AIR CANADA

Third Quarter 2016

INTERIM UNAUDITED

Condensed Consolidated
Financial Statements and Notes

November 7, 2016

A STAR ALLIANCE MEMBER

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Unaudited **(Canadian dollars in millions)**		**September 30, 2016**	**December 31, 2015**
ASSETS			
Current			
Cash and cash equivalents		$ 1,017	$ 572
Short-term investments		2,417	2,100
Total cash, cash equivalents and short-term investments		3,434	2,672
Restricted cash		88	91
Accounts receivable		760	654
Promissory notes receivable		-	143
Aircraft fuel inventory		71	68
Spare parts and supplies inventory		101	114
Prepaid expenses and other current assets		270	383
Total current assets		4,724	4,125
Property and equipment		8,503	7,030
Pension		557	851
Intangible assets		312	314
Goodwill		311	311
Deposits and other assets		443	496
Total assets		**$ 14,850**	**$ 13,127**
LIABILITIES			
Current			
Accounts payable and accrued liabilities		$ 1,752	$ 1,487
Advance ticket sales		1,984	1,818
Current portion of long-term debt and finance leases	Note 3	627	524
Total current liabilities		4,363	3,829
Long-term debt and finance leases	Note 3	6,350	5,870
Pension and other benefit liabilities		2,898	2,245
Maintenance provisions		874	892
Other long-term liabilities		204	251
Total liabilities		**$ 14,689**	**$ 13,087**
EQUITY			
Shareholders' equity			
Share capital		796	825
Contributed surplus		81	76
Hedging reserve		(7)	(11)
Deficit		(709)	(877)
Total shareholders' equity		161	13
Non-controlling interests		-	27
Total equity		161	40
Total liabilities and equity		**$ 14,850**	**$ 13,127**

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

CONSOLIDATED STATEMENT OF OPERATIONS

Unaudited		**Three months ended September 30**		**Nine months ended September 30**	
(Canadian dollars in millions except per share figures)		**2016**	**2015**	**2016**	**2015**
Operating revenues					
Passenger		$ 4,106	$ 3,716	$ 10,113	$ 9,584
Cargo		130	119	357	371
Other		215	188	782	731
Total revenues		**4,451**	**4,023**	**11,252**	**10,686**
Operating expenses					
Aircraft fuel		708	697	1,681	1,937
Regional airlines expense		639	584	1,786	1,730
Wages, salaries and benefits	Note 4	658	598	1,877	1,734
Airport and navigation fees		247	223	656	609
Aircraft maintenance		227	192	683	570
Depreciation, amortization and impairment		220	165	604	495
Sales and distribution costs		179	157	531	463
Ground package costs		72	63	388	328
Aircraft rent		118	89	342	255
Food, beverages and supplies		104	91	267	233
Communications and information technology		56	52	182	161
Special items	Note 9	-	-	-	(23)
Other		327	297	928	856
Total operating expenses		**3,555**	**3,208**	**9,925**	**9,348**
Operating income		**896**	**815**	**1,327**	**1,338**
Non-operating income (expense)					
Foreign exchange gain (loss)	Note 8	(42)	(251)	(9)	(603)
Interest income		12	12	35	33
Interest expense		(97)	(106)	(298)	(290)
Interest capitalized		12	20	50	50
Net financing expense relating to employee benefits	Note 4	(17)	(28)	(52)	(78)
Gain (loss) on financial instruments recorded at fair value	Note 8	6	(20)	(5)	(14)
Gain on sale and leaseback of assets	Note 10	-	-	19	-
Other		(2)	(5)	(12)	(12)
Total non-operating expense		(128)	(378)	(272)	(914)
Income before income taxes		**768**	**437**	**1,055**	**424**
Income taxes		-	-	-	-
Net income for the period		**$ 768**	**$ 437**	**$ 1,055**	**$ 424**
Net income attributable to:					
Shareholders of Air Canada		768	435	1,055	420
Non-controlling interests		-	2	-	4
		$ 768	**$ 437**	**$ 1,055**	**$ 424**
Net income per share attributable to shareholders of Air Canada	Note 6				
Basic earnings per share		$ 2.79	$ 1.52	$ 3.79	$ 1.47
Diluted earnings per share		$ 2.74	$ 1.48	$ 3.72	$ 1.43

