact of $6 million was a partly offsetting factor.

Other passenger revenues

In the fourth quarter of 2016, Other passenger revenues of $198 million increased $13 million or 7.3% from the fourth quarter of 2015.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters.

Other	Year-over-Year by Quarter (% Change)				
	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16
Passenger revenues	1.1	(1.5)	(6.4)	8.3	7.3
Capacity (ASMs)	9.5	7.5	6.0	12.5	13.2
Traffic (RPMs)	10.5	8.1	6.5	15.1	15.7
Passenger load factor (pp change)	0.7	0.4	0.3	1.9	1.8
Yield	(8.6)	(9.2)	(12.4)	(6.0)	(7.6)
PRASM	(7.8)	(8.8)	(12.1)	(3.9)	(5.5)

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

- The 15.7% traffic increase which reflected traffic growth on all major services, led by lower-cost Air Canada Rouge flying. International connections to and from South America increased compared to the same quarter in 2015, which is consistent with Air Canada's strategy of growing international-to-international traffic through its Canadian hubs.

- The 7.6% yield decrease which mainly reflected the impact of increased industry capacity and competitive pricing activities on services to traditional sun destinations.

Cargo revenues

In the fourth quarter of 2016, cargo revenues of $155 million increased $20 million or 15.0% from the fourth quarter of 2015, reflecting traffic growth of 27.3% partly offset by a yield decline of 9.7%. Traffic increases were recorded in all markets, led by the Pacific region, on higher capacity. Yields declined in all markets, driven by increased industry capacity, with the exception of Asia where yields were essentially at 2015 levels.

The table below provides cargo revenue by geographic region for the fourth quarter of 2016 versus the fourth quarter of 2015.

Cargo Revenue (Canadian dollars in millions)	**Fourth Quarter 2016**	**Fourth Quarter 2015**	**$ Change**	**% Change**
Canada	$ 18	$ 17	$ 1	3.3
U.S. transborder	9	7	2	16.2
Atlantic	52	48	4	7.1
Pacific	63	49	14	29.5
Other	13	14	(1)	3.9
System	**$ 155**	**$ 135**	**$ 20**	**15.0**

Other revenues

In the fourth quarter of 2016, other revenues of $235 million increased $24 million or 11% from the fourth quarter of 2015, reflecting, in large part, an increase in ground package revenues at Air Canada Vacations, the result of higher passenger volumes.

CASM and Adjusted CASM

In the fourth quarter of 2016, CASM and adjusted CASM decreased 3.8% and 6.1%, respectively, when compared to the fourth quarter of 2015. Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

The following table compares Air Canada's CASM and Adjusted CASM for the fourth quarter of 2016 to the fourth quarter of 2015.

	Fourth Quarter		Change	
(cents per ASM)	**2016**	**2015**	**cents**	**%**
Aircraft fuel	2.71	2.79	(0.08)	(2.9)
Regional airlines expense				
Aircraft fuel	0.41	0.43	(0.02)	(4.7)
Other	2.41	2.48	(0.07)	(2.8)
Wages and salaries	2.23	2.44	(0.21)	(8.6)
Benefits	0.64	0.68	(0.04)	(5.9)
Airport and navigation fees	0.92	1.02	(0.10)	(9.8)
Aircraft maintenance	0.89	1.08	(0.19)	(17.6)
Depreciation, amortization and impairment	0.96	0.85	0.11	12.9
Sales and distribution costs	0.78	0.77	0.01	1.3
Ground package costs	0.46	0.46	-	-
Aircraft rent	0.54	0.52	0.02	3.8
Food, beverages and supplies	0.37	0.43	(0.06)	(14.0)
Communications and information technology	0.27	0.27	-	-
Special items	0.41	0.16	0.25	156.3
Other	1.42	1.65	(0.23)	(0.1)
CASM	**15.42**	**16.03**	**(0.61)**	**(3.8)**
Remove:				
Aircraft fuel expense (1), ground package costs at Air Canada Vacations and special items	(3.98)	(3.85)	(0.13)	(3.4)
Adjusted CASM (2)	**11.44**	**12.18**	**(0.74)**	**(6.1)**

(1) Includes aircraft fuel expense related to regional airline operations.
(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating expenses

In the fourth quarter of 2016, operating expenses of $3,407 million increased $383 million or 13% from the fourth quarter of 2015 on capacity growth of 17.1%. The more notable components of the year-over-year change in operating expenses are described below.

Aircraft fuel expense

In the fourth quarter of 2016, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to $688 million, an increase of $80 million or 13% from the fourth quarter of 2015, reflecting the impact of a higher volume of fuel litres consumed, which accounted for an increase of $72 million, and the impact of higher base jet fuel prices (before the impact of foreign exchange), which accounted for an increase of $19 million. Partly offsetting these increases was a favourable currency impact of $10 million.

Regional airlines expense

In the fourth quarter of 2016, regional airlines expense of $622 million increased $73 million or 13% from the fourth quarter of 2015, reflecting the impact of increased flying, which was the result of fleet expansion initiatives in the Air Canada Express fleet operated by Sky Regional and Air Georgian. Partly offsetting this increase was the impact of lower rates associated with the Jazz CPA.

Wages, salaries and benefits expense

In the fourth quarter of 2016, wages, salaries and benefits expense of $633 million increased $43 million or 7% from the fourth quarter in 2015.

In the fourth quarter of 2016, wages and salaries expense of $492 million increased $31 million or 7% from the fourth quarter of 2015. This increase was mainly due to a higher number of FTE employees when compared to the same quarter in 2015. On the 17.1% capacity growth, the average number of FTE employees increased 4.4% year-over-year.

In the fourth quarter of 2016, employee benefits expense of $141 million increased $12 million or 9% from the fourth quarter in 2015, reflecting, largely, Air Canada having recorded an expense of $6 million in 2016 related to its collective agreement with its pilot union while no such expense was recorded in the fourth quarter of 2015.

Airport and navigation fees

In the fourth quarter of 2016, airport and navigation fees of $203 million increased $10 million or 5% from the fourth quarter of 2015, reflecting growth in wide-body and international flying. The favourable impact of Air Canada's agreement with the Greater Toronto Airport Authority, which is allowing the airline to increase its share of international connecting traffic at Toronto Pearson International Airport on a more cost effective basis, and the impact of a 6% Nav Canada rate reduction, which was effective on September 1, 2016, were partly offsetting factors.

Aircraft maintenance expense

In the fourth quarter of 2016, aircraft maintenance expense of $197 million decreased $6 million or 3% from the fourth quarter of 2015.

The following table provides a breakdown of the more significant items included in maintenance expense for the periods indicated:

	Fourth Quarter		Change	
(Canadian dollars in millions)	**2016**	**2015**	**$**	**%**
Technical maintenance	$ 151	$ 170	$ (19)	11
Maintenance provision (1)	39	17	22	129
Other	7	16	(9)	(56)
Total aircraft maintenance expense	**$ 197**	**$ 203**	**$ (6)**	**(3)**

(1) Maintenance provisions relate to return conditions on aircraft leases which are recorded over the term of the lease.

Depreciation, amortization and impairment expense

In the fourth quarter of 2016, depreciation, amortization and impairment expense of $212 million increased $52 million or 33% from the fourth quarter of 2015, reflecting, in large part, the addition of Boeing 787 aircraft to Air Canada's mainline fleet and the airline's aircraft refurbishment programs.

Sales and distribution costs

In the fourth quarter of 2016, sales and distribution costs of $172 million increased $27 million or 19% from the fourth quarter of 2015, reflecting higher commission expenses, in part due to new and enhanced competitive incentive programs. A higher volume of ticket sales, a higher proportion of sales through international points-of-sales which generally result in higher transaction costs, and an increase in credit card expenses (in line with sales and revenue growth) were also contributing factors to the increase in sales and distribution costs year-over-year.

Ground package costs

In the fourth quarter of 2016, ground package costs of $101 million increased $14 million or 16% from the fourth quarter of 2015, reflecting higher passenger volumes year-over-year, partly offset by a higher cost of ground packages.

Aircraft rent

In the fourth quarter of 2016, aircraft rent expense of $120 million increased $22 million or 22% from the fourth quarter of 2015, reflecting a greater number of leased aircraft, primarily Airbus A321 and Boeing 787 aircraft, and the reclassification of certain finance leases to operating leases.

Special items

In the fourth quarter of 2016, a past service cost expense of $91 million was recorded as a special item to reflect the estimated cost of pension increases applicable to members of the Air Canada Pilots Association ("ACPA") who participate in a defined benefit plan. Certain pension plan amendments (related to maximum annual pension per year of service) are conditional on meeting defined business plan targets tied to the number of operating aircraft in the fleet by 2017, 2020 and as of 2023. The past service cost expense of $91 million represents the out-of-period expense associated with benefits granted upon signing of the ACPA collective agreement in 2014 based on management's best estimate of the probability of meeting the defined business plan targets tied to the number of operating aircraft at the respective dates. Future changes in estimates surrounding the probability of meeting future plan targets will be recorded as actuarial gains (losses). The special charge does not impact any of the Corporation's prior or current incentive compensation.

In the fourth quarter of 2015, special items increased operating expenses by $31 million. These special items included:

- One-time payments totaling $26 million related to Air Canada's contract on collective agreement terms with CUPE;
- One-time payments totaling $36 million related to Air Canada's contract on collective agreement terms with the IAMAW; and
- A $30 million recovery related to cargo investigations which had been previously paid.

Other expenses

In the fourth quarter of 2016, other expenses of $316 million increased $6 million or 2% from the fourth quarter of 2015, reflecting, in large part, the capacity growth and the impact of Air Canada's international expansion strategy.

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

(Canadian dollars in millions)	Fourth Quarter 2016	Fourth Quarter 2015	Change $	Change %
Terminal handling	$ 55	$ 53	$ 2	4
Crew cycle	44	35	9	26
Miscellaneous fees and services	43	39	4	10
Building rent and maintenance	40	37	3	8
Remaining other expenses	134	146	(12)	(8)
Total other expenses	**$ 316**	**$ 310**	**$ 6**	**2**

Non-operating expense

In the fourth quarter of 2016, non-operating expense of $196 million decreased $78 million from the fourth quarter of 2015.

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

(Canadian dollars in millions)	Fourth Quarter 2016	Fourth Quarter 2015	Fourth Quarter $ Change
Foreign exchange loss	$ (29)	$ (159)	$ 130
Interest expense, net	(62)	(66)	4
Net financing expense relating to employee benefits	(24)	(27)	3
Gain (loss) on financial instruments recorded at fair value	9	(3)	12
Gain on sale and leaseback of assets	-	-	-
Loss on debt settlements	(82)	(13)	(69)
Other	(8)	(6)	(2)
Total non-operating expense	**$ (196)**	**$ (274)**	**$ 78**

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

- In fourth quarter of 2016, losses on foreign exchange amounted to $29 million compared to losses on foreign exchange of $159 million in the fourth quarter of 2015. In the fourth quarter of 2016, foreign exchange losses on U.S. denominated long-term debt and finance leases of $133 million were partly offset by foreign exchange gains on foreign currency derivatives of $115 million. The foreign exchange losses on U.S. denominated long-term debt were attributable to a weaker Canadian dollar at December 31, 2016 when compared to September 30, 2016. The December 31, 2016 closing exchange rate was US$1 = C$1.3427 while the September 30, 2016 closing exchange rate was US$1 = C$1.3117.

- In the fourth quarter of 2016, Air Canada recorded a loss on debt settlements of $82 million which pertained to the C$1.25 billion refinancing transaction concluded on October 6, 2016. In the fourth quarter of 2015, Air Canada recorded a loss on debt settlements of $13 million related to the prepayment of debt associated with the disposal of Embraer 190 aircraft.

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, 2016. 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.

