



Third Quarter 2016

**MANAGEMENT DISCUSSION  
AND ANALYSIS OF RESULTS  
OF OPERATIONS AND  
FINANCIAL CONDITION**

November 7, 2016



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# 1. HIGHLIGHTS

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

(Canadian dollars in millions, except where indicated)	Third Quarter			First Nine Months		
	2016	2015	\$ Change	2016	2015	\$ Change
<b>Financial Performance Metrics</b>						
Operating revenues	4,451	4,023	428	11,252	10,686	566
Operating income	896	815	81	1,327	1,338	(11)
Non-operating expense	(128)	(378)	250	(272)	(914)	642
Net income	768	437	331	1,055	424	631
Adjusted net income <sup>(1)</sup>	821	734	87	1,109	1,106	3
Operating margin %	20.1%	20.3%	(0.2) pp	11.8%	12.5%	(0.7) pp
EBITDAR <sup>(1)</sup>	1,248	1,076	172	2,313	2,109	204
EBITDAR margin % <sup>(1)</sup>	28.0%	26.7%	1.3 pp	20.6%	19.7%	0.9 pp
Unrestricted liquidity <sup>(2)</sup>	3,715	3,399	316	3,715	3,399	316
Net cash flows from operating activities	438	452	(14)	2,063	1,774	289
Free cash flow <sup>(1)</sup>	315	(114)	429	(277)	573	(850)
Adjusted net debt <sup>(1)</sup>	6,819	5,423	1,396	6,819	5,423	1,396
Return on invested capital ("ROIC") % <sup>(1)</sup>	15.5%	18.0%	(2.5) pp	15.5%	18.0%	(2.5) pp
Leverage ratio <sup>(1)</sup>	2.5	2.2	0.3	2.5	2.2	0.3
Diluted earnings per share	\$ 2.74	\$ 1.48	\$ 1.26	\$ 3.72	\$ 1.43	\$ 2.29
Adjusted earnings per share – diluted <sup>(1)</sup>	\$ 2.93	\$ 2.50	\$ 0.43	\$ 3.92	\$ 3.77	\$ 0.15
<b>Operating Statistics <sup>(3)</sup></b>			<b>% Change</b>			<b>% Change</b>
Revenue passenger miles ("RPM") (millions)	24,328	20,462	18.9	58,838	52,244	12.6
Available seat miles ("ASM") (millions)	28,458	23,535	20.9	70,635	62,002	13.9
Passenger load factor %	85.5%	86.9%	(1.5) pp	83.3%	84.3%	(1.0) pp
Passenger revenue per RPM ("Yield") (cents)	16.6	17.8	(7.0)	16.8	18.0	(6.4)
Passenger revenue per ASM ("PRASM") (cents)	14.2	15.5	(8.6)	14.0	15.2	(7.4)
Operating revenue per ASM (cents)	15.6	17.1	(8.5)	15.9	17.2	(7.6)
Operating expense per ASM ("CASM") (cents)	12.5	13.6	(8.3)	14.1	15.1	(6.8)
Adjusted CASM (cents) <sup>(1)</sup>	9.4	10.0	(5.9)	10.8	11.0	(1.9)
Average number of full-time equivalent ("FTE") employees (thousands) <sup>(4)</sup>	26.5	25.0	6.2	26.0	24.8	5.0
Aircraft in operating fleet at period-end	382	372	2.7	382	372	2.7
Average fleet utilization (hours per day)	11.4	11.0	3.3	10.4	10.3	1.7
Seats dispatched (thousands)	16,245	14,408	12.7	43,262	39,737	8.9
Aircraft frequencies (thousands)	156	154	0.6	429	431	(0.5)
Average stage length (miles) <sup>(5)</sup>	1,752	1,634	7.2	1,633	1,560	4.6
Fuel cost per litre (cents)	55.2	61.4	(10.2)	52.2	64.3	(18.9)
Fuel litres (millions)	1,458	1,290	13.0	3,677	3,443	6.8
Revenue passengers carried (thousands) <sup>(6)</sup>	13,327	11,723	13.7	34,130	31,439	8.6

- (1) *Adjusted net income (loss), EBITDAR, 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 6 and 14 of this MD&A for descriptions of Air Canada's non-GAAP financial measures and additional GAAP measures.*
- (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 September 30, 2016 unrestricted liquidity was comprised of cash and short-term investments of \$3,434 million and undrawn lines of credit of \$281 million. At September 30, 2015, unrestricted liquidity was comprised of cash and short-term investments of \$3,116 million and undrawn lines of credit of \$283 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 third quarter of 2016. This MD&A should be read in conjunction with Air Canada's interim unaudited condensed consolidated financial statements and notes for the third quarter of 2016, Air Canada's 2015 annual audited consolidated financial statements and notes, and Air Canada's 2015 MD&A dated February 17, 2016 ("Air Canada's 2015 MD&A"). All financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), as set out in the CPA Canada Handbook – Accounting ("CPA Handbook"), which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), except for any financial information specifically denoted otherwise.

Except as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 15 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of November 4, 2016. 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 Air Canada's 2015 MD&A, as it may be updated in section 12 of this MD&A. Air Canada issued a news release dated November 7, 2016 reporting on its results for the third quarter of 2016. This news release is available on Air Canada's website at [www.aircanada.com](http://www.aircanada.com) and on SEDAR's website at [www.sedar.com](http://www.sedar.com). For further information on Air Canada's public disclosures, including Air Canada's Annual Information Form, consult SEDAR at [www.sedar.com](http://www.sedar.com).

### CAUTION REGARDING FORWARD-LOOKING INFORMATION

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

Forward-looking statements, by their nature, are based on assumptions, including those described herein and are subject to important risks and uncertainties. Forward-looking statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, our ability to successfully achieve or sustain positive net profitability or to realize our initiatives and objectives, our ability to pay our indebtedness, reduce operating costs and secure financing, currency exchange, industry, market, credit, economic and geopolitical conditions, energy prices, competition, our ability to successfully implement strategic initiatives and our dependence on technology, war, terrorist acts, epidemic diseases, casualty losses, employee and labour relations, 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, changes in demand due to the seasonal nature of the business, dependence on suppliers and third parties, including regional carriers, Aeroplan and the Star Alliance, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties and the 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 Air Canada's 2015 MD&A, as it may be updated in section 12 of this MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of November 4, 2016 (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 low to modest Canadian GDP growth for 2016. 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\$1.33 per U.S. dollar in the fourth quarter of 2016 and C\$1.32 per U.S. dollar for the full year 2016 and that the price of jet fuel (taking the impact of fuel hedging into account) will average 60 CAD cents per litre in the fourth quarter and 54 CAD cents per litre for the full year 2016.

## **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 TM 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.

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### 3. STRATEGY AND OVERVIEW

In the third quarter of 2016, Air Canada generated record adjusted net income of \$821 million or \$2.93 per diluted share, an increase of \$87 million or \$0.43 per diluted share from the third quarter of 2015. Record EBITDAR of \$1,248 million increased \$172 million from the third quarter of 2015. EBITDAR, adjusted net income and adjusted earnings per diluted share are non-GAAP financial measures. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information. On a GAAP basis, Air Canada generated record operating income of \$896 million compared to operating income of \$815 million in the third quarter of 2015, an increase of \$81 million. Air Canada recorded net income of \$768 million or \$2.74 per diluted share in the third quarter of 2016 versus net income of \$437 million or \$1.48 per diluted share in the third quarter of 2015.