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

Unaudited		Three months ended September 30		Nine months ended September 30	
(Canadian dollars in millions)		**2016**	**2015**	**2016**	**2015**
Comprehensive income					
Net income for the period		$ 768	$ 437	$ 1,055	$ 424
Other comprehensive income (loss), net of taxes of nil:					
Items that will not be reclassified to net income					
Remeasurements on employee benefit liabilities	Note 4	111	(54)	(816)	736
Items that will be reclassified to net income					
Fuel derivatives designated as cash flow hedges, net	Note 8	(17)	(9)	4	(10)
Total comprehensive income		**$ 862**	**$ 374**	**$ 243**	**$ 1,150**
Comprehensive income attributable to:					
Shareholders of Air Canada		$ 862	$ 372	$ 243	**$** 1,146
Non-controlling interests		-	2	-	4
		$ 862	**$ 374**	**$ 243**	**$ 1,150**

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

Unaudited (Canadian dollars in millions)	Share capital	Contributed surplus	Hedging reserve	Deficit	Total shareholders' equity	Non-controlling interests	Total equity
January 1, 2015	$ 835	$ 77	$ –	$ (2,113)	$ (1,201)	$ 68	$ (1,133)
Net income	–	–	–	420	420	4	424
Remeasurements on employee benefit liabilities	–	–	–	736	736	–	736
Fuel derivatives designated as cash flow hedges, net	–	–	(10)	–	(10)	–	(10)
Total comprehensive income	–	–	(10)	1,156	1,146	4	1,150
Share-based compensation	–	3	–	(22)	(19)	–	(19)
Shares issued	3	(1)	–	–	2	–	2
Shares purchased and cancelled under issuer bid	(11)	–	–	(31)	(42)	–	(42)
Distributions	–	–	–	–	–	(9)	(9)
September 30, 2015	$ 827	$ 79	$ (10)	$ (1,010)	$ (114)	$ 63	$ (51)
January 1, 2016	$ 825	$ 76	$ (11)	$ (877)	$ 13	$ 27	$ 40
Net income	–	–	–	1,055	1,055	–	1,055
Remeasurements on employee benefit liabilities	–	–	–	(816)	(816)	–	(816)
Fuel derivatives designated as cash flow hedges, net	–	–	4	–	4	–	4
Total comprehensive income	–	–	4	239	243	–	243
Share-based compensation	–	5	–	(12)	(7)	–	(7)
Shares issued	1	–	–	–	1	–	1
Shares purchased and cancelled under issuer bid	(30)	–	–	(59)	(89)	–	(89)
Distributions	–	–	–	–	–	(27)	(27)
September 30, 2016	$ 796	$ 81	$ (7)	$ (709)	$ 161	$ –	$ 161

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

CONSOLIDATED STATEMENT OF CASH FLOW

Unaudited		**Three months ended September 30**		**Nine months ended September 30**	
(Canadian dollars in millions)		**2016**	**2015**	**2016**	**2015**
Cash flows from (used for)					
Operating					
Net income for the period		$ 768	$ 437	$ 1,055	$ 424
Adjustments to reconcile to net cash from operations					
Depreciation, amortization and impairment		226	169	621	507
Foreign exchange loss (gain)		29	275	(82)	645
Gain on sale and leaseback of assets	Note 10	-	-	(19)	-
Employee benefit funding less (greater) than expense	Note 4	59	9	131	(14)
Financial instruments recorded at fair value	Note 8	(4)	10	7	(7)
Change in maintenance provisions		37	20	112	22
Changes in non-cash working capital balances		(679)	(470)	227	236
Other		2	2	11	(39)
Net cash flows from operating activities		**438**	**452**	**2,063**	**1,774**
Financing					
Proceeds from borrowings		-	302	1,308	591
Reduction of long-term debt and finance lease obligations		(80)	(124)	(461)	(386)
Shares purchased for cancellation	Note 5	(31)	(41)	(89)	(42)
Distributions related to aircraft special purpose leasing entities		-	-	(32)	(9)
Issue of common shares		1	-	1	3
Financing fees		-	(1)	(2)	(23)
Net cash flows from (used in) financing activities		**(110)**	**136**	**725**	**134**
Investing					
Short-term investments		(144)	(227)	(337)	(517)
Additions to property, equipment and intangible assets		(123)	(566)	(2,691)	(1,201)
Proceeds from sale of assets		55	7	349	17
Proceeds from sale-leaseback transactions	Note 10	-	-	351	-
Other		15	7	7	23
Net cash flows used in investing activities		**(197)**	**(779)**	**(2,321)**	**(1,678)**
Effect of exchange rate changes on cash and cash equivalents		**4**	**24**	**(22)**	**19**
Increase (decrease) in cash and cash equivalents		**135**	**(167)**	**445**	**249**
Cash and cash equivalents, beginning of period		882	1,077	572	661
Cash and cash equivalents, end of period		**$ 1,017**	**$ 910**	**$ 1,017**	**$ 910**