Mainline	Total Seats	Number of Operating Aircraft	Average Age	Owned	Finance Lease	Owned – Special Purpose Entities (1)	Operating Lease
Wide-body Aircraft							
Boeing 787-8	251	8	2.2	8	-	-	-
Boeing 787-9	298	13	0.9	11	-	-	2
Boeing 777-300ER	450/400	19	6.5	10	1	-	8
Boeing 777-200LR	300	6	9.1	4	-	-	2
Boeing 767-300ER	211	14	26.5	6	1	-	7
Airbus A330-300	265	8	16.2	4	-	4	-
Narrow-body Aircraft							
Airbus A321	185	15	13.7	-	-	5	10
Airbus A320	146	42	23.2	1	-	-	41
Airbus A319	120	18	18.7	5	-	-	13
Embraer 190	97	25	9.5	25	-	-	-
Total Mainline		**168**	**14.7**	**74**	**2**	**9**	**83**
Air Canada Rouge							
Wide-body Aircraft							
Boeing 767-300ER (2)	282	20	18.5	2	2	-	16
Narrow-body Aircraft							
Airbus A321	200	5	1.0	-	-	-	5
Airbus A319 (2)	136	20	18.5	17	-	-	3
Total Air Canada Rouge		**45**	**16.6**	**19**	**2**	**-**	**24**
Total Mainline and Air Canada Rouge		**213**	**15.1**	**93**	**4**	**9**	**107**

(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) *The Boeing 767 aircraft and the 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, 2016 as well as Air Canada's planned operating fleet, including aircraft currently operating and expected to be operated by Air Canada Rouge, as at December 31, 2017 and December 31, 2018.

	Actual	Planned			
	December 31, 2016	**2017 Fleet Changes**	**December 31, 2017**	**2018 Fleet Changes**	**December 31, 2018**
Mainline					
Wide-body Aircraft					
Boeing 787-8	**8**	-	**8**	-	**8**
Boeing 787-9	**13**	9	**22**	5	**27**
Boeing 777-300ER	**19**	-	**19**	-	**19**
Boeing 777-200LR	**6**	-	**6**	-	**6**
Boeing 767-300ER	**14**	(6)	**8**	(3)	**5**
Airbus A330-300	**8**	-	**8**	-	**8**
Narrow-body Aircraft					
Boeing 737 MAX-8	**-**	2	**2**	16	**18**
Airbus A321	**15**	-	**15**	-	**15**
Airbus A320	**42**	-	**42**	-	**42**
Airbus A319	**18**	-	**18**	(8)	**10**
Embraer 190	**25**	-	**25**	-	**25**
Total Mainline	**168**	5	**173**	10	**183**
Air Canada Rouge					
Wide-body Aircraft					
Boeing 767-300ER	**20**	4	**24**	1	**25**
Narrow-body Aircraft					
Airbus A321	**5**	-	**5**	-	**5**
Airbus A319	**20**	-	**20**	-	**20**
Total Air Canada Rouge	**45**	4	**49**	1	**50**
Total wide-body Aircraft	**88**	7	**95**	3	**98**
Total narrow-body Aircraft	**125**	2	**127**	8	**135**
Total Mainline and Air Canada Rouge	**213**	9	**222**	11	**233**

Air Canada expects to introduce five Boeing 787-9 aircraft into its operating fleet in 2018 and the remaining two of the 37 aircraft on order in 2019.

Air Canada expects to introduce 16 Boeing 737 MAX aircraft into its operating fleet in 2018 and the remaining 43 of the 61 aircraft on order between 2019 and 2021.

In June 2016, Air Canada and Bombardier finalized a purchase agreement which includes a firm order for 45 Bombardier C-Series CS300 aircraft and options for an additional 30 Bombardier C-Series CS300 aircraft. Deliveries are scheduled to begin in late 2019 and extend to 2022. The first 25 aircraft on delivery are expected to replace Air Canada's existing mainline fleet of Embraer 190 aircraft, with incremental aircraft supporting Air Canada's hub and network growth.

Air Canada Express

The following table provides, as at December 31, 2016, the number of aircraft operated, on behalf of Air Canada, by Jazz, Sky Regional and other airlines operating flights under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada.

	As at December 31, 2016			
	Jazz	**Sky Regional**	**Air Georgian**	**Total**
Embraer 175	-	20	-	20
Bombardier CRJ-100/200	13	-	14	27
Bombardier CRJ-705	16	-	-	16
Bombardier Dash 8-100	19	-	-	19
Bombardier Dash 8-300	26	-	-	26
Bombardier Dash 8-Q400	39	5	-	44
Total Air Canada Express	**113**	**25**	**14**	**152**

The following table provides the number of aircraft planned, as at December 31, 2017, to be operated, on behalf of Air Canada, by Jazz, Sky Regional and other airlines operating flights under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada.

	As at December 31, 2017			
	Jazz	**Sky Regional**	**Air Georgian**	**Total**
Embraer 175	-	25	-	25
Bombardier CRJ-100/200	10	-	14	24
Bombardier CRJ-705	21	-	-	21
Bombardier Dash 8-100	16	-	-	16
Bombardier Dash 8-300	26	-	-	26
Bombardier Dash 8-Q400	44	-	-	44
Total Air Canada Express	**117**	**25**	**14**	**156**

Other aircraft with CPA carriers

Air Georgian and EVAS also operate a total of 16 18-passenger Beech 1900 aircraft on behalf of Air Canada pursuant to their capacity purchase agreements with Air Canada.

9. FINANCIAL AND CAPITAL MANAGEMENT

9.1. Liquidity

Air Canada manages its liquidity needs through a variety of strategies including by seeking to sustain and improve 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), which are further discussed in sections 9.6 and 9.7 of this MD&A, as well as covenants in credit card and other agreements, discussed in section 9.8 of this MD&A. Air Canada monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available for use 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. At December 31, 2016, unrestricted liquidity amounted to $3,388 million (comprised of cash and short-term investments of $2,979 million and undrawn lines of credit of $409 million). In addition, Air Canada monitors its financial leverage as measured by the adjusted net debt to EBITDAR ratio, as further described in section 9.3 of this MD&A.

9.2. Financial Position

The following table provides a condensed consolidated statement of financial position of Air Canada as at December 31, 2016 and as at December 31, 2015.

(Canadian dollars in millions)	December 31, 2016	December 31, 2015	$ Change
Assets			
Cash, cash equivalents and short-term investments	2,979	2,672	307
Other current assets	1,368	1,453	(85)
Current assets	4,347	4,125	222
Property and equipment	8,520	7,030	1,490
Pension assets	1,153	851	302
Intangible assets	315	314	1
Goodwill	311	311	-
Deposits and other assets	468	496	(28)
Total assets	**15,114**	**13,127**	**1,987**
Liabilities			
Current liabilities	4,424	3,829	595
Long-term debt and finance leases	5,911	5,870	41
Pension and other benefit liabilities	2,436	2,245	191
Maintenance provisions	922	892	30
Other long-term liabilities	202	251	(49)
Total liabilities	**13,895**	**13,087**	**808**
Total equity	**1,219**	**40**	**1,179**
Total liabilities and equity	**15,114**	**13,127**	**1,987**

Movements in current assets and current liabilities are described in section 9.4 "Working Capital" of this MD&A. Long-term debt and finance leases are discussed in sections 9.3 "Adjusted Net Debt" and 9.5 "Consolidated Cash Flow Movements" of this MD&A.

At December 31, 2016, property and equipment amounted to $8,520 million, an increase of $1,490 million from December 31, 2015. The increase in property and equipment was mainly due to additions to property and equipment of $2,889 million, partly offset by the sale of two Boeing 787 aircraft under a sale and leaseback transaction, the disposal of 12 Embraer 190 aircraft and the impact of depreciation expense of $793 million. In 2016, additions to property and equipment included seven Boeing 787-9 aircraft (excluding the two Boeing 787 aircraft under operating lease) and two Boeing 777-300ER aircraft, progress payments on future aircraft deliveries and capitalized maintenance costs.

The net long-term pension and other benefit liabilities of $1,283 million (comprised of pension and other benefit liabilities of $2,436 million net of pension assets of $1,153 million) decreased $111 million from December 31, 2015. This decrease was mainly due to strong investment returns on pension plan assets, partly offset by the impact of a 20 basis point decrease in the discount rate used to value the liabilities, resulting in a net gain on remeasurements on employee benefit liabilities of $412 million recorded in other comprehensive income for 2016.

9.3. Adjusted Net Debt

The following table reflects Air Canada's adjusted net debt balances as at December 31, 2016 and as at December 31, 2015.

(Canadian dollars in millions, except where indicated)	December 31, 2016	December 31, 2015	$ Change
Total long-term debt and finance leases	$ 5,911	$ 5,870	$ 41
Current portion of long-term debt and finance leases	707	524	183
Total long-term debt and finance leases, including current portion	6,618	6,394	224
Less cash, cash equivalents and short-term investments	(2,979)	(2,672)	(307)
Net debt	**$ 3,639**	**$ 3,722**	**$ (83)**
Capitalized operating leases (1)	3,451	2,569	882
Adjusted net debt	**$ 7,090**	**$ 6,291**	**$ 799**
EBITDAR (trailing 12 months)	**$ 2,768**	**$ 2,542**	**$ 226**
Adjusted net debt to EBITDAR ratio (2)	**2.6**	**2.5**	**0.1**

(1) *Adjusted net debt is an additional GAAP financial measure and 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. 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 (including aircraft rent expense related to regional airline operations) was $493 million for the 12 months ended December 31, 2016 and $367 million for the 12 months ended December 31, 2015.*

(2) *Adjusted net debt to trailing 12-month EBITDAR ratio (also referred to as "leverage ratio" in this MD&A) is a non-GAAP financial measure and is used by Air Canada as a means to measure financial leverage. Leverage ratio is calculated by dividing adjusted net debt by trailing 12-month EBITDAR. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.*

At December 31 2016, total long-term debt and finance leases (including current portion) of $6,618 million increased $224 million from December 31, 2015. In 2016, new borrowings amounting to $2,538 million were partly offset by debt repayments of $2,275 million and the favourable $126 million impact of a stronger Canadian dollar as at December 31, 2016 compared to December 31, 2015, on Air Canada's foreign currency denominated debt and finance leases (mainly U.S. dollars).

In October 2016, Air Canada completed a private offering of senior secured notes and a new credit facility in connection with a $1.25 billion refinancing transaction. In connection with this transaction, new debt was issued and together with cash of $444 million, existing debt of $1,674 million was redeemed (including redemption fees of $61 million). Refer to Note 7 of Air Canada's audited consolidated financial statements for 2016 for additional information. In 2016, remaining borrowings and debt repayments were mainly related to aircraft financings.

Adjusted net debt amounted to $7,090 million at December 31, 2016, an increase of $799 million from December 31, 2015. This increase in adjusted net debt reflected higher long-term debt and financial lease balances as discussed above, as well as a higher capitalized operating lease balance, which was mainly driven by additional aircraft leases and an unfavourable currency impact on aircraft rent expense. These increases were partly offset by the impact of higher cash and short-term investment balances year-over-year. At December 31, 2016, the adjusted net debt to EBITDAR ratio was 2.6 versus 2.5 as at December 31, 2015.

At December 31, 2016, Air Canada's weighted average cost of capital ("WACC"), on a pre-tax basis, was approximately 7.9% (compared to approximately 9.6% at December 31, 2015). WACC is based on an estimate by management and consists of an estimated cost of equity of 21.1% and an average cost of debt and finance leases of 4.6% (compared to an estimated cost of equity of 23.6% and an average cost of debt and finance leases of 5.4% at December 31, 2015).

9.4. Working Capital

The following table provides information on Air Canada's working capital balances as at December 31, 2016 and as at December 31, 2015.