#### Strategy

Air Canada's principal goal 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 goal through a focus on four core strategies:

- Identifying and implementing cost reduction and revenue generating initiatives;
- Pursuing profitable international growth opportunities and leveraging competitive advantages 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 continuously enhancing their travel experience and providing a consistently high level of customer service, with additional emphasis on premium and business passengers and products;
- Fostering positive culture change through employee engagement programs, including meaningful investments in required training and other tools, that promote an appreciation of how the airline and its employees can work together in a supportive and enriching environment, to successfully realize Air Canada's goals and objectives, including delivering top customer service.

Refer to section 4 of Air Canada's 2015 MD&A for additional information.

#### Third Quarter 2016 Financial Summary

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

- Operating revenues of \$4,451 million, an increase of \$428 million or 11% from the third quarter of 2015. Passenger revenues of \$4,106 million increased \$390 million or 10.5% from the third quarter of 2015.
- Operating expenses of \$3,555 million, an increase of \$347 million or 11% from the third quarter of 2015. CASM declined 8.3% from the third quarter of 2015. On an adjusted basis, CASM decreased 5.9% from the third quarter of 2015, in line with the 5.5% to 6.5% decrease forecast in Air Canada's news release dated July 29, 2016. Adjusted CASM is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Record EBITDAR of \$1,248 million compared to EBITDAR of \$1,076 million in the third quarter of 2015, an increase of \$172 million. EBITDAR is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Record operating income of \$896 million compared to operating income of \$815 million in the third quarter of 2015, an increase of \$81 million.

- Adjusted net debt of \$6,819 million at September 30, 2016, an increase of \$528 million from December 31, 2015. Adjusted net debt is an additional GAAP financial measure. Refer to section 6.2 of this MD&A for additional information. The airline's leverage ratio (adjusted net debt to trailing 12-month EBITDAR leverage ratio) was 2.5 at September 30, 2016, unchanged from December 31, 2015 (2.2 at September 30, 2015). Leverage ratio is a non-GAAP financial measure. Refer to section 6.2 "Adjusted Net Debt" and section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Net cash flows from operating activities of \$438 million, a decrease of \$14 million when compared to the same quarter in 2015, mainly due to changes in non-cash working capital. Free cash flow of \$315 million in the third quarter of 2016 improved by \$429 million from the third quarter of 2015. Refer to section 6.4 "Consolidated Cash Flow Movements" of this MD&A for additional information.
- Return on invested capital ("ROIC") for the 12 months ended September 30, 2016 of 15.5% (18.0% for the 12 months ended September 30, 2015). ROIC is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.



## 4. RESULTS OF OPERATIONS

The following table and discussion compares results of Air Canada for the periods indicated:

(Canadian dollars in millions, except where indicated)	Third Quarter				First Nine Months			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
<b>Operating revenues</b>								
Passenger	\$ 4,106	\$ 3,716	\$ 390	10	\$ 10,113	\$ 9,584	\$ 529	6
Cargo	130	119	11	9	357	371	(14)	(4)
Other	215	188	27	14	782	731	51	7
<b>Total revenues</b>	<b>4,451</b>	<b>4,023</b>	<b>428</b>	<b>11</b>	<b>11,252</b>	<b>10,686</b>	<b>566</b>	<b>5</b>
<b>Operating expenses</b>								
Aircraft fuel	708	697	11	2	1,681	1,937	(256)	(13)
Regional airlines expense								
Aircraft fuel	96	95	1	1	237	278	(41)	(15)
Other	543	489	54	11	1,549	1,452	97	7
Wages, salaries and benefits	658	598	60	10	1,877	1,734	143	8
Airport and navigation fees	247	223	24	11	656	609	47	8
Aircraft maintenance	227	192	35	18	683	570	113	20
Depreciation, amortization and impairment	220	165	55	33	604	495	109	22
Sales and distribution costs	179	157	22	14	531	463	68	15
Ground package costs	72	63	9	14	388	328	60	18
Aircraft rent	118	89	29	33	342	255	87	34
Food, beverages and supplies	104	91	13	14	267	233	34	15
Communications and IT	56	52	4	8	182	161	21	13
Special items	-	-	-	-	-	(23)	23	100
Other	327	297	30	10	928	856	72	8
<b>Total operating expenses</b>	<b>3,555</b>	<b>3,208</b>	<b>347</b>	<b>11</b>	<b>9,925</b>	<b>9,348</b>	<b>577</b>	<b>6</b>
<b>Operating income</b>	<b>896</b>	<b>815</b>	<b>81</b>		<b>1,327</b>	<b>1,338</b>	<b>(11)</b>	
<b>Non-operating income (expense)</b>								
Foreign exchange loss	(42)	(251)	209		(9)	(603)	594	
Interest income	12	12	-		35	33	2	
Interest expense	(97)	(106)	9		(298)	(290)	(8)	
Interest capitalized	12	20	(8)		50	50	-	
Net financing expense relating to employee benefits	(17)	(28)	11		(52)	(78)	26	
Gain (loss) on financial instruments recorded at fair value	6	(20)	26		(5)	(14)	9	
Gain on sale and leaseback of assets	-	-	-		19	-	19	
Other	(2)	(5)	3		(12)	(12)	-	
<b>Total non-operating expense</b>	<b>(128)</b>	<b>(378)</b>	<b>250</b>		<b>(272)</b>	<b>(914)</b>	<b>642</b>	
<b>Income before income taxes</b>	<b>768</b>	<b>437</b>	<b>331</b>		<b>1,055</b>	<b>424</b>	<b>631</b>	
Income taxes	-	-	-		-	-	-	
<b>Net income</b>	<b>\$ 768</b>	<b>\$ 437</b>	<b>\$ 331</b>		<b>\$ 1,055</b>	<b>\$ 424</b>	<b>\$ 631</b>	
<b>Diluted earnings per share</b>	<b>\$ 2.74</b>	<b>\$ 1.48</b>	<b>\$ 1.26</b>		<b>\$ 3.72</b>	<b>\$ 1.43</b>	<b>\$ 2.29</b>	
<b>EBITDAR <sup>(1)</sup></b>	<b>\$ 1,248</b>	<b>\$ 1,076</b>	<b>\$ 172</b>		<b>\$ 2,313</b>	<b>\$ 2,109</b>	<b>\$ 204</b>	
<b>Adjusted net income <sup>(1)</sup></b>	<b>\$ 821</b>	<b>\$ 734</b>	<b>\$ 87</b>		<b>\$ 1,109</b>	<b>\$ 1,106</b>	<b>\$ 3</b>	
<b>Adjusted earnings per share – diluted <sup>(1)</sup></b>	<b>\$ 2.93</b>	<b>\$ 2.50</b>	<b>\$ 0.43</b>		<b>\$ 3.92</b>	<b>\$ 3.77</b>	<b>\$ 0.15</b>	

(1) EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent), adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

### System passenger revenues

In the third quarter of 2016, system passenger revenues of \$4,106 million increased \$390 million or 10.5% from the third quarter of 2015 on traffic growth of 18.9% partly offset by a yield decline of 7.0%. Business cabin system revenues increased \$47 million or 7.6% on traffic growth of 12.9% partly offset by a yield decline of 4.7%.