Cash payments of interest	Note 3	**$ 51**	**$ 39**	**$ 209**	**$ 188**
Cash payments of income taxes		**$ -**	**$ -**	**$ -**	**$ -**

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

Notes to the interim condensed consolidated financial statements (unaudited)
(Canadian dollars in millions – except per share amounts and where otherwise noted)

1. GENERAL INFORMATION

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

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

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

2. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Corporation prepares its financial statements in accordance with generally accepted accounting principles in Canada ("GAAP") as set out in the CPA Canada Handbook – Accounting ("CPA Handbook") which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). These financial statements have been prepared in accordance with IFRS applicable to the preparation of interim financial statements, including IAS 34 "Interim Financial Reporting". In accordance with GAAP, these financial statements do not include all of the financial statement disclosures required for annual financial statements and should be read in conjunction with the Corporation's annual consolidated financial statements for the year ended December 31, 2015. In management's opinion, the financial statements reflect all adjustments that are necessary for a fair presentation of the results for the interim period presented.

These financial statements were approved for issue by the Board of Directors of the Corporation on November 4, 2016.

These financial statements are based on the accounting policies consistent with those disclosed in Note 2 to the 2015 annual consolidated financial statements of the Corporation.

3. LONG-TERM DEBT AND FINANCE LEASES

	Final Maturity	Weighted Average Interest Rate (%)	September 30 2016	December 31 2015
Aircraft financing				
Fixed rate U.S. dollar financing	2017 – 2027	4.61	$ 3,599	$ 2,718
Floating rate U.S. dollar financing	2017 – 2026	1.93	472	573
Floating rate CDN dollar financing	2026 - 2027	1.55	374	398
Floating rate Japanese yen financing	2020	0.10	84	91
Senior secured notes – U.S. dollar	2019 – 2020	7.61	918	968
Senior secured notes – CDN dollar	2019	7.63	300	300
Senior unsecured notes – U.S. dollar	2021	7.75	525	554
Other secured financing – U.S. dollar	2018 – 2019	4.51	483	513
Other secured financing – CDN dollar	2018	8.15	44	45
Long-term debt		**5.00**	**6,799**	**6,160**
Finance lease obligations	2018 – 2033	9.61	279	330
Total debt and finance leases		**5.18**	**7,078**	**6,490**
Unamortized debt issuance costs			(101)	(96)
Current portion			(627)	(524)
Long-term debt and finance leases			**$ 6,350**	**$ 5,870**

The above table provides terms of instruments disclosed in Note 7 to the 2015 annual consolidated financial statements of the Corporation as well as terms of instruments concluded during the nine months ended September 30, 2016 described below.

In connection with the acquisition of seven Boeing 787 aircraft and two Boeing 777 aircraft in the nine month period ended September 30, 2016, principal of US$1,004 is included in fixed rate U.S. dollar financing in the table above. The acquisition of these aircraft was financed with proceeds from the sale of the enhanced equipment trust certificates that were issued through private offerings in 2015 as described in Note 7 to the 2015 annual consolidated financial statements of the Corporation.

During the nine month period ended September 30, 2016, principal of US$49 was prepaid relating to the financing of six Embraer 190 aircraft. During the nine month period ended September 30, 2016, an amount of $7 is included in interest charges related to the prepayment of fixed rate debt.

Refer to Note 11 Subsequent event for a description of the private offering of senior secured notes and new credit facility completed in October 2016 in connection with a refinancing transaction.