(Canadian dollars in millions)	December 31, 2016	December 31, 2015	$ Change
Cash, cash equivalents and short-term investments	$ 2,979	$ 2,672	$ 307
Accounts receivable	707	654	53
Other current assets	661	799	(138)
Total current assets	**$ 4,347**	**$ 4,125**	**$ 222**
Accounts payable and accrued liabilities	1,644	1,487	157
Advance ticket sales	2,073	1,818	255
Current portion of long-term debt and finance leases	707	524	183
Total current liabilities	**$ 4,424**	**$ 3,829**	**$ 595**
Net working capital	**$ (77)**	**$ 296**	**$ (373)**

The net negative working capital of $77 million at December 31, 2016 represented a decrease of $373 million from December 31, 2015. This decrease in net working capital was largely due to the use of $444 million of cash to repay long-term debt in connection with the $1.25 billion refinancing transaction completed in October 2016, as further discussed above. The impact of capital expenditures of $2,921 million resulted in a net cash outflow of $1,262 million (after deducting the financing drawn or sale-leaseback proceeds received relating to the delivery of nine Boeing 787 aircraft and two Boeing 777 aircraft) and was more than offset by the cash flow benefit of positive operating results in 2016.

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)	**2016**	**2015**	**$ Change**	**2016**	**2015**	**$ Change**
Net cash flows from operating activities	**$ 351**	**$ 251**	**$ 100**	**$ 2,421**	**$ 2,025**	**$ 396**
Proceeds from borrowings	1,230	314	916	2,538	905	1,633
Reduction of long-term debt and finance lease obligations	(1,807)	(321)	(1,486)	(2,275)	(707)	(1,568)
Shares purchased for cancellation	(5)	(21)	16	(94)	(63)	(31)
Distributions related to aircraft special purpose leasing entities	-	(42)	42	(32)	(51)	19
Issue of shares	1	1	-	2	4	(2)
Financing fees	-	(9)	9	(2)	(32)	30
Net cash flows from (used in) financing activities	**$ (581)**	**$ (78)**	**$ (503)**	**$ 137**	**$ 56**	**$ 81**
Short-term investments	238	119	119	(99)	(398)	299
Additions to property, equipment and intangible assets	(230)	(614)	384	(2,921)	(1,815)	(1,106)
Proceeds from sale of assets	3	6	(3)	352	23	329
Proceeds from sale and leaseback of assets	-	-	-	351	-	351
Other	(16)	(21)	5	(9)	2	(11)
Net cash flows used in investing activities	**$ (5)**	**$ (510)**	**$ 505**	**$ (2,326)**	**$ (2,188)**	**$ (138)**
Effect of exchange rate changes on cash and cash equivalents	**$ 5**	**$ (1)**	**$ 6**	**$ (17)**	**$ 18**	**$ (35)**
Increase (decrease) in cash and cash equivalents	**$ (230)**	**$ (338)**	**$ 108**	**$ 215**	**$ (89)**	**$ 304**

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

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2016**	**2015**	**$ Change**	**2016**	**2015**	**$ Change**
Net cash flows from operating activities	**$ 351**	**$ 251**	**$ 100**	**$ 2,421**	**$ 2,025**	**$ 396**
Additions to property, equipment and intangible assets, net of proceeds from sale-leaseback transactions	(230)	(614)	384	(2,570)	(1,815)	(755)
Free cash flow (1)	**$ 121**	**$ (363)**	**$ 484**	**$ (149)**	**$ 210**	**$ (359)**

(1) Free cash flow is a non-GAAP financial measure used by Air Canada as an indicator of the financial strength and performance of its business, indicating how much cash it is able to generate from operations and after capital expenditures. Free cash flow is calculated as net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale-leaseback transactions. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

Net cash flows from operating activities and free cash flow

In 2016, net cash flows from operating activities of $2,421 million increased $396 million from 2015. This improvement was due to higher cash earnings (consistent with the growth in EBITDAR of $226 million) and pension funding payments that were $215 million lower in 2016 versus 2015, as further described in section 9.7 of this MD&A. Negative free cash flow of $149 million represented a decrease in free cash flow of $359 million due to a higher level of capital expenditures year-over-year, partly offset by the impact of higher cash flows from operating activities.

In the fourth quarter of 2016, net cash flows from operating activities of $351 million increased $100 million from the same quarter in 2015, mainly due to higher cash earnings and lower pension funding payments, as further described above. Free cash flow of $121 million represented an increase in free cash flow of $484 million due to a lower level of capital expenditures year-over-year, as well as the impact of higher cash flows from operating activities.

9.6. Capital Expenditures and Related Financing Arrangements

Boeing 787 Aircraft

As of the date of this MD&A, Air Canada had outstanding purchase commitments with Boeing for 13 Boeing 787 aircraft (six of which remain to be delivered in 2017, five in 2018 and two in 2019). Air Canada 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).

Subject to certain conditions, as at the date of this MD&A, Air Canada had various financing or sale and leaseback commitments covering up to 10 of the remaining 13 Boeing 787 firm aircraft orders, which are summarized as follows:

- For seven of the Boeing 787 aircraft, which are scheduled for delivery by 2019, the financing terms are for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments.

- Sale and leaseback transactions with third parties for three Boeing 787 aircraft scheduled for delivery in 2017.

Boeing 737 Aircraft

Air Canada has an agreement with Boeing for the purchase of Boeing 737 MAX aircraft which provides for:

- 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.

- Purchase options for 18 Boeing 737 aircraft.

- Certain rights to purchase an additional 30 Boeing 737 aircraft.

Deliveries of Boeing 737 MAX aircraft are scheduled to begin in 2017 with two aircraft, with the remaining deliveries between 2018 and 2021, subject to deferral and acceleration rights.

Air Canada has financing commitments, subject to certain conditions, covering all 61 of the Boeing 737 MAX firm aircraft orders. The financing terms are for 80% of the aircraft delivery price and the term to maturity is 10 years with mortgage-style repayments.

Bombardier C-Series CS 300 Aircraft

In June 2016, Air Canada and Bombardier finalized a purchase agreement which includes a firm order for 45 Bombardier C-Series CS300 aircraft and options for an additional 30 Bombardier CS300 aircraft. Deliveries are scheduled to begin in late 2019 and extend to 2022.

Capital Commitments

As outlined in the table below, the estimated aggregate cost of the future firm Boeing 787, Boeing 737 MAX and Bombardier C-Series CS300 aircraft deliveries and other capital purchase commitments as at December 31, 2016 approximates $8,433 million.

(Canadian dollars in millions)	2017	2018	2019	2020	2021	Thereafter	Total
Projected committed expenditures	$ 2,142	$ 1,785	$ 1,408	$ 1,438	$ 1,057	$ 603	$ 8,433
Projected planned but uncommitted expenditures	238	283	391	374	443	Not available	Not available
Projected planned but uncommitted capitalized maintenance (1)	140	122	114	117	121	Not available	Not available
Total projected expenditures (2)	**$ 2,520**	**$ 2,190**	**$ 1,913**	**$ 1,929**	**$ 1,621**	**Not available**	**Not available**

(1) Future capitalized maintenance amounts for 2020 and 2021 and beyond are not yet determinable, however estimates of $117 million and $121 million, respectively, have been made for 2020 and 2021.

(2) U.S. dollar amounts are converted using the December 31, 2016 closing exchange rate of US$1 = C$1.3427. 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, 2016.

9.7. Pension Funding Obligations

Air Canada maintains several defined benefit pension plans, including domestic registered pension plans, supplemental pension plans and international pension plans. Air Canada also has several defined contribution pension plans as well as plans providing other retirement and post-employment benefits to its employees.

Total employer pension funding contributions in 2016 amounted to $97 million.

(Canadian dollars in millions)	2016
Past service domestic registered plans	$ 7
Current service domestic registered plans	12
Other pension arrangements (1)	78
Total employer pension funding contributions	**$ 97**

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

As at January 1, 2016, the aggregate solvency surplus in the domestic registered pension plans was $1.3 billion. Based on preliminary estimates, including actuarial assumptions, as at January 1, 2017, the aggregate solvency surplus in Air Canada's domestic registered pension plans is projected to be $1.5 billion. The final valuations to be made as at January 1, 2017 will be completed in the first half of 2017. Assuming final valuations confirm that Air Canada's domestic registered pension plans are in a solvency surplus position as at January 1, 2017, Air Canada does not expect any past service cost payments in 2017.

As permitted by applicable legislation and subject to applicable plan rules, amounts in excess of 105% on a solvency basis may be used to reduce current service contributions under the defined benefit component or to fund the employer contribution to a defined contribution component within the same pension plan. As a result, total employer pension funding contributions during 2016 (including the international and supplemental plans) amounted to $97 million. Air Canada does not intend to make current service cost payments for 2017 for plans for which it is allowed to not do so. Taking this into account, on a cash basis, total pension funding contributions for 2017 are forecasted to be $90 million, as described in the table below.

(Canadian dollars in millions)	**2017**
Past service domestic registered plans	$ -
Current service domestic registered plans	1
Other pension arrangements (1)	89
Total projected employer pension funding contributions	**$ 90**

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

As at December 31, 2016, taking into account the effect of financial instrument risk management tools, approximately 75% of Air Canada's pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk. Air Canada may continue to increase the percentage of pension liabilities being matched with fixed income products, subject to favourable market conditions.

Refer to the "Pension Plans" discussion in section 17 "Risk Factors" of this MD&A for additional information and a discussion of important risks relating to Air Canada pension funding obligations.

9.8. Contractual Obligations

C$1.25 Billion Refinancing Transaction

On October 6, 2016, Air Canada completed a private offering of senior secured notes and a new credit facility in connection with its C$1.25 billion refinancing transaction. As part of this transaction, Air Canada entered into a purchase agreement with a syndicate of initial purchasers relating to a private offering of C$200 million aggregate principal amount of 4.75% senior secured first lien notes due 2023 (the "2016 Senior Notes"), which were sold at par. Air Canada also received proceeds of a US$800 million term loan, maturing in 2023, and entered into a new, US$300 million revolving credit facility expiring in 2021 (collectively with the term loan, the "2016 Credit Facility"). The revolving credit facility, which remained undrawn as of December 31, 2016, has an initial interest rate of 275 basis points over LIBOR (subject to a LIBOR floor of 75 basis points).

Air Canada used the net proceeds from the sale of the 2016 Senior Notes, together with the borrowings under the term loan under the 2016 Credit Facility, and $444 million of cash on hand, to pay the redemption price for all of Air Canada's then outstanding senior secured notes (the "2013 Secured Notes"), and to repay Air Canada's then outstanding US$300 million term loan.

In conjunction with such repayment and redemption, a loss on debt settlements of $82 million was recorded in the fourth quarter of 2016.

The table below provides Air Canada's contractual obligations as at December 31, 2016, including those relating to interest and principal repayment obligations on Air Canada's long-term debt and finance lease obligations, operating lease obligations and committed capital expenditures.

(Canadian dollars in millions)	2017	2018	2019	2020	2021	Thereafter	Total
Principal							
Long-term debt obligations	$ 666	$ 679	$ 514	$ 522	$ 872	$ 3,194	$ 6,447
Finance lease obligations	41	49	46	50	17	72	275
Total principal obligations	**$ 707**	**$ 728**	**$ 560**	**$ 572**	**$ 889**	**$ 3,266**	**$ 6,722**
Interest							
Long-term debt obligations	$ 266	$ 222	$ 207	$ 179	$ 134	$ 330	$ 1,338
Finance lease obligations	23	19	15	10	5	20	92
Total interest obligations	**$ 289**	**$ 241**	**$ 222**	**$ 189**	**$ 139**	**$ 350**	**$ 1,430**
Total long-term debt and finance lease obligations	**$ 996**	**$ 969**	**$ 782**	**$ 761**	**$ 1,028**	**$ 3,616**	**$ 8,152**
Operating lease obligations	**$ 572**	**$ 507**	**$ 420**	**$ 305**	**$ 206**	**$ 508**	**$ 2,518**
Committed capital expenditures	**$ 2,142**	**$ 1,785**	**$ 1,408**	**$ 1,438**	**$ 1,057**	**$ 603**	**$ 8,433**
Total contractual obligations (1)	**$ 3,710**	**$ 3,261**	**$ 2,610**	**$ 2,504**	**$ 2,291**	**$ 4,727**	**$ 19,103**

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

Covenants in Credit Card Agreements

Air Canada's principal credit card processing agreements for credit card processing services contain triggering events upon which Air Canada would be required to provide the applicable credit card processor with cash deposits. The obligations 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 Air Canada. In 2016, Air Canada made no cash deposits under these agreements (nil in 2015).