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

<b>Passenger Revenue</b> (Canadian dollars in millions)	<b>Third Quarter 2016</b>	<b>Third Quarter 2015</b>	<b>\$ Change</b>	<b>% Change</b>
Canada	\$ 1,314	\$ 1,253	\$ 61	4.8
U.S. transborder	791	694	97	14.0
Atlantic	1,136	1,027	109	10.7
Pacific	676	568	108	19.2
Other	189	174	15	8.3
<b>System</b>	<b>\$ 4,106</b>	<b>\$ 3,716</b>	<b>\$ 390</b>	<b>10.5</b>

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

<b>Third Quarter 2016 versus Third Quarter 2015</b>	<b>Passenger Revenue % Change</b>	<b>Capacity (ASMs) % Change</b>	<b>Traffic (RPMs) % Change</b>	<b>Passenger Load Factor pp Change</b>	<b>Yield % Change</b>	<b>PRASM % Change</b>
Canada	4.8	6.3	8.2	1.5	(3.1)	(1.4)
U.S. transborder	14.0	19.3	20.8	1.0	(5.6)	(4.5)
Atlantic	10.7	28.1	21.8	(4.4)	(9.1)	(13.6)
Pacific	19.2	34.8	29.0	(3.9)	(7.6)	(11.6)
Other	8.3	12.5	15.1	1.9	(6.0)	(3.9)
<b>System</b>	<b>10.5</b>	<b>20.9</b>	<b>18.9</b>	<b>(1.5)</b>	<b>(7.0)</b>	<b>(8.6)</b>

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

<b>System</b>	<b>Year-over-Year by Quarter (% Change)</b>				
	<b>Q3'15</b>	<b>Q4'15</b>	<b>Q1'16</b>	<b>Q2'16</b>	<b>Q3'16</b>
Passenger revenues	6.9	3.0	2.8	2.0	10.5
Capacity (ASMs)	10.5	8.4	8.2	11.0	20.9
Traffic (RPMs)	10.2	8.6	7.7	9.3	18.9
Passenger load factor (pp change)	(0.2)	0.1	(0.3)	(1.2)	(1.5)
Yield	(3.8)	(5.5)	(4.7)	(6.8)	(7.0)
PRASM	(4.0)	(5.3)	(5.1)	(8.2)	(8.6)

An ASM capacity increase of 20.9% in the third quarter of 2016, when compared to the third quarter of 2015, reflected capacity growth in all markets. The capacity increase was primarily driven by additional Boeing 787 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 third quarter system passenger revenues included:

- The 18.9% 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, the traffic growth in the third quarter of 2016 reflected a 27.9% increase in lower-yielding connecting traffic via Canada to international destinations.
- The 7.0% yield decrease which largely reflected:
  - o an increase in average stage length of 7.2%, due to long-haul international expansion, which had the effect of reducing system yield by 4.0 percentage points;
  - o a higher proportion of seats into long-haul leisure markets led by an increase in lower-cost flights operated by Air Canada Rouge;
  - o a higher proportional growth of lower-yielding connecting traffic via Canada to international destinations (sixth freedom traffic) in support of the airline's international expansion strategy; and
  - o a reduction in carrier surcharges relating to lower fuel prices, especially where carrier surcharges are regulated.

A favourable currency impact of \$49 million was a partly offsetting factor.

In the first nine months of 2016, system passenger revenues of \$10,113 million increased \$529 million or 5.5% from the first nine months of 2015 on traffic growth of 12.6% partly offset by a yield decline of 6.4%. The impact of a weaker Canadian dollar on foreign-currency denominated passenger revenues, when compared to the first nine months of 2015, increased passenger revenues by \$197 million in the first nine months of 2016.

The table below provides passenger revenue by geographic region for the first nine months of 2016 versus the first nine months of 2015.

<b>Passenger Revenue</b> (Canadian dollars in millions)	<b>First Nine Months 2016</b>	<b>First Nine Months 2015</b>	<b>Change</b>	<b>% Change</b>
Canada	\$ 3,347	\$ 3,326	\$ 21	0.6
U.S. transborder	2,182	2,053	129	6.3
Atlantic	2,407	2,203	204	9.2
Pacific	1,543	1,368	175	12.8
Other	634	634	-	(0.1)
<b>System</b>	<b>\$ 10,113</b>	<b>\$ 9,584</b>	<b>\$ 529</b>	<b>5.5</b>

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

<b>First Nine Months 2016 versus First Nine Months 2015</b>	<b>Passenger Revenue % Change</b>	<b>Capacity (ASMs) % Change</b>	<b>Traffic (RPMs) % Change</b>	<b>Passenger Load Factor pp Change</b>	<b>Yield % Change</b>	<b>PRASM % Change</b>
Canada	0.6	5.7	5.8	0.1	(5.1)	(5.0)
U.S. transborder	6.3	13.8	12.3	(1.1)	(5.5)	(6.7)
Atlantic	9.2	21.0	16.9	(2.8)	(6.6)	(9.7)
Pacific	12.8	17.7	17.3	(0.3)	(3.7)	(4.1)
Other	(0.1)	8.4	9.5	0.8	(9.1)	(8.2)
<b>System</b>	<b>5.5</b>	<b>13.9</b>	<b>12.6</b>	<b>(1.0)</b>	<b>(6.4)</b>	<b>(7.4)</b>

### Domestic passenger revenues

In the third quarter of 2016, domestic passenger revenues of \$1,314 million increased \$61 million or 4.8% from the third quarter of 2015.

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

<b>Canada</b>	<b>Year-over-Year by Quarter (% Change)</b>				
	<b>Q3'15</b>	<b>Q4'15</b>	<b>Q1'16</b>	<b>Q2'16</b>	<b>Q3'16</b>
Passenger revenues	0.6	(4.1)	(2.3)	(1.6)	4.8
Capacity (ASMs)	4.8	4.0	6.3	4.5	6.3
Traffic (RPMs)	3.5	2.4	4.1	4.2	8.2
Passenger load factor (pp change)	(1.1)	(1.2)	(1.7)	(0.2)	1.5
Yield	(4.8)	(7.3)	(6.5)	(5.8)	(3.1)
PRASM	(6.0)	(8.7)	(8.4)	(6.1)	(1.4)

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

- The 8.2% 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 3.1% yield decrease which reflected:
  - a 1.3% longer average stage length, which had the effect of reducing domestic yield by 0.7 percentage points in the third 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;
  - Increased competition on regional routes, particularly in eastern Canada.

A favourable currency impact of \$7 million was a partly offsetting factor.

In the first nine months of 2016, domestic passenger revenues of \$3,347 million increased \$21 million or 0.6% from the first nine months of 2015 on traffic growth of 5.8% partly offset by a yield decline of 5.1%.

### U.S. transborder passenger revenues

In the third quarter of 2016, U.S. transborder passenger revenues of \$791 million increased \$97 million or 14.0% from the third quarter of 2015.

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

U.S. transborder	Year-over-Year by Quarter (% Change)				
	Q3'15	Q4'15	Q1'16	Q2'16	Q3'16
Passenger revenues	17.3	10.5	2.5	2.3	14.0
Capacity (ASMs)	15.2	11.9	10.2	12.3	19.3
Traffic (RPMs)	15.6	11.6	5.8	10.8	20.8
Passenger load factor (pp change)	0.3	(0.2)	(3.3)	(1.1)	1.0
Yield	1.4	(0.9)	(3.3)	(7.9)	(5.6)
PRASM	1.8	(1.1)	(7.1)	(9.1)	(4.5)

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

- The 20.8% traffic increase which reflected traffic growth on all major U.S. transborder services.
- The 5.6% yield decline which mainly reflected the impact of increased competition and capacity on U.S. short-haul routes, as well as competitive pricing activities on lower-cost Air Canada Rouge-operated U.S. sun routes. A relatively stronger premium cabin performance, an increase in U.S.-originating traffic and a favourable currency impact of \$13 million were partly offsetting factors.

In the first nine months of 2016, U.S. transborder passenger revenues of \$2,182 million increased \$129 million or 6.3% from the first nine months of 2015 on traffic growth of 12.3% partly offset by a yield decline of 5.5%.