Maturity Analysis

Principal and interest repayment requirements as at September 30, 2016 on Long-term debt and finance lease obligations are as follows. U.S. dollar amounts are converted using the September 30, 2016 closing rate of CDN$1.3117.

Principal	Remainder of 2016	2017	2018	2019	2020	Thereafter	Total
Long-term debt obligations	$ 121	$ 658	$ 662	$ 1,695	$ 895	$ 2,768	**$ 6,799**
Finance lease obligations	9	40	48	46	49	87	**279**
	$ 130	**$ 698**	**$ 710**	**$ 1,741**	**$ 944**	**$ 2,855**	**$ 7,078**

Interest	Remainder of 2016	2017	2018	2019	2020	Thereafter	Total
Long-term debt obligations	$ 82	$ 322	$ 277	$ 245	$ 136	$ 326	**$ 1,388**
Finance lease obligations	6	23	19	14	10	24	**96**
	$ 88	**$ 345**	**$ 296**	**$ 259**	**$ 146**	**$ 350**	**$ 1,484**

4. PENSIONS AND OTHER BENEFIT LIABILITIES

The Corporation has recorded net defined benefit pension and other employee future benefits expense as follows:

	Three months ended September 30		Nine months ended September 30	
	2016	**2015**	**2016**	**2015**
Consolidated Statement of Operations				
Operating expenses				
Wages, salaries and benefits				
Pension benefits	$ 71	$ 63	$ 195	$ 192
Other employee benefits (a)	4	4	2	(5)
	$ 75	**$ 67**	**$ 197**	**$ 187**
Non-operating income (expense)				
Net financing expense relating to employee benefit liabilities				
Pension benefits	$ (3)	$ (15)	$ (12)	$ (40)
Other employee benefits	(14)	(13)	(40)	(38)
	$ (17)	**$ (28)**	**$ (52)**	**$ (78)**
Consolidated Other Comprehensive Income (Loss)				
Remeasurements on employee benefit liabilities				
Pension benefits	$ 145	$ (68)	$ (660)	$ 710
Other employee benefits	(34)	14	(156)	26
	$ 111	**$ (54)**	**$ (816)**	**$ 736**

(a) During the nine months ended September 30, 2016, a gain of $10 was recorded on post-employment liabilities related to long-term disability benefits. During the nine months ended September 30, 2015, as a result of a plan amendment which included a reduction in post-retirement benefits for both current and future retirees and increased member contributions towards the cost of the benefits, a benefit plan amendment credit of $19 was recorded.

The funding of employee benefits as compared to the expense recorded in the consolidated statement of operations is summarized in the table below.

	Three months ended September 30		Nine months ended September 30	
	2016	**2015**	**2016**	**2015**
Net defined pension and other future employee benefits expense recorded in the consolidated statement of operations				
Wages, salaries and benefits	$ 75	$ 67	$ 197	$ 187
Net financing expense relating to employee benefit liabilities	17	28	52	78
	$ 92	**$ 95**	**$ 249**	**$ 265**
Employee benefit funding by Air Canada				
Pension benefits	$ 19	$ 72	$ 82	$ 246
Other employee benefits	14	14	36	33
	$ 33	**$ 86**	**$ 118**	**$ 279**
Employee benefit funding less (greater) than expense	**$ 59**	**$ 9**	**$ 131**	**$ (14)**

5. SHARE CAPITAL

Issuer Bid

As described in Note 11 to the 2015 annual consolidated financial statements, in 2015, the Corporation implemented a normal course issuer bid to purchase, for cancellation, up to 10 million Class B Voting Shares and Class A Variable Voting Shares of the Corporation ("Shares"). This maximum allotment was completed in the first quarter of 2016. In March 2016, the Board of Directors of the Corporation approved the purchase for cancellation of up to an additional 5 million Shares as part of and before the expiry of that normal course issuer bid on May 28, 2016.

In May 2016, the Board of Directors of the Corporation approved 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 percent of the public float as at May 16, 2016. This renewal followed the conclusion of the 2015 normal course issuer bid which expired on May 28, 2016 and under which the Corporation purchased and cancelled a total of 11,300,000 Shares since May 29, 2015 for aggregate consideration of $110.