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:

	December 31, 2016	December 31, 2015
Issued and outstanding shares		
Class A variable voting shares	86,657,994	98,059,765
Class B voting shares	186,554,808	184,722,413
Total issued and outstanding shares	**273,212,802**	**282,782,178**
Class A variable voting and Class B voting shares potentially issuable		
Stock options	8,985,958	8,735,634
Total shares potentially issuable	**8,985,958**	**8,735,634**
Total outstanding and potentially issuable shares	**282,198,760**	**291,517,812**

Issuer Bid

Following receipt of approvals from the Toronto Stock Exchange ("TSX"), in May 2015, Air Canada implemented a normal course issuer bid that expired May 28, 2016, to purchase for cancellation, up to 10 million Class B voting shares and Class A variable voting shares (collectively the "Shares") of Air Canada, and in March 2016, added five million Shares to the normal course issuer bid.

Following the conclusion of this normal course issuer bid, in May 2016, Air Canada received TSX approval and implemented a new normal course issuer bid, authorizing, between May 30, 2016 and May 29, 2017, the purchase of up to 22,785,511 Shares, representing 10% of the public float as at May 16, 2016.

In 2016, pursuant to these normal course issuer bids, the Corporation purchased, for cancellation, 10,768,465 Shares at an average cost of $8.77 per Share for aggregate consideration of $94 million. At December 31, 2016, a total of 18,333,111 Shares remain available for repurchase under the existing normal course issuer bid.

10. QUARTERLY FINANCIAL DATA

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

	2015				2016			
(Canadian dollars in millions, except where indicated)	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Passenger	$ 2,786	$ 3,082	$ 3,716	$ 2,836	$ 2,864	$ 3,143	$ 4,106	$ 3,035
Cargo	129	123	119	135	116	111	130	155
Other	334	209	188	211	363	204	215	235
Operating revenues	**3,249**	**3,414**	**4,023**	**3,182**	**3,343**	**3,458**	**4,451**	**3,425**
Aircraft fuel	592	648	697	527	446	527	708	598
Regional airlines expense								
Aircraft fuel	86	97	95	81	64	77	96	90
Other	466	497	489	468	505	501	543	532
Wages, salaries & benefits	568	568	598	590	608	611	658	633
Airport and navigation fees	185	201	223	193	198	211	247	203
Aircraft maintenance	188	190	192	203	217	239	227	197
Depreciation, amortization and impairment	153	177	165	160	182	202	220	212
Sales and distribution costs	154	152	157	145	182	170	179	172
Ground package costs	181	84	63	87	231	85	72	101
Aircraft rent	82	84	89	98	112	112	118	120
Food, beverages and supplies	62	80	91	81	77	86	104	82
Communications and IT	57	52	52	50	67	59	56	60
Special items	-	(23)	-	31	-	-	-	91
Other	275	284	297	310	300	301	327	316
Operating expenses	**3,049**	**3,091**	**3,208**	**3,024**	**3,189**	**3,181**	**3,555**	**3,407**
Operating income	**200**	**323**	**815**	**158**	**154**	**277**	**896**	**18**
Foreign exchange gain (loss)	(408)	56	(251)	(159)	50	(17)	(42)	(29)
Interest income	9	12	12	13	10	13	12	13
Interest expense	(90)	(94)	(106)	(99)	(96)	(98)	(97)	(83)
Interest capitalized	9	21	20	20	23	15	12	8
Net financing expense relating to employee benefits	(25)	(25)	(28)	(27)	(18)	(17)	(17)	(24)
Gain (loss) on financial instruments recorded at fair value	1	5	(20)	(3)	(10)	(1)	6	9
Gain on sale and leaseback of assets	-	-	-	-	-	19	-	-
Loss on debt settlements	-	-	-	(13)	(6)	(1)	-	(82)
Other	(5)	(2)	(5)	(6)	(6)	(4)	(2)	(8)
Total non-operating expense	**(509)**	**(27)**	**(378)**	**(274)**	**(53)**	**(91)**	**(128)**	**(196)**
Income (loss) before income taxes	$ (309)	$ 296	$ 437	$ (116)	$ 101	$ 186	$ 768	$ (178)
Income taxes	-	-	-	-	-	-	-	(1)
Net income (loss)	**$ (309)**	**$ 296**	**$ 437**	**$ (116)**	**$ 101**	**$ 186**	**$ 768**	**$ (179)**
Diluted earnings (loss) per share	**$ (1.08)**	**$ 1.00**	**$ 1.48**	**$ (0.41)**	**$ 0.35**	**$ 0.66**	**$ 2.74**	**$ (0.66)**
EBITDAR [(1)]	**$ 442**	**$ 568**	**$ 1,076**	**$ 456**	**$ 460**	**$ 605**	**$ 1,248**	**$ 455**
Adjusted net income [(1)]	**$ 122**	**$ 250**	**$ 734**	**$ 116**	**$ 85**	**$ 203**	**$ 821**	**$ 38**
Adjusted earnings per share – diluted [(1)]	**$ 0.41**	**$ 0.85**	**$ 2.50**	**$ 0.40**	**$ 0.30**	**$ 0.72**	**$ 2.93**	**$ 0.14**

(1) EBITDAR, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 19 "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.

	2015				2016			
System	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Passenger PRASM (cents)	14.9	15.0	15.5	14.7	14.1	13.8	14.2	13.5
CASM (cents)	16.6	15.4	13.6	16.0	16.1	14.2	12.5	15.4
Adjusted CASM (cents) (1)	11.9	11.3	10.0	12.2	12.3	11.2	9.4	11.4
Economic fuel price per litre (cents) (2)	66.3	66.9	61.4	58.6	48.1	52.2	55.2	59.4

(1) Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.
(2) Includes aircraft fuel expense related to regional airline operations and fuel handling expenses. Economic fuel price per litre is a non-GAAP financial measure. Refer to section 6 "Results of Operations" of this MD&A for additional information.

The following table provides Air Canada's revenue passenger miles (RPMs), available seat miles (ASMs) and passenger load factors, on a system-basis and by market, for the last eight quarters.

	2015				2016			
System	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
RPMs (millions)	14,937	16,845	20,462	15,301	16,092	18,418	24,328	17,643
ASMs (millions)	18,335	20,132	23,535	18,869	19,833	22,344	28,458	22,091
Passenger load factor (%)	81.5%	83.7%	86.9%	81.1%	81.1%	82.4%	85.5%	79.9%
Domestic								
RPMs (millions)	3,805	4,525	5,606	4,291	3,960	4,717	6,068	4,534
ASMs (millions)	4,657	5,433	6,649	5,222	4,952	5,678	7,066	5,510
Passenger load factor (%)	81.7%	83.3%	84.3%	82.2%	80.0%	83.1%	85.9%	82.3%
U.S. transborder								
RPMs (millions)	3,191	2,804	2,992	2,768	3,376	3,107	3,613	3,182
ASMs (millions)	3,883	3,384	3,539	3,493	4,278	3,799	4,223	3,985
Passenger load factor (%)	82.2%	82.9%	84.5%	79.2%	78.9%	81.8%	85.6%	79.9%
Atlantic								
RPMs (millions)	2,938	4,864	6,792	3,719	3,401	5,394	8,270	4,437
ASMs (millions)	3,860	5,839	7,640	4,755	4,383	6,805	9,785	5,778
Passenger load factor (%)	76.1%	83.3%	88.9%	78.2%	77.6%	79.3%	84.5%	76.8%
Pacific								
RPMs (millions)	3,026	3,432	3,877	3,202	3,218	3,902	5,002	3,959
ASMs (millions)	3,621	4,000	4,318	3,773	3,732	4,496	5,821	4,977
Passenger load factor (%)	83.6%	85.8%	89.8%	84.9%	86.2%	86.8%	85.9%	79.6%
Other								
RPMs (millions)	1,977	1,220	1,195	1,322	2,137	1,298	1,375	1,531
ASMs (millions)	2,314	1,476	1,389	1,626	2,488	1,566	1,563	1,841
Passenger load factor (%)	85.4%	82.6%	86.0%	81.3%	85.8%	82.9%	87.9%	83.1%

11. SELECTED ANNUAL INFORMATION

The following table provides selected annual information for Air Canada for the years 2014 through to 2016.

	Full Year		
(Canadian dollars in millions, except per share figures)	**2016**	**2015**	**2014**
Operating revenues	$ 14,677	$ 13,868	$ 13,272
Operating expenses (1)	13,332	12,372	12,457
Operating income	**1,345**	**1,496**	**815**
Total non-operating expense and income taxes (2)	(469)	(1,188)	(710)
Net income	**876**	**308**	**105**
EBITDAR (3)	**$ 2,768**	**$ 2,542**	**$ 1,660**
Adjusted net income (3)	**$ 1,147**	**$ 1,222**	**$ 531**
Basic earnings per share	**$ 3.16**	**$ 1.06**	**$ 0.35**
Diluted earnings per share	**$ 3.10**	**$ 1.03**	**$ 0.34**
Adjusted earnings per share – diluted (3)	**$ 4.06**	**$ 4.18**	**$ 1.81**
Cash, cash equivalents and short-term investments	**$ 2,979**	**$ 2,672**	**$ 2,275**
Total assets	**$ 15,146**	**$ 13,127**	**$ 10,648**
Total long-term liabilities (4)	**$ 10,178**	**$ 9,782**	**$ 8,728**
Total liabilities	**$ 13,895**	**$ 13,087**	**$ 11,781**

(1) *In 2016, Air Canada recorded a special item which increased operating expenses by $91 million. In 2015, Air Canada recorded special items which increased operating expenses by $8 million and recorded impairment charges totaling $14 million. Refer to section 6 of this MD&A for additional information. In 2014, Air Canada recorded special items which reduced operating expenses by $11 million.*

(2) *In 2016, Air Canada recorded a loss on debt settlements of $89 million of which $82 million was related to a $1.25 billion refinancing transaction and $7 million was related to the prepayment of debt associated with the disposal of Embraer 190 aircraft. In 2015, Air Canada recorded a loss on debt settlements of $13 million related to the prepayment of debt associated with the disposal of Embraer 190 aircraft.*

(3) *EBITDAR, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.*

(4) *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 gains (losses) 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)	**2016**	2015	**2016**	2015
Fuel derivatives	$ -	$ -	$ -	$ (11)
Share forward contracts	9	(4)	9	(9)
Prepayment options on senior secured notes	-	1	(5)	1
Interest rate swaps	-	-	-	2
Financial instruments recorded at fair value	**$ 9**	**$ (3)**	**$ 4**	**$ (17)**

Risk Management

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

As noted below, Air Canada uses derivative instruments to provide economic hedges to mitigate certain risks. The fair values of these instruments 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. The 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 techniques incorporate all factors that would be considered in setting a price, including Air Canada's and the counterparty's respective credit risk.

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 may use derivative contracts based on jet fuel, heating oil and crude-oil. Air Canada's policy permits hedging of up to 75% of the projected jet fuel purchases required 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. Air Canada performs regular reviews to assess market conditions and adjust its hedging strategy where management considers it warranted.