## Atlantic passenger revenues

In the third quarter of 2016, Atlantic passenger revenues of \$1,136 million increased \$109 million or 10.7% from the third quarter of 2015.

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

Atlantic	Year-over-Year by Quarter (% Change)				
	Q3'15	Q4'15	Q1'16	Q2'16	Q3'16
Passenger revenues	9.1	9.1	12.9	5.0	10.7
Capacity (ASMs)	12.7	15.3	13.6	16.6	28.1
Traffic (RPMs)	12.7	14.2	15.8	10.9	21.8
Passenger load factor (pp change)	-	(0.7)	1.5	(4.0)	(4.4)
Yield	(3.2)	(4.5)	(2.5)	(5.4)	(9.1)
PRASM	(3.2)	(5.4)	(0.6)	(9.9)	(13.6)

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

- The 21.8% 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 and Germany. Travel concerns continued into the third quarter of 2016, following the earlier terrorist attacks in France, Belgium and Turkey, which contributed to some of the load factor decline in the third quarter of 2016.
- The 9.1% yield decline which reflected an increase in average stage length of 2.4%, which had the effect of reducing Atlantic yield by 1.4 percentage points. Increased industry capacity 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 \$7 million was a partly offsetting factor.

In the first nine months of 2016, Atlantic passenger revenues of \$2,407 million increased \$204 million or 9.2% from the first nine months of 2015 on traffic growth of 16.9% partly offset by a yield decline of 6.6%.

### Pacific passenger revenues

In the third quarter of 2016, Pacific passenger revenues of \$676 million increased \$108 million or 19.2% from the third quarter of 2015.

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

Pacific	Year-over-Year by Quarter (% Change)				
	Q3'15	Q4'15	Q1'16	Q2'16	Q3'16
Passenger revenues	5.6	4.7	7.7	8.8	19.2
Capacity (ASMs)	11.8	3.4	3.1	12.4	34.8
Traffic (RPMs)	12.1	7.9	6.3	13.7	29.0
Passenger load factor (pp change)	0.2	3.6	2.6	1.0	(3.9)
Yield	(5.7)	(2.9)	1.4	(4.2)	(7.6)
PRASM	(5.5)	1.3	4.6	(3.1)	(11.6)

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

- The 29.0% traffic increase which reflected traffic growth on all major Pacific services. 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 7.6% 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 \$19 million was a partly offsetting factor.

In the first nine months of 2016, Pacific passenger revenues of \$1,543 million increased \$175 million or 12.8% from the first nine months of 2015 on traffic growth of 17.3% partly offset by a yield decline of 3.7%.

### Other passenger revenues

In the third quarter of 2016, Other passenger revenues of \$189 million increased \$15 million or 8.3% from the third quarter of 2015.

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

Other	Year-over-Year by Quarter (% Change)				
	Q3'15	Q4'15	Q1'16	Q2'16	Q3'16
Passenger revenues	8.5	1.1	(1.5)	(6.4)	8.3
Capacity (ASMs)	12.2	9.5	7.5	6.0	12.5
Traffic (RPMs)	11.5	10.5	8.1	6.5	15.1
Passenger load factor (pp change)	(0.5)	0.7	0.4	0.3	1.9
Yield	(3.1)	(8.6)	(9.2)	(12.4)	(6.0)
PRASM	(3.6)	(7.8)	(8.8)	(12.1)	(3.9)

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

- The 15.1% 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. 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 6.0% yield decrease which mainly reflected the impact of increased industry capacity and competitive pricing activities on routes to Mexico as well as an increase in lower-cost Air Canada Rouge capacity on leisure-oriented lower-yielding tour package markets. A favourable currency impact of \$3 million was a partly offsetting factor.

In the first nine months of 2016, Other passenger revenues of \$634 million was unchanged from the first nine months of 2015 as traffic growth of 9.5% was offset by a yield decline of 9.1%.



### Cargo revenues

In the third quarter of 2016, cargo revenues of \$130 million increased \$11 million or 9.0% from the third quarter of 2015, reflecting increased cargo volumes partly offset by the impact of lower yields due to increased industry capacity and competitive pricing activities.

In the first nine months of 2016, cargo revenues of \$357 million decreased \$14 million or 3.9% from the same period in 2015, reflecting a reduction in cargo demand in the first half of 2016 and the impact of increased industry capacity and competitive pricing activities in the first nine months of 2016.

The table below provides cargo revenue by geographic region for the third quarter of 2016 and the first nine months of 2016 versus the same periods in 2015.

Cargo Revenue (Canadian dollars in millions)	Third Quarter			First Nine Months		
	2016	2015	% Change	2016	2015	% Change
Canada	\$ 16	\$ 16	1.6	\$ 45	\$ 50	(10.5)
U.S. transborder	7	5	33.6	20	17	19.1
Atlantic	47	45	6.6	135	140	(3.1)
Pacific	51	46	11.1	130	139	(6.4)
Other	9	7	9.3	27	25	2.9
<b>System</b>	<b>\$ 130</b>	<b>\$ 119</b>	<b>9.0</b>	<b>\$ 357</b>	<b>\$ 371</b>	<b>(3.9)</b>

### Other revenues

Other revenues of \$215 million in the third quarter of 2016 and \$782 million in the first nine months of 2016 increased \$27 million or 14% and \$51 million or 7%, respectively, from the same periods in 2015, reflecting an increase in ground package revenues at Air Canada Vacations, primarily the result of higher passenger volumes, and growth in passenger and airline-related fees.

### CASM and Adjusted CASM

In the third quarter of 2016, CASM and adjusted CASM decreased 8.3% and 5.9%, respectively, when compared to the third quarter of 2015. In the first nine months of 2016, CASM and adjusted CASM decreased 6.8% and 1.9%, respectively, when compared to the first nine months of 2015.

The following table compares Air Canada's CASM and Adjusted CASM for the third quarter of 2016 and the first nine months of 2016 to the same periods in 2015.

(cents per ASM)	Third Quarter			First Nine Months		
	2016	2015	% Change	2016	2015	% Change
Aircraft fuel	2.49	2.96	(15.9)	2.38	3.12	(23.7)
Regional airlines expense						
Aircraft fuel	0.34	0.40	(15.0)	0.34	0.45	(24.4)
Other	1.90	2.08	(8.7)	2.19	2.34	(6.4)
Wages and salaries	1.82	1.97	(7.6)	2.04	2.14	(4.7)
Benefits	0.49	0.57	(14.0)	0.61	0.66	(7.6)
Airport and navigation fees	0.87	0.95	(8.4)	0.93	0.98	(5.1)
Aircraft maintenance	0.80	0.81	(1.2)	0.97	0.92	5.4
Depreciation, amortization and Impairment	0.77	0.70	10.0	0.85	0.80	6.2
Sales and distribution costs	0.63	0.67	(6.0)	0.75	0.75	-
Ground package costs	0.25	0.27	(7.4)	0.55	0.53	3.8
Aircraft rent	0.41	0.38	7.9	0.48	0.41	17.1
Food, beverages and supplies	0.37	0.39	(5.1)	0.38	0.38	-
Communications and IT	0.20	0.22	(9.1)	0.26	0.26	-
Special items	-	-	-	-	(0.04)	100.0
Other	1.15	1.26	(0.1)	1.32	1.38	-
<b>CASM</b>	<b>12.49</b>	<b>13.63</b>	<b>(8.3)</b>	<b>14.05</b>	<b>15.08</b>	<b>(6.8)</b>
<b>Remove:</b>						
Aircraft fuel expense <sup>(1)</sup> and ground package costs at Air Canada Vacations, and special items	(3.08)	(3.63)	15.2	(3.26)	(4.09)	20.1
<b>Adjusted CASM <sup>(2)</sup></b>	<b>9.41</b>	<b>10.00</b>	<b>(5.9)</b>	<b>10.79</b>	<b>10.99</b>	<b>(1.9)</b>

(1) Includes aircraft fuel expense related to regional airline operations.