In the third quarter of 2016, the Corporation purchased, for cancellation, 3,454,400 Shares at an average cost of $8.97 per Share for aggregate consideration of $31 (10,368,465 Shares at an average cost of $8.60 per Share for aggregate consideration of $89 for the nine months ended September 30, 2016). The excess of the cost over the average book value of $21 ($59 for the nine months ended September 30, 2016) was charged to the deficit. At September 30, 2016, a total of 18,733,111 Shares remain available for repurchase under the existing normal course issuer bid.

6. EARNINGS PER SHARE

The following table outlines the calculation of basic and diluted earnings per share.

	Three months ended September 30		Nine months ended September 30	
in millions, except per share amounts	**2016**	**2015**	**2016**	**2015**
Numerator:				
Numerator for basic and diluted earnings per share:				
Net income attributable to shareholders of Air Canada	$ 768	$ 435	$ 1,055	$ 420
Denominator:				
Weighted-average shares - basic	275	287	278	286
Effect of potential dilutive securities:				
Stock options	5	7	5	7
Total potential dilutive securities	5	7	5	7
Remove anti-dilutive impact	-	-	-	-
Adjusted denominator for diluted earnings per share	280	294	283	293
Basic earnings per share	**$ 2.79**	**$ 1.52**	**$ 3.79**	**$ 1.47**
Diluted earnings per share	**$ 2.74**	**$ 1.48**	**$ 3.72**	**$ 1.43**

The calculation of earnings per share is based on whole dollars and not on rounded millions. As a result, the above amounts may not be recalculated to the per share amount disclosed above.

Excluded from the calculation of diluted earnings per share were outstanding options where the exercise prices were greater than the average market price of the shares for the period.

7. COMMITMENTS

Capital Commitments

In June 2016, Air Canada finalized a purchase agreement with Bombardier Inc. 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.

Capital commitments consist of the future firm Boeing 787, Boeing 737 Max and Bombardier C Series aircraft deliveries and commitments related to acquisition of other property and equipment. The estimated aggregate cost of aircraft is based on delivery prices that include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day U.S. LIBOR rate at September 30, 2016. U.S. dollar amounts are converted using the September 30, 2016 closing rate of CDN$1.3117. Minimum future commitments under these contractual arrangements are shown below.

	Remainder of 2016	2017	2018	2019	2020	Thereafter	Total
Capital commitments	$ 181	$ 1,945	$ 1,653	$ 1,300	$ 1,347	$ 1,606	**$ 8,032**

8. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Refer also to Note 15 to the 2015 annual consolidated financial statements for information on the Corporation's risk management strategy.

Summary of gain (loss) on financial instruments recorded at fair value

	Three months ended September 30		Nine months ended September 30	
	2016	**2015**	**2016**	**2015**
Fuel derivatives	$ -	$ (7)	$ -	$ (11)
Share forward contracts	6	(14)	-	(5)
Prepayment option on senior secured notes	-	-	(5)	-
Interest rate swaps	-	1	-	2
Gain (loss) on financial instruments recorded at fair value	**$ 6**	**$ (20)**	**$ (5)**	**$ (14)**

Fuel Price Risk Management

During the third quarter of 2016:

- In the third quarter of 2016, hedging gains on the settlement of fuel derivatives of $10 and the associated premium costs of $13, for a net hedging loss of $3 were reclassified from other comprehensive income to Aircraft fuel expense ($13 loss for the nine months ended September 30, 2016; in 2015, loss of $7 and $11 recorded in Gain (loss) on financial instruments recorded at fair value related to fuel derivatives not designated as hedges for accounting purposes for the three and nine month periods ended September 30, 2015, respectively).

- The Corporation purchased crude-oil call options covering a portion of 2016 and 2017 fuel exposure. The cash premium related to these contracts was $9 ($33 for the nine months ended September 30, 2016; $10 and $27 respectively for the three and nine month periods ended September 30, 2015, respectively, for 2015 and 2016 exposures).

- Fuel derivative contracts cash settled at $10 in favour of the Corporation ($22 for the nine months ended September 30, 2016; nil and $1 in favour of the Corporation, respectively, for the three and nine month periods ended September 30, 2015).