In 2016:

- Air Canada recorded hedging gains on the settlement of fuel derivatives of $23 million and the associated premium costs of $46 million, for a net hedging loss of $23 million which was reclassified from other comprehensive income to aircraft fuel expense (net fuel hedging loss of $10 million was reclassified from other comprehensive income to aircraft fuel expense in 2015). No hedge ineffectiveness was recorded. For derivatives not designated under hedge accounting, a loss of $11 million was recorded in gain (loss) on financial instruments recorded at fair value in 2015 on Air Canada's consolidated statement of operations.

- Air Canada purchased crude-oil call options covering a portion of its 2016 and 2017 fuel exposure. The cash premium related to these contracts was $34 million ($39 million in 2015 for 2015 and 2016 exposures).

- Fuel derivative contracts cash settled with a fair value of $23 million in favour of Air Canada ($1 million in favour of Air Canada in 2015).

As of December 31, 2016, approximately 9% of Air Canada's anticipated purchases of jet fuel for 2017 are hedged at an average West Texas Intermediate ("WTI") equivalent capped price of US$52 per barrel for WTI prices up to US$57 per barrel and at an average equivalent capped price of US$57 per barrel for WTI prices above US$63 per barrel. Air Canada's contracts to hedge anticipated jet fuel purchases over the 2017 period are comprised of call options with notional volumes of 2,973,000 barrels. The fair value of the fuel derivatives portfolio at December 31, 2016 is $14 million in favour of Air Canada (2015 – $10 million in favour of Air Canada) and is recorded within prepaid expenses and other current assets on Air Canada's consolidated statement of financial condition.

Foreign Exchange Risk Management

Air Canada's financial results are reported in Canadian dollars, while a large portion of its expenses, debt obligations and capital commitments are in foreign currencies, primarily U.S. dollars. Foreign exchange risk is the risk that fluctuations in foreign exchange rates may have on 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 generates certain sales in U.S. dollars and in other foreign currencies which are converted to U.S. dollars under Air Canada's risk management program. In 2016, these net operating cash inflows totaled approximately US$3.2 billion. Also in 2016, U.S. denominated operating costs amounted to approximately US$3.5 billion. Non-operating cash outflows in U.S. dollars, primarily related to interest payments on U.S. dollar denominated debt and net financing outflows amounted to approximately US$1.8 billion. For 2016, this resulted in a U.S. dollar net cash flow exposure of approximately US$2.1 billion. Air Canada has a target coverage of 70% on a rolling 18 month basis to manage the net U.S. dollar cash flow exposure described above utilizing the following risk management strategies:

Air Canada holds U.S. cash reserves as an economic hedge against changes in the value of the U.S. dollar. As at December 31, 2016, U.S. dollar cash and short-term investment balances amounted to $560 million (US$416 million) ($490 million (US$358 million) as at December 31, 2015). A portion of the cash and investment reserves are an economic hedge against long-term U.S. dollar debt while the remainder of the cash is operational cash and investment reserves which are applied against the rolling 18 month net U.S. dollar cash flow exposure. In 2016, a loss of $25 million (gain of $123 million in 2015) was recorded in foreign exchange gain (loss) on Air Canada's consolidated statement of operations reflecting the change in Canadian equivalent market value of the U.S. dollar cash and short-term investment balances held.

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 outflows, as well as the amount attributed to aircraft and debt payments. Based on the notional amount of currency derivatives outstanding at December 31, 2016, as further described below, approximately 80% of net U.S. cash outflows are hedged for 2017 and 29% for 2018, resulting in derivative coverage of 68% over the next 18 months. Operational U.S. dollar cash and investment reserves combined with derivative coverage results in a coverage of 73%.

As at December 31, 2016, Air Canada had outstanding foreign currency options and swap agreements, settling in 2017 and 2018, to purchase at maturity $2,612 million (US$1,946 million) of U.S. dollars at a weighted average rate of $1.2898 per US$1.00 (2015 – $3,234 million (US$2,337 million) with settlements in 2016 and 2017 at a weighted average rate of $1.2683 per $1.00 U.S. dollar). Air Canada also has protection in place to sell a portion of its excess Euros, Sterling, Yen, Yuan and AUD (EUR €82 million, GBP £69 million, JPY ¥2,334 million, CNY ¥53 million, and AUD $33 million) which settle in 2017 at weighted average rates of €1.1059, £1.2589, ¥0.0096, ¥0.1522 and $0.7500 per $1.00 U.S. dollar, respectively (2015 – EUR €42 million, GBP £9 million, JPY ¥2,052 million, CNY ¥288 million, and AUD $18 million with settlement in 2016 at weighted average rates of €1.1663, £1.6150, ¥0.0088, ¥0.1562 and $0.7230 respectively per $1.00 U.S. dollar).

The hedging structures put in place have various option pricing features, such as knock-out terms and profit cap limitations, and based on the assumed volatility used in the fair value calculation, the net fair value of these foreign currency contracts as at December 31, 2016 was $5 million in favour of Air Canada (2015 – $89 million in favour of Air Canada). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During 2016, a loss of $136 million was recorded in Foreign exchange gain (loss) related to these derivatives (2015 – $164 million gain). In 2016, foreign exchange derivative contracts cash settled with a net fair value of $51 million in favour of the counterparties ($104 million in 2015 in favour of the Air Canada). The total combined loss, related to U.S. cash, investments and foreign exchange derivatives recorded by Air Canada in 2016 was $160 million ($287 million gain in 2015).

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 cash and 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 Air Canada's capital structure and is based upon a long-term objective of 60% fixed and 40% floating but allows the flexibility to adjust to prevailing market conditions. The ratio at December 31, 2016, was 76% fixed and 24% floating (79% and 21%, respectively, as at December 31, 2015).

13. CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

Critical accounting estimates are those estimates of management 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 and judgments about the effect of matters that are inherently uncertain. Actual results could differ from those estimates and judgments under different assumptions or conditions.

Air Canada has identified the following areas that depend on 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 and employment 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	
	2016	**2015**	**2016**	**2015**
Discount rate used to determine:				
Net interest on the net benefit obligation for the year ended December 31	4.1%	4.0%	4.1%	3.9%
Service cost for the year end December 31	4.3%	4.2%	4.3%	4.1%
Accrued benefit obligation as at December 31	3.9%	4.1%	3.9%	4.1%
Rate of future increases in compensation used to determine:				
Accrued benefit cost for the year ended December 31	2.5%	2.5%	not applicable	not applicable
Accrued benefit obligation as at December 31	2.5%	2.5%	not applicable	not applicable

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 that used for calculating the liability recognized in the consolidated statement of financial position.

Sensitivity analysis on 2016 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	$ 19	$ (18)
Net financing expense relating to pension benefit liabilities	22	(18)
Total	**$ 41**	**$ (36)**
Increase (decrease) in pension obligation	**$ 678**	**$ (655)**

The increase (decrease) in the pension obligation for a 0.25 percentage point change in the discount rate relates to the gross amount of the pension liabilities and is before the impact of any change in plan assets. As at December 31, 2016, approximately 75% of Air Canada's pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk.

An increase of one year life expectancy would increase the pension benefit obligation by $465 million.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 5.8% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2016 (2015 – 5.5%). The rate is assumed to decrease to 5% by 2020 (2015 – assumed to decrease gradually to 5% by 2019). 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 $62 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 $62 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 $55 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 $43 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. When required, 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 dispose 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 value 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 $16 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 $51 million at December 31, 2016 and an increase to maintenance expense in 2017 of approximately $7 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 $17 million at December 31, 2016. Due to low market rates of interest, a 1% decrease in discount rates was not considered a reasonable scenario.

Income taxes

Deferred income tax assets are recognized only to the extent that it is probable that future taxable income will be available to realize them. In making this assessment, consideration is given to available positive and negative evidence and relevant assumptions. Consideration is given to, among other things, future projections of taxable income, overall business environment, historical financial results, and industry-wide trends and outlooks. At December 31, 2016, no deferred income tax assets were recorded. Income for 2016 and the previous year provides positive evidence, however based upon the weight of other factors, in particular historical financial results for Air Canada and the airline industry's historically cyclical results, determination was made that deferred income tax assets could not be recorded at December 31, 2016. Air Canada's income position and income trend will continue to be evaluated to assess the realizability of the deferred income tax assets.

14. ACCOUNTING POLICIES

Accounting Standards and Amendments Issued but Not Yet Adopted

The following is an overview of accounting standard changes that Air Canada will be required to adopt in future years. Air Canada continues to evaluate the impact of these standards on its consolidated financial statements.

IFRS 15 – Revenue from Contracts with Customers

IFRS 15 replaces IAS 18 Revenue and related interpretations. The core principle of the new standard is to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new standard is intended to enhance disclosures about revenue, provide more comprehensive guidance for transactions that were not previously addressed and improve guidance for multiple-element arrangements. IFRS 15 is effective for annual periods beginning on January 1, 2018, with early adoption permitted.

Air Canada will apply the standard effective January 1, 2018. The standard will be applied retrospectively with adjustment to the opening consolidated statement of financial position as at January 1, 2017. Under IFRS 15, incremental costs of obtaining passenger revenues, such as credit card fees and global distribution system charges, will be capitalized at time of sale and expensed at the time of passenger revenue recognition. Currently, these costs are expensed as incurred at the time the flight ticket is sold. With this change in accounting policy for contract costs, the timing of expense recognition will be impacted. Air Canada continues to evaluate the financial impact of this expected change to capitalize contract costs along with other possible impacts of this standard on its consolidated financial statements.

IFRS 16 – Leases

IFRS 16 replaces IAS 17 Leases and related interpretations. The core principle is that a lessee recognize assets and liabilities for all leases with a lease term of more than 12 months. A lessee is required to recognize a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments. Assets and liabilities arising from a lease are initially measured on a present value basis. The measurement includes non-cancellable lease payments (including inflation-linked payments), and also includes payments to be made in optional periods if the lessee is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease. The new standard is intended to provide a faithful representation of leasing transactions, in particular those that do not currently require the lessees to recognize an asset and liability arising from an operating lease. IFRS 16 is effective for annual periods beginning on January 1, 2019, with early adoption permitted for entities that would also apply IFRS 15 Revenue from Contracts with Customers.

Air Canada continues to evaluate the impact the adoption of this standard will have on its consolidated financial statements, but expects this standard will have a significant impact on its consolidated balance sheet, along with a change to the recognition, measurement and presentation of lease expenses in the consolidated statement of operations. Air Canada expects to apply the standard with its mandatory effective date.

15. OFF-BALANCE SHEET ARRANGEMENTS

Guarantees

Guarantees in Fuel Facilities Arrangements

Air Canada participates in fuel facility arrangements operated through eight Fuel Facility Corporations, and two aircraft de-icing service facilities, along with other airlines that contract for fuel and de-icing services at various major airports in Canada. These entities operate on a cost recovery basis. The aggregate debt of these entities that has not been consolidated by Air Canada under IFRS 10 Consolidated Financial Statements is approximately $487 million as at December 31, 2016 (December 31, 2015 - $425 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 these entities 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, such as real estate leases or operating agreements, aircraft financing or leasing agreements, technical service agreements, and director/officer contracts, and other commercial 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 expects that it would be covered by insurance for most tort liabilities and certain related contractual indemnities.

16. RELATED PARTY TRANSACTIONS

At December 31, 2016, Air Canada had no transactions with related parties as defined in the CPA Handbook, except those pertaining to transactions with key management personnel in the ordinary course of their employment or directorship agreements.

17. RISK FACTORS

The risks described below should be read carefully when evaluating Air Canada's business and the forward-looking statements contained in this report and other statements Air Canada may make from time to time. Any of these risks could materially and adversely affect Air Canada's business, operating results, financial condition and the actual outcome of matters as to which forward-looking statements are made. In addition, these risks 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 not to be material may surface and have a material and adverse impact on Air Canada, its business, results from operations and financial condition.