(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

### Operating expenses

In the third quarter of 2016, operating expenses of \$3,555 million increased \$347 million or 11% from the third quarter of 2015 on capacity growth of 20.9%. The impact of a weaker Canadian dollar on foreign currency denominated operating expenses increased operating expenses by \$20 million in the third quarter of 2016 (comprised of \$13 million related to aircraft fuel expense and an aggregate of \$7 million related to non-fuel operating expenses). The more notable components of the year-over-year change in operating expenses are described below.

In the first nine months of 2016, operating expenses of \$9,925 million increased \$577 million or 6% from the first nine months of 2015. This increase was mainly driven by the 13.9% capacity growth and the impact of a weaker Canadian dollar on foreign currency denominated operating expenses which increased operating expenses by \$245 million in the first nine months of 2016 (comprised of \$81 million related to aircraft fuel expense and an aggregate of \$164 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 but taking into account fuel expense related to regional airline operations).

### Aircraft fuel expense

In the third quarter of 2016, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to \$804 million, an increase of \$12 million or 2% from the third quarter of 2015. This increase in aircraft fuel expense reflected the impact of a higher volume of fuel litres consumed, which accounted for an increase of \$103 million, and the unfavourable impact of a weaker Canadian dollar versus the U.S. dollar when compared to the third quarter of 2015, which accounted for an increase of \$13 million. These increases were mostly offset by the impact of lower base jet fuel prices (before the impact of foreign exchange) year-over-year, which accounted for a reduction of \$107 million.

In the first nine months of 2016, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to \$1,918 million, a decrease of \$297 million or 13% from the first nine months of 2015. This decrease in aircraft fuel expense reflected lower base jet fuel prices (before the impact of foreign exchange) year-over-year, which accounted for a reduction of \$538 million. This decrease was partly offset by the impact of a higher volume of fuel litres consumed, which accounted for an increase of \$147 million, and by the unfavourable impact of a weaker Canadian dollar versus the U.S. dollar when compared to the first nine months 2015, which accounted for an increase of \$81 million.

The table below provides Air Canada's fuel cost per litre and economic fuel cost per litre (including aircraft fuel expense related to regional airline operations) for the periods indicated. In the third quarter and the first nine months of 2016, hedging gains on the settlement of fuel derivatives partly offset the associated premium costs.

(Canadian dollars in millions, except where indicated)	Third Quarter			First Nine Months		
	2016	2015	% Change	2016	2015	% Change
Aircraft fuel expense	\$ 708	\$ 697	2	\$ 1,681	\$ 1,937	(13)
Aircraft fuel expense related to Regional airline operations	96	95	1	237	278	(15)
<b>Total Aircraft fuel expense – GAAP</b>	<b>\$ 804</b>	<b>\$ 792</b>	<b>2</b>	<b>\$ 1,918</b>	<b>\$ 2,215</b>	<b>(13)</b>
<b>Add:</b>						
Net cash payments on fuel derivatives <sup>(1)</sup>	-	14	(100)	-	36	(100)
<b>Economic cost of fuel – Non-GAAP <sup>(2)</sup></b>	<b>\$ 804</b>	<b>\$ 806</b>	<b>-</b>	<b>\$ 1,918</b>	<b>\$ 2,251</b>	<b>(15)</b>
<b>Fuel consumption (thousands of litres)</b>	<b>1,457,725</b>	<b>1,289,911</b>	<b>13.0</b>	<b>3,676,755</b>	<b>3,442,909</b>	<b>6.8</b>
<b>Fuel cost per litre (cents) – GAAP</b>	<b>55.2</b>	<b>61.4</b>	<b>(10.2)</b>	<b>52.2</b>	<b>64.3</b>	<b>(18.9)</b>
<b>Economic fuel cost per litre (cents) – Non-GAAP <sup>(2)</sup></b>	<b>55.2</b>	<b>62.5</b>	<b>(11.7)</b>	<b>52.2</b>	<b>65.4</b>	<b>(20.2)</b>

(1) Includes net cash settlements on maturing fuel derivatives and premium costs associated with those derivatives. With adoption of hedge accounting for fuel derivatives effective April 1, 2015, any premium costs associated with fuel derivatives are deferred as cost of the hedge and reclassified to aircraft fuel expense when the hedged jet fuel is used, as are any net cash settlements on maturing fuel derivatives.

(2) The economic cost of fuel is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning, and may not be comparable to similar measures presented by other public companies. Air Canada uses this measure to

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

### Regional airlines expense

Regional airlines expense of \$639 million in the third quarter of 2016 increased \$55 million or 9% from the third quarter of 2015, mainly due to the impact of increased flying as a result of fleet expansion initiatives in the Air Canada Express fleet operated by Sky Regional and Air Georgian.

Regional airlines expense of \$1,786 million in the first nine months of 2016 increased \$56 million or 3% from the same period in 2015. In the first nine months of 2016, the impact of increased flying as a result of fleet expansion initiatives in the Air Canada Express fleet operated by Sky Regional and Air Georgian and an unfavourable currency impact of \$42 million were partly offset by the impact of lower jet fuel prices and lower rates associated with the Jazz CPA.

The following table provides a breakdown of Regional airlines expense for the periods indicated:

(Canadian dollars in millions)	Third Quarter			First Nine Months		
	2016	2015	% Change	2016	2015	% Change
Capacity purchase fees	\$ 313	\$ 298	5	\$ 895	\$ 874	2
Aircraft fuel	96	95	1	237	278	(15)
Airport and navigation	79	74	7	218	209	4
Sales and distribution costs	36	32	13	106	98	8
Aircraft rent	8	3	167	23	9	156
Depreciation, amortization and Impairment	6	4	50	17	12	42
Other operating expenses	101	78	29	290	250	16
<b>Total regional airlines expense</b>	<b>\$ 639</b>	<b>\$ 584</b>	<b>9</b>	<b>\$ 1,786</b>	<b>\$ 1,730</b>	<b>3</b>

### Wages, salaries and benefits expense

Wages, salaries and benefits expense of \$658 million in the third quarter of 2016 and \$1,877 million in the first nine months increased \$60 million or 10% and \$143 million or 8%, respectively, from the same periods in 2015.

Wages and salaries expense of \$518 million in the third quarter of 2016 and \$1,444 million in the first nine months of 2016 increased \$55 million or 12% and \$117 million or 9%, respectively, from the same periods in 2015. These increases were mainly due to higher average salaries (primarily driven by the impact of collective agreements concluded in 2014 and 2015, growth in wide-body flying, and an increase in crew training related to Air Canada's new Boeing 787 aircraft) and a higher number of full-time equivalent (FTE) employees when compared to the same periods in 2015. As a result of the capacity growth, in the third quarter and the first nine months of 2016, the average number of FTE employees increased 6.2% and 5.0%, respectively, when compared to the same periods in 2015.

Employee benefits expense of \$140 million in the third quarter of 2016 and \$433 million in the first nine months of 2016 increased \$5 million or 4% and \$26 million or 6%, respectively, from the same periods in 2015. In the first nine months of 2016, Air Canada recorded a gain of \$10 million on post-employment liabilities related to long-term disability benefits. In the first nine months of 2015, Air Canada recorded a credit of \$19 million related to benefit plan amendments pertaining to U.S. post-retirement health plans.