As of September 30, 2016, approximately 40% of the Corporation's anticipated purchases of jet fuel for the remainder of 2016 are hedged at an average West Texas Intermediate ("WTI") equivalent capped price of US$53 per barrel for WTI prices up to US$56 per barrel and an average equivalent capped price of US$56 per barrel for WTI prices above US$58 per barrel. The Corporation's contracts to hedge anticipated jet fuel purchases over the remainder of 2016 are comprised of call options with notional volumes of 2,871,000 barrels. The Corporation has also hedged approximately 8% of its 2017 anticipated jet fuel purchases with call options with notional volumes of 2,598,000 barrels at an average WTI equivalent capped price of US$52 per barrel for WTI prices up to US$58 per barrel and an average equivalent capped price of US$57 per barrel for WTI prices above US$64 per barrel. The fair value of the fuel derivatives portfolio at September 30, 2016 is $13 in favour of the Corporation ($10 in favour of the Corporation as at December 31, 2015) and is recorded within Prepaid expenses and other current assets.

A summary of amounts related to fuel derivatives designated as hedging instruments at September 30, 2016 is presented below.

	Carrying amount of the hedging instrument				
	Nominal amount of the hedging instrument (in barrels)	**Assets**	**Liabilities**	**Consolidated statement of financial position classification**	**Changes in fair value used for calculating hedge ineffectiveness**
Cash flow hedge					
Fuel price risk – option contracts	5,469,000	$ 13	$ -	Prepaid expenses and other current assets	$ -

Foreign Exchange Risk Management

Based on the notional amount of currency derivatives outstanding at September 30, 2016, as further described below, approximately 96% of net U.S. cash outflows are hedged for the remainder of 2016, 59% for 2017, and 15% for 2018, resulting in derivative coverage of 62% over the next 18 months. Operational U.S. dollar cash and investment reserves combined with derivative coverage results in 69% coverage.

As at September 30, 2016, the Corporation had outstanding foreign currency options and swap agreements, settling in 2016, 2017, and 2018, to purchase at maturity $2,579 (US$1,966) of U.S. dollars at a weighted average rate of $1.2968 per US$1.00. (as at December 31, 2015 – $3,234 (US$2,337) with settlements in 2016 and 2017 at a weighted average rate of $1.2683 per $1.00 U.S. dollar). The Corporation also has protection in place to sell a portion of its excess Euros, YUAN, YEN and AUD (EUR €3, CNY ¥105, JPY ¥4,309 and AUD $39) which settle in 2016 and 2017 at weighted average rates of €1.1185, ¥0.1521, ¥0.0084, and $0.7379 per $1.00 U.S. dollar respectively (as at December 31, 2015 - EUR €42, GBP £9, JPY ¥2,052, CNY ¥288, and AUD $18 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). Based on the assumed volatility used in the fair value calculation, the net fair value of these foreign currency contracts as at September 30, 2016 was $111 in favour of the counterparties (as at December 31, 2015 – $89 in favour of the Corporation). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During the third quarter of 2016, a gain of $52 was recorded in Foreign exchange gain (loss) related to these derivatives ($251 loss for the nine month period ended September 30, 2016; gain of $77 and $118 for the three and nine month periods ended September 30, 2015). In the third quarter of 2016, foreign exchange derivative contracts cash settled with a net fair value of $25 in favour of the counterparties ($52 for the nine month period ended September 30, 2016 in favour of the counterparties; $27 and $87 for the three and nine month periods ended September 30, 2015 in favour of the Corporation). The total combined gain, related to U.S. cash, investments and foreign derivatives recorded by the Corporation in the third quarter of 2016 was $64 ($292 loss for the nine month period ended September 30, 2016; $130 gain and $230 gain for the three and nine month periods ended September 30, 2015).

The Corporation also holds U.S. cash reserves as an economic hedge against changes in the value of the U.S. dollar. U.S. dollar cash and short-term investment balances as at September 30, 2016 amounted to $923 (US$705) ($490 (US$358) as at December 31, 2015). During the third quarter of 2016, a gain of $13 ($40 loss for the nine month period ended September 30, 2016; gain of $53 and $112 for the three and nine month periods ended September 30, 2015) was recorded in Foreign exchange gain (loss) reflecting the change in Canadian equivalent market value of the U.S. dollar cash and short-term investment balances held.