Risks Relating to Air Canada

Operating Results - Air Canada may sustain significant losses and not be able to successfully achieve and/or sustain positive net profitability or realize the objectives of any or all of its initiatives

A variety of factors, including economic conditions and other factors described in this "Risk Factors" section, may result in Air Canada incurring significant losses (which it has incurred in the past). Despite ongoing strategic and business initiatives, including efforts at securing cost reductions, revenue improvements and international growth as well as efforts relating to its seat capacity expansion and the expansion of Air Canada Rouge, Air Canada may not be able to successfully achieve and/or sustain positive net profitability or realize the objectives of any or all of its initiatives, including those which seek to decrease costs, improve margins, profitably deploy additional capacity, generate sufficient returns on its capital expenditures (including those related to the additional capacity) or offset or mitigate risks facing Air Canada, including those relating to economic conditions, foreign exchange rates, competition, labour issues, liquidity, and volatility in fuel costs and other expenses.

Leverage - Air Canada has, and is expected to continue to incur, a significant amount of indebtedness, and there can be no assurance that it will be able to pay its debts and lease obligations

Air Canada has, and is expected to continue to have and incur, a significant amount of indebtedness, including substantial fixed obligations under aircraft leases, aircraft purchases and other financings, and as a result of any challenging economic or other conditions affecting Air Canada, Air Canada may incur greater levels of indebtedness than currently exist or are planned. The amount of indebtedness that Air Canada 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 changes in its business environment, including competitive pressures.

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 floating interest rates, to the extent these interest rates increase, its interest expense will increase. Moreover, Air Canada incurs a significant proportion of its indebtedness in foreign currencies, primarily in U.S. dollars, and as a result future debt servicing repayments are subject to foreign exchange risk and the Canadian equivalent amount of indebtedness may 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.

Foreign Exchange - A significant deterioration of the Canadian dollar relative to the U.S. dollar could have a material adverse effect on Air Canada, its business, results from operations and financial condition

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./Canadian dollar exchange rate. Air Canada incurs significant expenses in U.S. dollars for items such as fuel, aircraft maintenance, airport charges, ground package costs, sales and distribution costs, interest and debt servicing payments, while a substantial portion of its revenues are generated in Canadian dollars. Due to the competitive nature of the airline industry and customer sensitivity to travel costs, Air Canada may not be able to pass on increases in foreign exchange costs to its customers by increasing its fares. In addition, Air Canada may be unable to appropriately or sufficiently hedge the risks associated with fluctuations in exchange rates. A significant deterioration of the Canadian dollar relative to the U.S. dollar or other foreign currencies would increase the costs of Air Canada relative to its U.S. or other foreign competitors. Any of these factors could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Economic and Geopolitical Conditions - Changes in economic and geopolitical conditions could have a material adverse effect on Air Canada, its business, results from operations and financial condition

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, operating revenues (including by impacting our ability to repatriate funds from foreign jurisdictions), costs and availability of fuel, foreign exchange costs, pension plan contributions, and costs and availability of capital and supplies required by Air Canada. Especially in light of Air Canada's substantial fixed cost structure, any prolonged or significant impact arising from economic and geopolitical conditions, including weakness of the Canadian, U.S. or world economies, or threatened or actual outbreaks of hostilities in or adjacent to regions Air Canada serves or over which it operates flights (or to regions it plans to do so), 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 is also impacted by economic conditions. Depressed economic conditions in areas served by Air Canada, geopolitical instability in various areas of the world and concerns about the environmental impacts of air travel and tendencies towards "green" travel initiatives where customers reduce their travel activities, could each have the effect of reducing demand for air travel in Canada and abroad and could materially adversely impact Air Canada, its business, results of operations and financial condition.

Fuel Costs - Significant fluctuations or increases in fuel prices could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Fuel costs constitute one of Air Canada's largest operating cost items. Fuel prices have and may continue to 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. 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. In addition, Air Canada may be unable to appropriately or sufficiently hedge the risks associated with fluctuations in fuel prices. Furthermore, the impact of lower jet fuel prices could be offset by increased price competition, and a resulting decrease in revenues, for all air carriers. Significant fluctuations (including increases) in fuel prices could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Competition - Air Canada operates in a highly competitive environment and faces increasing competition in North America and internationally

Air Canada operates within a highly competitive industry and continuously encounters substantial price competition. Carriers, including low-cost carriers, have entered, announced their intention to enter or continue to enter or expand into the domestic (including regional), the U.S. transborder and international markets, as well as leisure-oriented markets in which Air Canada operates or plans to operate.

Carriers against which Air Canada competes, including U.S. carriers, may also 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 against Air Canada. Consolidation within the airline industry and carriers increasingly entering into integrated commercial cooperation arrangements, such as joint ventures, which may be able to compete more effectively, could result in increased competition.

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 has redirected appreciable passenger traffic away from Canadian airports to airports in the United States. Low-cost carriers based in the United States have and may continue to increase their capacity at these airports and attract Canadian-originating, price-sensitive customers.

Given Canada's diverse and multicultural population, Canadian gateways such as Toronto, Montreal, and Vancouver are deemed attractive by international carriers. In 2016, foreign carriers such as AeroMexico, Air China, Beijing Capital Airlines, Brussels Airlines, China Airlines, China Eastern Airlines, China Southern Airlines, EVA Air, Hainan Airlines, Hong Kong Airlines, Icelandair, WOW Air, Korean Air, TAP Portugal, Tunisair and Xiamen Air have entered or announced their intention to enter or expand their international operations into Canada.

The prevalence Internet travel websites and other travel product distribution channels has also resulted in a substantial increase in discounted and promotional fares initiated by Air Canada's competitors. Competitors also continue to pursue commissions/incentive actions and, in many cases, increase these payments.

Air Canada's ability to reduce its fares in order to effectively compete is dependent on Air Canada's ability to achieve acceptable operating margins and may be limited by government policies to encourage competition. A decision by Air Canada to match competitors' fares or react to other competitive actions could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Increased competition, from existing, emerging or new competitors, including competitors utilizing disruptive business models or technologies, and other competitive actions, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Need for Additional Capital and Liquidity - Air Canada may not be able to obtain sufficient funds in a timely way and on acceptable terms to provide adequate liquidity and to finance necessary operating and capital expenditures

Air Canada's liquidity levels may be adversely impacted by risks identified in this MD&A, including economic conditions, foreign exchange rates, increased competition from domestic, international, and U.S. transborder carriers, including low-cost carriers, volatile fuel prices, labour issues, and contractual covenants (which require Air Canada to maintain minimum cash reserves and which could require Air Canada to deposit cash collateral with third parties). As part of Air Canada's efforts to manage 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 manage any challenges and support its business strategy if cash flows from operations and liquidity levels are insufficient.

A major decline in the market price of Air Canada's securities may negatively impact Air Canada's ability to raise capital, issue debt, retain employees, make strategic acquisitions or enter into joint arrangements. Differences between Air Canada's actual or anticipated financial results and the published expectations of financial analysts, as well as events affecting our business or operating environment, may contribute to volatility in Air Canada's securities. A major decline in the capital markets in general, or an adjustment in the market price or trading volumes of Air Canada's securities, may negatively affect our ability to raise capital, issue debt, retain senior executives and other key employees, make strategic acquisitions or enter into joint arrangements.

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.

Dependence on Technology - Air Canada relies heavily on technology to operate its business and any technology systems failure or data breach could have a material adverse effect on Air Canada, its business, results from operations and financial condition

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 its airport customer services and flight operations. Air Canada also depends on the performance of its many suppliers, whose performance is in turn dependent upon their respective technology systems.

As part of regular business operations, Air Canada collects, processes and stores sensitive data, including personal information of our passengers and employees and information of our business partners. The secure operation of the networks and systems on which this type of information is stored, processed and maintained is critical to our business.

Technology systems may be vulnerable to a variety of sources of failure, interruption or misuse, including by reason of human error, third party suppliers' acts or omissions, natural disasters, terrorist attacks, telecommunications failures, power failures, computer viruses, unauthorized or fraudulent users (including cyber-attacks or cyber intrusions, malware, ransomware, computer viruses and the like), and other operational and security issues.

It is generally viewed that cyber-attacks have and will continue to increase in both prevalence and sophistication. Air Canada continually pursues and invests in initiatives, including security initiatives and disaster recovery plans; however these pursuits or initiatives may not be successful or adequate. Any technology systems failure, interruption or misuse, security breach or failure to comply with applicable data confidentiality, privacy or security obligations, whether at Air Canada or a third party on whom Air Canada relies, could adversely affect Air Canada's reputation and expose Air Canada to litigation, claims for contract breach, fines, sanctions or otherwise materially and adversely affect Air Canada's operations, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Strategic, Business, Technology and Other Important Initiatives - A delay or failure to identify and devise, invest in and implement certain important initiatives could have a material impact on Air Canada, its business, results from operations and financial condition

In order to operate its business, achieve its goals and remain competitive, Air Canada continually 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 leisure or low-cost market (including the planned growth of Air Canada Rouge), the aircraft fleet renewal program (including the scheduled delivery of Boeing 787 aircraft and the planned re-fleeting of narrow-body aircraft with Boeing 737 MAX aircraft and Bombardier C-Series aircraft), revenue enhancement initiatives, business processes, information technology, revenue management, 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 aircraft such as Boeing 787, 737 MAX aircraft and Bombardier C-Series aircraft. A delay or failure in the completion of Air Canada's fleet restructuring, including delays by suppliers involved in the delivery of these 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 could, 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 – Increases in airport user fees and air navigation fees could have a material adverse effect on Air Canada, its business, results from operation and financial condition

With the privatization of airports and air navigation authorities in Canada, airport and air navigation authorities have or could significantly increase 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.

High Fixed Costs and Low Margins – The airline industry is characterized by low profit margins and high fixed costs

The airline industry has historically been characterized by low 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, fare pricing or traffic mix could have a significant impact on Air Canada's operating and financial results. This condition may be exacerbated by aggressive pricing by competitors, which could have the effect of driving down fares in certain markets. Accordingly, a shortfall from expected revenue levels or profit margins could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Air Canada has sought an improved ability to weather downturns in its business; however such efforts may not be successful. 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 within a timeframe required to overcome any downturns, and Air Canada may also be required to incur significant termination or other restructuring costs, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key Supplies and Suppliers - Air Canada's failure or inability to obtain certain goods and services from key suppliers on favourable terms could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada is dependent upon its ability to source, on favourable terms and costs, sufficient quantities and of goods and services of desirable quality, in a timely manner, including those available at airports or from airport authorities, or otherwise required for Air Canada's business or operations, such as fuel, aircraft and related parts, aircraft maintenance services, and information technology systems and services. In certain cases, Air Canada may only be able to access goods and services from a limited number of suppliers (or from sole source suppliers) and the transition to new or alternative suppliers, which may be necessitated by reason of such suppliers increasing their rates or by their failure to perform, may not be possible or may take a significant amount of time or 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. Any failure or inability of Air Canada to successfully source goods and services, or to source goods and services of desirable quality 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.

Regional Carriers - The failure by regional carriers to fulfill their obligations to Air Canada could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada seeks to enhance its network through capacity purchase agreements with regional airlines such as Jazz, Sky Regional and other airlines operating flights on behalf of Air Canada. For example, 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 and Air Canada Rouge routes. Pursuant to the terms of the Jazz CPA, Air Canada pays Jazz a number of fees, some of which are fixed and others which are determined based upon certain costs incurred by Jazz. Air Canada also reimburses Jazz for certain pass-through costs incurred by Jazz, such as fuel, navigation, landing and terminal fees. In addition, the Jazz CPA requires that Jazz maintain a minimum fleet size and contains a minimum average daily utilization guarantee which requires Air Canada to utilize Jazz for that amount of flying. Significant increases in Jazz's costs, the failure by Jazz to adequately fulfill its obligations under the Jazz CPA, factors which may reduce the utilization of the Jazz fleet, including economic or market downturns, and unexpected interruptions or cessation of Jazz's services could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

The failure by Air Canada's other regional carriers to fulfill their obligations under their respective agreements, or unexpected interruptions or disruptions of their services, 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.