### Airport and navigation fees

Airport and navigation fees of \$247 million in the third quarter of 2016 and \$656 million in the first nine months of 2016 increased \$24 million or 11% and \$47 million or 8%, respectively, from the same periods in 2015, largely due to growth in wide-body and international flying. The increase in airport and navigation fees in the first nine months of 2016 when compared to the first nine months of 2015 included an unfavourable currency impact of \$8 million. These increases were partly offset by 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.

### Aircraft maintenance expense

Aircraft maintenance expense of \$227 million in the third quarter of 2016 increased \$35 million or 18% from the third quarter of 2015. This increase in aircraft maintenance expense was mainly driven by the impact of having additional Boeing 787 aircraft in the fleet which are under power-by-the-hour arrangements (where maintenance costs accrue by hours flown), and by an increase in end of lease maintenance provisions versus the same period in 2015.

Aircraft maintenance expense of \$683 million in the first nine months of 2016 increased \$113 million or 20% from the same period in 2015, mainly reflecting an increase in end of lease maintenance provisions versus the same period in 2015, an unfavourable currency impact of \$48 million and, to a lesser extent, the impact of having additional Boeing 787 aircraft in the fleet which are under power-by-the-hour arrangements. Partly offsetting these increases was the impact of a lower volume of maintenance activity year-over-year.

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

(Canadian dollars in millions)	Third Quarter			First Nine Months		
	2016	2015	% Change	2016	2015	% Change
Technical maintenance	\$ 192	\$ 170	13	\$ 576	\$ 545	6
Maintenance provision	30	17	76	94	9	944
Other	5	5	-	13	16	(19)
<b>Total aircraft maintenance expense</b>	<b>\$ 227</b>	<b>\$ 192</b>	<b>18</b>	<b>\$ 683</b>	<b>\$ 570</b>	<b>20</b>

### Depreciation, amortization and impairment expense

Depreciation, amortization and impairment expense of \$220 million in the third quarter of 2016 and \$604 million in the first nine months of 2016 increased \$55 million or 33% and \$109 million or 22%, respectively, from the same periods in 2015, largely due to the addition of Boeing 787 aircraft to Air Canada's mainline fleet and the airline's aircraft refurbishment programs. In the first nine months of 2015, Air Canada recorded impairment charges of \$14 million related to the planned disposal of two Airbus A340-300 aircraft (neither of which was operated by Air Canada). No such charges were recorded in the first nine months of 2016.

### Sales and distribution costs

Sales and distribution costs of \$179 million in the third quarter of 2016 and \$531 million in the first nine months of 2016 increased \$22 million or 14% and \$68 million or 15%, respectively, from the same periods in 2015. These increases reflected higher commission expenses, in part due to new 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) was also a contributing factor to the growth in sales and distribution costs.

versus the same periods in 2015. The increase in the first nine months of 2016 when compared to the first nine months of 2015 included an unfavourable currency impact of \$14 million.

### Ground package costs

Ground package costs of \$72 million in the third quarter of 2016 and \$388 million in the first nine months of 2016 increased \$9 million or 14% and \$60 million or 18%, respectively, from the same periods in 2015, on higher passenger volumes, particularly in the first quarter of 2016. The increase in ground package costs in the first nine months of 2016 when compared to the first nine months of 2015 included an unfavourable currency impact of \$26 million.

### Aircraft rent

Aircraft rent of \$118 million in the third quarter of 2016 and \$342 million in the first nine months of 2016 increased \$29 million or 33% and \$87 million or 34%, respectively, from the same periods in 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. The increase in aircraft rent expense in the first nine months of 2016 when compared to the first nine months in 2015 included an unfavourable currency impact of \$17 million.

### Special items

In first nine months of 2015, Air Canada recorded favourable tax-related provision adjustments of \$23 million. No special items were recorded in the first nine months of 2016.

### Other expenses

Other expenses of \$327 million in the third quarter of 2016 and \$928 million in the first nine months of 2016 increased \$30 million or 10% and \$72 million or 8%, respectively, from the same periods in 2015, reflecting, in large part, the capacity growth and the impact of Air Canada's international expansion strategy. The increase in other expenses in the first nine months of 2016 when compared to the first nine months of 2015 included an unfavourable currency impact of \$12 million.

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

(Canadian dollars in millions)	Third Quarter			First Nine Months		
	2016	2015	% Change	2016	2015	% Change
Terminal handling	\$ 64	\$ 65	(2)	\$ 182	\$ 174	5
Building rent and maintenance	38	36	6	114	108	6
Crew cycle	52	43	21	133	114	17
Miscellaneous fees and services	31	32	(3)	98	98	-
Remaining other expenses	142	121	17	401	362	11
<b>Total other expenses</b>	<b>\$ 327</b>	<b>\$ 297</b>	<b>10</b>	<b>\$ 928</b>	<b>\$ 856</b>	<b>8</b>

## Non-operating expense

Non-operating expense of \$128 million in the third quarter of 2016 decreased \$250 million from the third quarter of 2015. In the first nine months of 2016, non-operating expense of \$272 million decreased \$642 million from the same period in 2015.

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

(Canadian dollars in millions)	Third Quarter			First Nine Months		
	2016	2015	\$ Change	2016	2015	\$ Change
Foreign exchange loss	\$ (42)	\$ (251)	\$ 209	\$ (9)	\$ (603)	\$ 594
Interest expense, net	(73)	(74)	1	(213)	(207)	(6)
Net financing expense relating to employee benefits	(17)	(28)	11	(52)	(78)	26
Gain (loss) on financial instruments recorded at fair value	6	(20)	26	(5)	(14)	9
Gain on sale and leaseback of assets	-	-	-	19	-	19
Other	(2)	(5)	3	(12)	(12)	-
<b>Total non-operating expense</b>	<b>\$ (128)</b>	<b>\$ (378)</b>	<b>\$ 250</b>	<b>\$ (272)</b>	<b>\$ (914)</b>	<b>\$ 642</b>

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

- Losses on foreign exchange which amounted to \$42 million in the third quarter of 2016 compared to losses on foreign exchange of \$251 million in the third quarter of 2015. In the third quarter of 2016, foreign exchange losses on U.S. denominated long-term debt of \$98 million were partly offset by gains on foreign currency derivatives of \$52 million. The foreign exchange losses on U.S. denominated long-term debt were attributable to a weaker Canadian dollar at September 30, 2016 when compared to June 30, 2016. The September 30, 2016 closing exchange rate was US\$1 = C\$1.3117 while the June 30, 2016 closing exchange rate was US\$1 = C\$1.2917. In the first nine months of 2016, losses on foreign exchange amounted to \$9 million compared to losses on foreign exchange of \$603 million in the first nine months of 2015. Foreign exchange gains on U.S. denominated long-term debt of \$259 million and foreign exchange gains on maintenance provisions of \$48 million were largely offset by losses on foreign currency derivatives of \$251 million and losses on cash and short-term investment balances of \$41 million.
- The increase in net interest expense of \$6 million in the first nine months of 2016 which largely reflected the impact of new aircraft financing transactions. In addition, in the first nine months of 2016, Air Canada recorded special charges amounting to \$7 million related to the prepayment of debt associated with the disposal of Embraer 190 aircraft.
- Decreases in net financing expense relating to employee benefits of \$11 million in the third quarter of 2016 and \$26 million in the first nine months of 2016 which were mainly due to the impact of the lower net defined pension benefit obligation.
- In the second quarter of 2016, Air Canada recorded a gain of \$19 million on the sale and operating leaseback of two Boeing 787-9 aircraft.