Financial Instrument Fair Values in the Consolidated Statement of Financial Position

The carrying amounts reported in the consolidated statement of financial position for short term financial assets and liabilities, which includes Accounts receivable and Accounts payable and accrued liabilities, approximate fair values due to the immediate or short-term maturities of these financial instruments.

The carrying amounts of derivatives are equal to their fair value, which is based on the amount at which they could be settled based on estimated market rates at September 30, 2016.

Based on significant observable inputs (Level 2 in the fair value hierarchy), the estimated fair value of debt and finance leases is $7,077 compared to its carrying value of $6,977.

The following is a classification of fair value measurements recognized in the consolidated statement of financial position using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. There are no changes in classifications or methods of measuring fair value from those disclosed in Note 15 to the 2015 annual consolidated financial statements. There were no transfers within the fair value hierarchy during the nine months ended September 30, 2016.

		Fair value measurements at reporting date using:		
	September 30, 2016	**Quoted prices in active markets for identical assets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**
Financial Assets				
Held–for–trading securities				
Cash equivalents	$ 217	$ –	$ 217	$ –
Short–term investments	2,417	–	2,417	–
Deposits and other assets				
Prepayment option on senior secured notes	–	–	–	–
Derivative instruments				
Fuel derivatives	13	–	13	–
Share forward contracts	32	–	32	–
Foreign exchange derivatives	8	–	8	–
Total	**2,687**	–	**2,687**	–
Financial Liabilities				
Derivative instruments				
Foreign exchange derivatives	119	–	119	–
Total	**$ 119**	**$ –**	**$ 119**	**$** –

Financial assets held by financial institutions in the form of cash and restricted cash have been excluded from the fair value measurement classification table above as they are not valued using a valuation technique. In measuring the fair value of the prepayment option on the Senior Notes issued in 2013, which is categorized as Level 3 in the fair value hierarchy, the Corporation takes into account various factors including the prepayment terms in the notes, market rates of interest, the conditions in credit markets and the estimated credit margin applicable to the Corporation at September 30, 2016. The fair value of the prepayment option is nil ($5 as at December 31, 2015).

9. SPECIAL ITEMS

In the nine months ended September 30, 2015, the Corporation recorded a special item of $23 related to a tax-related provision adjustment.

10. SALE-LEASEBACK

In the nine months ended September 30, 2016, the Corporation took delivery of two 787 aircraft that were financed under sale-leaseback transactions with proceeds of $351. The sales were at fair value and accordingly the resulting gain on sale of $19 was recognized in non-operating income. The leases are accounted for as operating leases with 12 year terms, paid monthly.

11. SUBSEQUENT EVENT

On October 6, 2016, Air Canada completed a private offering of senior secured notes and a new credit facility in connection with its $1.25 billion refinancing transaction.

As part of its refinancing transaction, Air Canada entered into a purchase agreement with a syndicate of initial purchasers relating to a private offering of $200 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 term loan, maturing in 2023, and entered into a new, undrawn US$300 revolving credit facility expiring in 2021 (collectively with the term loan, the "2016 Credit Facility"). The 2016 Credit Facility has an initial interest rate of 275 basis points over LIBOR (subject to a LIBOR floor of 75 basis points).

Air Canada may redeem some or all of the 2016 Senior Notes at any time on or after October 6, 2019 at certain established redemption prices, plus accrued and unpaid interest. At any time prior to October 6, 2019, Air Canada may redeem some or all of the 2016 Senior Notes at a price equal to 100% of their principal amount redeemed plus a "make-whole" premium and accrued and unpaid interest. At any time prior to October 6, 2019, Air Canada may redeem up to 35% of the aggregate principal amount of the 2016 Senior Notes with the proceeds of certain equity offerings, at established redemption prices, plus accrued and unpaid interest. In addition, at any time and from time to time prior to October 6, 2021, Air Canada may redeem, during any twelve-month period, up to 10% of the original aggregate principal amount of the 2016 Senior Notes at a redemption price of 103% of the principal amount, plus accrued and unpaid interest.

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 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 term loan.

In conjunction with such repayment and redemption, $61 in premium costs were paid, and a write-off of transaction costs and discounts of $21 was recorded, both of which will be reported as a special interest charge in the fourth quarter of 2016.