Labour Costs and Labour Relations - Air Canada may not be able to maintain labour costs at appropriate levels or secure labour agreements which permit it to successfully pursue its strategic initiatives. There can be no assurance that collective bargaining agreements will be further renewed without labour conflicts and/or disruptions

Labour costs constitute one of Air Canada's largest operating cost items. There can be no assurance that Air Canada will be able to maintain such costs at levels that do not negatively affect its business, results from operations and financial condition. Most of Air Canada's employees are unionized. While Air Canada has established long term arrangements with unions representing a significant portion of its unionized employees, 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 outcomes 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, or terms and conditions restricting or reducing, Air Canada's ability to sustain its business objectives or pursue its strategic initiatives, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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 execute on its business plans or operate its business, either of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In respect of the unions for Canadian-based employees, strikes or lock-outs may lawfully occur following the term and negotiations of the renewal of collective agreements once a number of pre-conditions prescribed by the *Canada Labour Code* have been satisfied.

Any labour disruption or work stoppage by any of the unionized work groups of Jazz or other parties with whom Air Canada conducts business or relies on 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 or involving the operations of key airports could result in lower demand for connecting traffic with Air Canada, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Air Canada's Brand – The failure to preserve or grow the value of Air Canada's brand could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada believes that its success is dependent on the value of its brand and on Air Canada's ability to preserve, grow and leverage that value. The Air Canada brand is recognized throughout the world, and Air Canada has received high ratings in external brand value studies, based in part on consumer perceptions on a variety of subjective qualities. Air Canada believes it has and continues to build an excellent reputation globally for the safety and quality of its services, and for the delivery of a consistently positive passenger experience. Any failure to preserve or grow Air Canada's brand value, including by reason of the conduct of Air Canada or any of its business partners or other external parties, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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

Air Canada maintains several defined benefit pension plans, including domestic registered pension plans, supplemental pension plans and international 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).

Air Canada's pension funding obligations (including projected funding obligations) may vary significantly based on a wide variety of factors, including pension plan solvency valuations, regulatory developments, plan demographics, changes to plan provisions, assumptions and methods used and changes in economic conditions (mainly the return on fund assets and changes in interest rates) and other factors, as well as the application of normal past service contribution rules which would generally require one fifth of any solvency deficit in a domestic registered plan, determined on the basis of an average over the previous three years, to be funded each year. Actual contributions that are determined on the basis of future valuation reports filed annually may vary significantly from projections. In addition, current service contributions in respect of a domestic registered plan are required unless they are funded (if permitted subject to applicable plan rules and legislation) through a sufficient surplus in such plan. Deteriorating economic conditions or a 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. Underfunded pension plans or a failure or inability by Air Canada to make required cash contributions to its registered pension plans could have a material adverse effect on Air Canada, its business, results from operations and financial condition. See section 9.7 "Pension Funding Obligations" of this MD&A for additional information.

Limitations Due to Restrictive Covenants - Covenants contained in agreements to which Air Canada is a party affect and, in some cases, significantly limit or prohibit the manner in which Air Canada operates its business

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. Although Air Canada has more recently been able to negotiate more favourable and less restrictive covenants, there can be no assurance that it will be able to continue to do so. Future financing and other significant agreements may be subject to similar or stricter 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 "Contractual Obligations" of this MD&A for information on Air Canada's credit card processing agreements.

Aeroplan - Failure by Aeroplan to fulfill its obligations to Air Canada or other interruptions of Aeroplan services could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada and Aeroplan are parties to a Commercial Participation and Services Agreement ("CPSA") which is set to expire in 2020. Through the CPSA, Air Canada offers its customers who are Aeroplan members the opportunity to earn Aeroplan Miles, which management believes is a significant factor in many customers' decision to travel with Air Canada and contributes to building customer loyalty. Aeroplan's failure to adequately operate the Aeroplan program, or to fulfill its obligations under the CPSA, or interruptions or disruptions of Aeroplan services, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Should the term of the CPSA not be extended, Air Canada would seek to implement an alternative program which would involve certain risks and uncertainties, including risks of transitioning Air Canada, as well as its customers who are Aeroplan members, to such other program. Though Air Canada believes it would be able to mitigate and overcome such risks and successfully transition to an alternative program, such a transition may entail risks which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Star Alliance - Departure of a key member from Star Alliance or the failure by a key member to meet its obligations could have a material adverse effect on Air Canada, its business, results from operations and financial condition

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 - Interruptions or disruptions in service could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada's business is significantly dependent upon its ability to operate without interruption to or from a number of hub airports, including Toronto Pearson. Delays or disruptions in service, including those due to security, computer malfunctions 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 - Air Canada is involved in or may be subject to legal proceedings which could materially adversely impact Air Canada

Investigations by competition authorities relating to Air Canada Cargo

The European Commission, the United States Department of Justice and the Competition Bureau in Canada investigated, 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 cooperated with these investigations, which 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 or is otherwise involved in, and may become further implicated, in a number of class action lawsuits and other proceedings in Canada, Europe and the United States in connection with these allegations. The investigations instituted by the US Department of Justice and by the Competition Bureau in Canada concluded with no proceedings having been instituted against Air Canada. 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 $29 million) was imposed on Air Canada. Air Canada appealed the 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. On December 16, 2015, the European General Court granted Air Canada's appeal and annulled the decision of the European Union with regard to Air Canada and certain other airlines. As a result of the European General Court's decision, the European Commission was required to refund Air Canada the fine of 21 million Euros ($30 million), which amount was recorded as a receivable as at December 31, 2015 and received in February 2016. Though the European Commission did not appeal the European General Court's decision, it announced its intention to issue a new decision in 2017. Air Canada cannot be certain of the impact of such decision, including as to whether it will include findings in respect of Air Canada.

As at December 31, 2016, Air Canada has a provision of $17 million ($17 million as at December 31, 2015) relating to outstanding claims in these matters, 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 remaining proceedings and investigations. Based on the outcome of any developments regarding proceedings and investigations, Air Canada 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.

Future Legal Proceedings

In the course of conducting their business, airlines are subject to various claims and litigation (including class action claims), including with respect to its contractual arrangements and current or new laws and regulations. Any future claims or litigation could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key Personnel - Air Canada is dependent on key employees and could be materially adversely affected by a shortfall or substantial turnover

Air Canada is dependent on the industry experience, qualifications and knowledge of a variety of employees, including its executive officers, managers, airline flight and operations personnel and other key employees to execute its business plan and operate its business. If Air Canada were to experience a shortfall or 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 - Terrorist attacks and related consequences could have a material adverse effect on Air Canada, its business, results from operations and financial condition

The potential for terrorist attacks and terrorist activity causes concern and uncertainty in the minds of the traveling public. The occurrence of a terrorist attack, an attempted attack or the perceived threat of one (whether or not involving Air Canada or another carrier, or involving Air Canada's destinations, or other destinations or regions), and 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, security and other costs, including higher operating costs to avoid flying over airspace near conflict zones. 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 - Epidemic diseases could impact passenger demand for air travel

Outbreaks or the threat of outbreaks of viruses or other contagions or epidemic diseases, including influenza, SARS, Ebola, Zika, as well as any travel or other advisories relating to same, whether domestic or international or whether relating to Canadian cities or regions or other cities, regions or countries, could have a material adverse effect on demand for air travel and could result in a major negative impact on traffic on Air Canada's network. 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 - Air Canada's business makes it subject to large liability claims for serious personal injury or death arising out of accidents or disasters

Due to the nature of its core 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 otherwise serviced by Air Canada or through third parties providing services to Air Canada, including claims for serious personal injury or death. Any such accident or disaster 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. 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.

Accidents and disasters may occur despite all appropriate measures being taken, and as a result of a variety of factors beyond Air Canada's control including acts of terrorism and sabotage, severe weather, lighting strikes and other natural phenomenon, bird strikes as well as the increasing prevalence of unmanned aerial vehicles.

Regulatory Matters - Air Canada is subject to extensive and evolving domestic and foreign regulation

The airline industry is subject to extensive legal, regulatory and administrative controls and oversight, including in relation to taxes, airport fees and operations, route rights, security, passenger and consumer rights, advertising, privacy, data security, licensing, competition, pensions, environment (including noise levels and carbon emissions), foreign exchange controls and, in some measure, pricing.

Compliance with current or future Canadian and international laws, regulations and administrative requirements, including potentially inconsistent or conflicting laws or regulations, or laws or regulations which disproportionally apply to Canadian airlines or Air Canada specifically (such as the *Air Canada Public Participation Act)*, may impose significant costs, impediments and/or competitive disadvantages, and there cannot be any assurance that current or future laws, regulations and administrative requirements will not adversely affect Air Canada, its business, results from operations and financial condition.

The ability of Air Canada to operate flights or otherwise offer air services on international routes between airports in Canada and other countries may be subject to change. Applicable arrangements between Canada and foreign governments, which govern many areas including traffic rights, may be amended from time to time, rules and policies with respect to airport operations may be revised, and the availability of appropriate slots or facilities may change. Air Canada currently operates a number of flights on international routes under government arrangements, regulations or policies that designate the number of carriers permitted to operate on such routes, the capacity of the carriers providing services on such routes, the airports at which carriers may operate international flights, or the number of carriers allowed access to particular airports. Any further limitations, additions or modifications to such arrangements, regulations or policies could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Additionally, if Canada were to adopt a more liberalized approach in relation to air services arrangements with foreign countries, such an approach could have a material adverse impact on Air Canada, its business, results from operations and financial condition and could result in the impairment of material amounts of related tangible and intangible assets.

Air Canada's current and future plans to enter into or expand revenue-sharing joint ventures and other alliance arrangements on various international routes are and may be subject to receipt of approvals from applicable Canadian and international authorities, to their not challenging them, and to satisfying the necessary applicable regulatory requirements. There can be no assurance that such conditions will be met or will continue in effect or that existing, or changes in, regulatory requirements or standards can be satisfied.

Many aspects of Air Canada's operations may also be subject to the proliferation of increasingly stringent laws and regulations relating to environmental reforms, such as in the area of climate change, and including the following:

The European Union ("EU") emissions trading system ("ETS"), which includes carbon emissions from aviation, including for flights between Canada and EU countries. The European Parliament and Council has exempted all flights between Europe and third countries from the EU ETS, pending the creation of a satisfactory International Civil Aviation Organization ("ICAO") led global market-based measure ("MBM"). In 2016, the ICAO Assembly adopted a resolution on a MBM which includes emissions from international flights. The MBM is set to be implemented in phases, with the first two phases (occurring from 2021 to 2023, and 2024 to 2026, respectively) to be voluntary, with the third phase (from 2027 to 2035) to be mandatory. Canada voluntarily adopted the first phase. On the basis of the MBM, the European Commission may continue to extend the exemption of flights between Europe and third countries from the ETS; however, Air Canada cannot predict whether or how long such exemption will continue.

Canadian provincial governments have implemented or are seeking to implement carbon emissions pricing and other initiatives. In 2016, the Canadian federal government also proposed that a carbon emissions initiative be implemented in all Canadian jurisdictions by 2018.

Air Canada cannot predict whether, or the manner in which, these or other initiatives will ultimately be implemented or the impact on Air Canada; however, future developments in Canada and abroad could adversely impact Air Canada, including by increasing its costs. While Air Canada is continually focused on efficiency improvements, including carbon footprint reduction initiatives, the impact to Air Canada of climate change and other environmental initiatives may, in part, depend upon the extent to which the increased costs relating such initiatives, if any, could be recovered, including in the form of higher passenger fares and cargo rates.