## 5. FLEET

The following table provides the number of aircraft in Air Canada's operating fleet as at December 31, 2015 and September 30, 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, 2016 and December 31, 2017.

	Actual			Planned			
	December 31, 2015	First Nine Months 2016 Fleet Changes	September 30, 2016	Remainder of 2016 Fleet Changes	December 31, 2016	2017 Fleet Changes	December 31, 2017
Mainline							
<b><u>Wide-body aircraft</u></b>							
Boeing 787-8	8	-	8	-	8	-	8
Boeing 787-9	4	9	13	-	13	9	22
Boeing 777-300ER	17	2	19	-	19	-	19
Boeing 777-200LR	6	-	6	-	6	-	6
Boeing 767-300ER	17	(2)	15	-	15	(5)	10
Airbus A330-300	8	-	8	-	8	-	8
<b><u>Narrow-body aircraft</u></b>							
Boeing 737 MAX	-	-	-	-	-	2	2
Airbus A321	14	1	15	-	15	-	15
Airbus A320	42	-	42	-	42	-	42
Airbus A319	18	-	18	-	18	-	18
Embraer 190	37	(12)	25	-	25	-	25
<b>Total Mainline</b>	<b>171</b>	<b>(2)</b>	<b>169</b>	<b>-</b>	<b>169</b>	<b>6</b>	<b>175</b>
Air Canada Rouge							
<b><u>Wide-body aircraft</u></b>							
Boeing 767-300ER	15	4	19	-	19	5	24
<b><u>Narrow-body aircraft</u></b>							
Airbus A321	4	1	5	-	5	-	5
Airbus A319	20	-	20	-	20	-	20
<b>Total Air Canada Rouge</b>	<b>39</b>	<b>5</b>	<b>44</b>	<b>-</b>	<b>44</b>	<b>5</b>	<b>49</b>
<b>Total wide-body aircraft</b>	<b>75</b>	<b>13</b>	<b>88</b>	<b>-</b>	<b>88</b>	<b>9</b>	<b>97</b>
<b>Total narrow-body aircraft</b>	<b>135</b>	<b>(10)</b>	<b>125</b>	<b>-</b>	<b>125</b>	<b>2</b>	<b>127</b>
<b>Total Mainline and Air Canada Rouge</b>	<b>210</b>	<b>3</b>	<b>213</b>	<b>-</b>	<b>213</b>	<b>11</b>	<b>224</b>



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 has firm orders for 61 Boeing 737 MAX aircraft, of which 16 aircraft are expected to be delivered in 2018, to replace existing aircraft in its mainline fleet. As part of this narrow-body replacement program, Air Canada is currently reviewing which aircraft will be retired.

In June 2016, Air Canada and Bombardier Inc. ("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 will 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 September 30, 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. No changes are expected to the Air Canada Express fleet between September 30, 2016 and December 31, 2016.

	As at September 30, 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
<b>Total Air Canada Express</b>	<b>113</b>	<b>25</b>	<b>14</b>	<b>152</b>

### Other CPA carriers

In addition, Air Georgian and EVAS operate a total of 17 18-passenger Beech 1900 aircraft on behalf of Air Canada pursuant to capacity purchase agreements with Air Canada.

## 6. FINANCIAL AND CAPITAL MANAGEMENT

### 6.1. Financial Position

The following table provides a condensed consolidated statement of financial position of Air Canada as at September 30, 2016 and as at December 31, 2015.

(Canadian dollars in millions)	September 30, 2016	December 31, 2015	\$ Change
<b>Assets</b>			
Cash, cash equivalents and short-term investments	3,434	2,672	762
Other current assets	1,290	1,453	(163)
Current assets	4,724	4,125	599
Property and equipment	8,503	7,030	1,473
Pension	557	851	(294)
Intangible assets	312	314	(2)
Goodwill	311	311	-
Deposits and other assets	443	496	(53)
<b>Total assets</b>	<b>14,850</b>	<b>13,127</b>	<b>1,723</b>
<b>Liabilities</b>			
Current liabilities	4,363	3,829	534
Long-term debt and finance leases	6,350	5,870	480
Pension and other benefit liabilities	2,898	2,245	653
Maintenance provisions	874	892	(18)
Other long-term liabilities	204	251	(47)
<b>Total liabilities</b>	<b>14,689</b>	<b>13,087</b>	<b>1,602</b>
<b>Total equity</b>	<b>161</b>	<b>40</b>	<b>121</b>
<b>Total liabilities and equity</b>	<b>14,850</b>	<b>13,127</b>	<b>1,723</b>

Movements in current assets and current liabilities are described in section 6.3 "Working Capital" of this MD&A. Long-term debt and finance leases are discussed in sections 6.2 "Adjusted Net Debt" and 6.4 "Consolidated Cash Flow Movements" of this MD&A.

At September 30, 2016, property and equipment amounted to \$8,503 million, an increase of \$1,473 million from December 31, 2015. The increase in property and equipment was mainly due to additions to property and equipment of \$2,670 million, partly offset by the sale of two Boeing 787 aircraft under a sale and operating leaseback transaction, the disposal of 12 Embraer 190 aircraft and the impact of depreciation expense of \$584 million. The additions to property and equipment in the first nine months of 2016 included seven Boeing 787-9 aircraft (excluding the two Boeing 787 aircraft under operating lease) and two Boeing 777-300ER, progress payments on future aircraft deliveries and capitalized maintenance costs.

The net pension and other benefit liabilities of \$2,341 million (comprised of pension and other benefit liabilities of \$2,898 million net of pension assets of \$557 million) increased \$947 million from December 31, 2015. This increase was mainly due to an 80 basis point decrease in the discount rate used to value the liabilities, partly offset by gains on pension plan assets, which contributed to an actuarial loss on Remeasurements on employee benefit liabilities of \$816 million recorded in Other comprehensive income.

## 6.2. Adjusted Net Debt

The following table reflects Air Canada's adjusted net debt balances as at September 30, 2016 and as at December 31, 2015.

(Canadian dollars in millions, except where indicated)	September 30, 2016	December 31, 2015	\$ Change
Total long-term debt and finance leases	\$ 6,350	\$ 5,870	\$ 480
Current portion of long-term debt and finance leases	627	524	103
Total long-term debt and finance leases, including current portion	6,977	6,394	583
Less cash, cash equivalents and short-term investments	(3,434)	(2,672)	(762)
<b>Net debt</b>	<b>\$ 3,543</b>	<b>\$ 3,722</b>	<b>\$ (179)</b>
Capitalized operating leases <sup>(1)</sup>	3,276	2,569	707
<b>Adjusted net debt</b>	<b>\$ 6,819</b>	<b>\$ 6,291</b>	<b>\$ 528</b>
<b>EBITDAR (trailing 12 months)</b>	<b>\$ 2,738</b>	<b>\$ 2,534</b>	<b>\$ 204</b>
<b>Adjusted net debt to EBITDAR ratio <sup>(2)</sup></b>	<b>2.5</b>	<b>2.5</b>	<b>-</b>

(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 \$468 million for the 12 months ended September 30, 2016 and \$367 million for the 12 months ended December 31, 2015.

(2) Adjusted net debt to trailing 12-month EBITDAR leverage 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 14 of this MD&A for additional information.