Air Canada is also subject to domestic and foreign laws regarding privacy and security of passenger data, employee and other data, including advance passenger information and access to airline reservation systems, which are not consistent in all countries which may assert jurisdiction over Air Canada, including in countries where Air Canada operates or conducts business. The need to comply with these laws and regulatory regimes results in additional operating costs and further regulation in this area or non-compliance, including in relation to data privacy and security requirements, could have a material adverse effect on Air Canada, its business (including by impacting Air Canada's goodwill and reputation), results from operations and financial condition.

Foreign jurisdictions (including the United States, European Union countries and other jurisdictions where Air Canada operates or conducts business) 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 could adversely impact Air Canada, its business, results from operations and financial condition.

Availability of Insurance Coverage and Increased Insurance Costs - Increases in insurance costs or reduction in insurance coverage could have a material adverse effect on Air Canada, its business, results from operations and financial condition

The aviation insurance industry has been continually re-evaluating the terrorism risks that it covers which may adversely affect some of Air Canada's existing insurance carriers or Air Canada's ability to obtain future insurance coverage (including war risk 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 could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

18. 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, 2016, 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 (2013). Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2016, 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 quarter ended December 31, 2016 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

19. NON-GAAP FINANCIAL MEASURES

Below is a description of certain non-GAAP financial measures used by Air Canada in an effort to provide readers with additional information on its financial and operating performance. Such measures are not recognized measures for financial statement presentation under GAAP, do not have standardized meanings, may not be comparable to similar measures presented by other entities and should not be considered a substitute for or superior to GAAP results.

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent) is commonly used in the airline industry and is used by Air Canada as a means to view operating results before interest, taxes, 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. Air Canada excludes special items from EBITDAR as such items would distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

EBITDAR is reconciled to operating income as follows:

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2016**	**2015**	**$ Change**	**2016**	**2015**	**$ Change**
Operating income – GAAP	$ 18	$ 158	$ (140)	$ 1,345	$ 1,496	$ (151)
Add back (as reflected on Air Canada's consolidated statement of operations):						
Depreciation, amortization and impairment	212	160	52	816	655	161
Aircraft rent	120	98	22	462	353	109
Add back (included in Regional airlines expense):						
Depreciation, amortization and impairment	6	4	2	23	16	7
Aircraft rent	8	5	3	31	14	17
EBITDAR (including special items)	**$ 364**	**$ 425**	**$ (61)**	**$ 2,677**	**$ 2,534**	**$ 143**
Remove effect of special items	91	31	60	91	8	83
EBITDAR	**$ 455**	**$ 456**	**$ (1)**	**$ 2,768**	**$ 2,542**	**$ 226**

Adjusted Net Debt to Trailing 12-Month EBITDAR (Leverage Ratio)

Adjusted net debt to trailing 12-month EBITDAR ratio (also referred to as "leverage ratio" in this MD&A) is commonly used in the airline industry and is used by Air Canada as a means to measure financial leverage. Leverage ratio is calculated by dividing adjusted net debt by trailing 12-month EBITDAR. Refer to section 9.3 "Adjusted Net Debt" of this MD&A for a reconciliation of this non-GAAP financial measure to the nearest measure under GAAP. As mentioned above, Air Canada excludes special items from EBITDAR results (which are used to determine leverage ratio) as such items would distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

Free Cash Flow

Free cash flow is commonly used in the airline industry and is used by Air Canada as an indicator of the financial strength and performance of its business, indicating the amount of cash Air Canada is able to generate from operations and after capital expenditures. Free cash flow is calculated as net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale-leaseback transactions. Refer to section 9.5 "Consolidated Cash Flow Movements" of this MD&A for a reconciliation of this non-GAAP financial measure to the nearest measure under GAAP.

Adjusted CASM

Air Canada uses adjusted CASM as a means to assess the operating and cost performance of its ongoing airline business without the effects of aircraft fuel expense, the cost of ground packages at Air Canada Vacations and special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

Aircraft 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.

Excluding aircraft fuel expense, the cost of ground packages at Air Canada Vacations and special 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 reconciled to GAAP operating expense as follows:

(Canadian dollars in millions, except where indicated)	Fourth Quarter			Full Year		
	2016	2015	$ Change	2016	2015	$ Change
Operating expense – GAAP	**$ 3,407**	**$ 3,024**	**$ 383**	**$ 13,332**	**$ 12,372**	**$ 960**
Adjusted for:						
Aircraft fuel expense (as reflected on Air Canada's consolidated statement of operations)	(598)	(527)	(71)	(2,279)	(2,464)	185
Aircraft fuel expense (included in Regional airlines expense)	(90)	(81)	(9)	(327)	(359)	32
Impairment charges	-	-	-	-	(14)	14
Ground package costs	(101)	(87)	(14)	(489)	(415)	(74)
Special items	(91)	(31)	(60)	(91)	(8)	(83)
Operating expense, adjusted for the above-noted items	**$ 2,527**	**$ 2,298**	**$ 229**	**$ 10,146**	**$ 9,112**	**$ 1,034**
ASMs (millions)	**22,091**	**18,869**	**17.1%**	**92,726**	**80,871**	**14.7%**
Adjusted CASM (cents)	**¢ 11.44**	**¢ 12.18**	**(6.1)%**	**¢ 10.94**	**¢ 11.27**	**(2.9)%**

Adjusted Net Income and Adjusted Earnings per Share – Diluted

Air Canada uses adjusted net income and adjusted earnings per share – diluted as a means to assess the overall financial 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 special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful. Air Canada also uses adjusted net income as a measure to determine its return on invested capital which is described below.

	Fourth Quarter			Full Year		
(Canadian dollars in millions, except per share values)	**2016**	**2015**	**$ Change**	**2016**	**2015**	**$ Change**
Net income (loss) attributable to shareholders of Air Canada	**$ (179)**	**$ (117)**	**$ (62)**	**$ 876**	**$ 303**	**$ 573**
Adjusted for:						
Special items	91	31	60	91	8	83
Impairment charges	-	-	-	-	14	(14)
Foreign exchange loss	29	159	(130)	38	762	(724)
Net financing expense relating to employee benefits	24	27	(3)	76	105	(29)
Loss (gain) on financial instruments recorded at fair value	(9)	3	(12)	(4)	17	(21)
Gain on sale and leaseback of assets	-	-	-	(19)	-	(19)
Loss on debt settlements	82	13	69	89	13	76
Adjusted net income	**$ 38**	**$ 116**	**$ (78)**	**$ 1,147**	**$ 1,222**	**$ (75)**
Weighted average number of outstanding shares used in computing diluted income per share (in millions)	279	290	(11)	282	292	(10)
Adjusted earnings per share – diluted	**$ 0.14**	**$ 0.40**	**$ (0.26)**	**$ 4.06**	**$ 4.18**	**$ (0.12)**

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

	Fourth Quarter		Full Year	
(in millions)	**2016**	**2015**	**2016**	**2015**
Weighted average number of shares outstanding – basic	**273**	**284**	**277**	**285**
Effect of dilution	6	6	5	7
Weighted average number of shares outstanding – diluted	**279**	**290**	**282**	**292**

Return on Invested Capital

Air Canada uses return on invested capital ("ROIC") as a means to assess the efficiency with which it allocates its capital to generate returns. Return is based on adjusted net income (loss), excluding interest expense and implicit interest on operating leases. Invested capital includes (i) average year-over-year total assets (excluding pension assets), net of average year-over-year non-interest-bearing operating liabilities, and (ii) the value of capitalized operating leases (calculated by multiplying annualized aircraft rent by 7).

	12 Months Ended		
(Canadian dollars in millions, except where indicated)	**December 31, 2016**	**December 31, 2015**	**$ Change**
Net income for the period attributable to shareholders of Air Canada	**$ 876**	**$ 303**	**$ 573**
Remove:			
Special items	91	8	83
Impairment charges	-	14	(14)
Foreign exchange loss	38	762	(724)
Net financing expense relating to employee benefits	76	105	(29)
(Gain) loss on financial instruments recorded at fair value	(4)	17	(21)
Gain on sale and leaseback of assets	(19)	-	(19)
Loss on debt settlements	89	13	76
Adjusted net income	**$ 1,147**	**$ 1,222**	**$ (132)**
Adjusted for:			
Interest expense (1)	374	389	(15)
Implicit interest on operating leases (2)	242	180	62
Adjusted income before interest	**$ 1,763**	**$ 1,791**	**$ (85)**
Invested capital:			
Working capital, excluding current portion of long-term debt and finance leases	725	623	102
Long-term assets, excluding pension assets	8,883	7,661	1,222
Maintenance provisions	(907)	(844)	(63)
Other operating long-term liabilities	(177)	(233)	56
Capitalized operating leases (3)	3,451	2,569	882
Invested capital	**$ 11,975**	**$ 9,776**	**$ 2,199**
Return on invested capital (%)	**14.7%**	**18.3%**	**3.6 pp**

(1) *Interest expense excludes the loss on debt settlements related to the C$1.25 billion refinancing transaction and to the disposal of Embraer 190 aircraft in 2015 and 2016.*

(2) *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.*

(3) *Capitalized operating leases are calculated by multiplying the trailing 12 months of aircraft rent by 7. Aircraft rent totaled $493 million for the 12 months ended December 31, 2016 and $367 million for the 12 months ended December 31, 2015 (includes aircraft rent related to regional operations).*

20. GLOSSARY

ACPA – Refers to the Air Canada Pilots Association.

Adjusted CASM – Refers to operating expense per ASM adjusted to remove the effects of aircraft fuel expense, ground packages costs at Air Canada Vacations and special items. Refer to section 19 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 special items. Refer to section 19 of this MD&A for additional information.

Air Georgian – Refers to Air Georgian Limited.

Atlantic passenger and cargo revenues – Refer to revenues from flights that cross the Atlantic Ocean with origins and destinations principally in Europe. Also refers to revenues from flights to and from India, the United Arab Emirates and Morocco.

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.

Average stage length – Refers to the average mile per departure seat and is calculated by dividing total ASMs by total seats dispatched.

Boeing – Refers to The Boeing Company.

Bombardier – Refers to Bombardier Inc.

CALDA – Refers to the Canadian Airline Dispatchers Association.

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 19 of this MD&A for additional information. Air Canada excludes special items from EBITDAR.

EVAS – Refers to Exploits Valley Air Services Ltd.

Free cash flow – Refers to net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale-leaseback transactions. Free cash flow is a non-GAAP financial measure. Refer to sections 9.5 and 19 of this MD&A for additional information.

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

Jazz – Refers to Jazz Aviation LP.

Jazz CPA – Refers to the capacity purchase agreement between Air Canada and Jazz dated January 1, 2015 which became effective on January 1, 2015.

Leverage ratio – Refers to adjusted net debt to trailing 12-month EBITDAR ratio (calculated by dividing adjusted net debt by trailing 12-month EBITDAR). Leverage ratio is a non-GAAP financial measure. Refer to sections 9.3 and 19 of this MD&A for additional information.

Loss on debt settlements – Refer to losses related to debt settlements that, in management's view, are to be separately disclosed by virtue of their size or incidence to enable a fuller understanding of the Corporation's financial performance.

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

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 19 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.

Seats dispatched – Refers to the number of seats on non-stop flights. A non-stop flight refers to a single take-off and landing.

Sky Regional – Refers to Sky Regional Airlines Inc.

Special items – Refers to those items that, in management's view, are to be separately disclosed by virtue of their significance to the financial statements, to enable a fuller understanding of the Corporation's financial performance.

Unifor – Refers to the trade union in Canada, launched in 2013, as a merger of the Canadian Auto Workers and Communications, Energy and Paperworkers unions.

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.

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).