At September 30, 2016, total long-term debt and finance leases (including current portion) of \$6,977 million increased \$583 million from December 31, 2015. In the first nine months of 2016, new borrowings of \$1,308 million, which were all related to aircraft financings, were partly offset by debt repayments of \$461 million and the favourable impact of a stronger Canadian dollar of \$259 million, as at September 30, 2016 compared to December 31, 2015, on Air Canada's foreign currency denominated debt (mainly U.S. dollars).

Adjusted net debt amounted to \$6,819 million at September 30, 2016, an increase of \$528 million from December 31, 2015. This increase in adjusted net debt reflected higher long-term debt and financial lease balances as discussed above. The impact of higher cash and short-term investment balances more than offset the impact of higher capitalized operating lease balances which was largely driven by additional aircraft leases and an unfavourable currency impact on aircraft rent expense. At September 30, 2016, the adjusted net debt to EBITDAR ratio was 2.5, unchanged from December 31, 2015.

At September 30, 2016, Air Canada's weighted average cost of capital ("WACC"), on a pre-tax basis, was approximately 9.3% (compared to approximately 9.2% at September 30, 2015). WACC is based on an estimate by management and consists of an estimated cost of equity of 24.3% and an average cost of debt and finance leases of 5.2% (compared to an estimated cost of equity of 20.2% and an average cost of debt and finance leases of 5.4% at September 30, 2015).

### 6.3. Working Capital

The following table provides information on Air Canada's working capital balances as at September 30, 2016 and as at December 31, 2015.

(Canadian dollars in millions)	September 30, 2016	December 31, 2015	\$ Change
Cash, cash equivalents and short-term investments	\$ 3,434	\$ 2,672	\$ 762
Accounts receivable	760	654	106
Other current assets	530	799	(269)
<b>Total current assets</b>	<b>\$ 4,724</b>	<b>\$ 4,125</b>	<b>\$ 599</b>
Accounts payable and accrued liabilities	1,752	1,487	265
Advance ticket sales	1,984	1,818	166
Current portion of long-term debt and finance leases	627	524	103
<b>Total current liabilities</b>	<b>\$ 4,363</b>	<b>\$ 3,829</b>	<b>\$ 534</b>
<b>Net working capital</b>	<b>\$ 361</b>	<b>\$ 296</b>	<b>\$ 65</b>

The net working capital of \$361 million at September 30, 2016 represented an improvement of \$65 million from December 31, 2015. The cash flow benefit of positive operating results in the first nine months of 2016 more than offset the impact of capital expenditures of \$2,691 million (which resulted in a net cash outflow of \$1,032 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). The increase in accounts payable and accrued liabilities largely reflected the normal seasonal increase. The cash flow impact of debt repayments of \$461 million was more than offset by proceeds of \$351 million from the sale and leaseback of two Boeing 787 aircraft and proceeds from sale of assets of \$349 million.

## 6.4. Consolidated Cash Flow Movements

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

(Canadian dollars in millions)	Third Quarter			First Nine Months		
	2016	2015	\$ Change	2016	2015	\$ Change
<b>Net cash flows from operating activities</b>	<b>\$ 438</b>	<b>\$ 452</b>	<b>\$ (14)</b>	<b>\$ 2,063</b>	<b>\$ 1,774</b>	<b>\$ 289</b>
Proceeds from borrowings	-	302	(302)	1,308	591	717
Reduction of long-term debt and finance lease obligations	(80)	(124)	44	(461)	(386)	(75)
Shares purchased for cancellation	(31)	(41)	10	(89)	(42)	(47)
Distributions related to aircraft special purpose leasing entities	-	-	-	(32)	(9)	(23)
Issue of common shares	1	-	1	1	3	(2)
Financing fees	-	(1)	1	(2)	(23)	21
<b>Net cash flows from (used in) financing activities</b>	<b>\$ (110)</b>	<b>\$ 136</b>	<b>\$ (246)</b>	<b>\$ 725</b>	<b>\$ 134</b>	<b>\$ 591</b>
Short-term investments	(144)	(227)	83	(337)	(517)	180
Additions to property, equipment and intangible assets	(123)	(566)	443	(2,691)	(1,201)	(1,490)
Proceeds from sale of assets	55	7	48	349	17	332
Proceeds from sale-leaseback transactions	-	-	-	351	-	351
Other	15	7	8	7	23	(16)
<b>Net cash flows used in investing activities</b>	<b>\$ (197)</b>	<b>\$ (779)</b>	<b>\$ 582</b>	<b>\$ (2,321)</b>	<b>\$ (1,678)</b>	<b>\$ (643)</b>
<b>Effect of exchange rate changes on cash and cash equivalents</b>	<b>\$ 4</b>	<b>\$ 24</b>	<b>\$ (20)</b>	<b>\$ (22)</b>	<b>\$ 19</b>	<b>\$ (41)</b>
<b>Increase (decrease) in cash and cash equivalents</b>	<b>\$ 135</b>	<b>\$ (167)</b>	<b>\$ 302</b>	<b>\$ 445</b>	<b>\$ 249</b>	<b>\$ 196</b>

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

(Canadian dollars in millions)	Third Quarter			First Nine Months		
	2016	2015	\$ Change	2016	2015	\$ Change
<b>Net cash flows from operating activities</b>	<b>\$ 438</b>	<b>\$ 452</b>	<b>\$ (14)</b>	<b>\$ 2,063</b>	<b>\$ 1,774</b>	<b>\$ 289</b>
Additions to property, equipment and intangible assets, net of proceeds from sale-leaseback transactions	(123)	(566)	443	(2,340)	(1,201)	(1,139)
<b>Free cash flow <sup>(1)</sup></b>	<b>\$ 315</b>	<b>\$ (114)</b>	<b>\$ 429</b>	<b>\$ (277)</b>	<b>\$ 573</b>	<b>\$ (850)</b>

(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 14 of this MD&A for additional information.

**Net cash flows from operating activities and free cash flow**

In the third quarter of 2016, net cash flows from operating activities of \$438 million decreased \$14 million when compared to the same quarter in 2015. The cash benefit of stronger operating income was offset by unfavourable changes in non-cash working capital balances of \$209 million. Changes in working capital included higher advance booking levels at June 30, 2016 leading into the third quarter of 2016 versus the prior year's third quarter. Free cash flow of \$315 million in the third quarter of 2016 represented an increase of \$429 million from the negative free cash flow of \$114 million in the third quarter of 2015. This improvement was due to a lower level of capital expenditures year-over-year.

In the first nine months of 2016, net cash flows from operating activities of \$2,063 million increased \$289 million from the first nine months of 2015, mainly due to the improvement in operating income. Negative free cash flow of \$277 million represented an \$850 million decrease in free cash flow due to a higher level of capital expenditures year-over-year, partly offset by the impact of higher cash flows from operating activities.

**6.5. Capital Expenditures and Related Financing Arrangements**Boeing

As at September 30, 2016, Air Canada had outstanding purchase commitments with Boeing for 16 Boeing 787 aircraft and firm orders for 33 Boeing 737 MAX 8 and 28 737 MAX 9 aircraft with substitution rights between them as well as for the 737 MAX 7 aircraft. Additional information on Air Canada's purchase commitments and related financial arrangements is described in section 9.6 of Air Canada's 2015 MD&A.

Subject to certain conditions, Air Canada has various financing or sale and leaseback commitments covering up to 12 of the remaining 16 Boeing 787 firm aircraft orders, which are summarized as follows:

- For 10 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 a third party for two Boeing 787 aircraft scheduled for delivery in 2017.

Air Canada is exploring two additional sale and leaseback transaction opportunities for Boeing 787 aircraft scheduled for delivery in 2017.

Bombardier

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 CS300 aircraft deliveries and other capital purchase commitments as at September 30, 2016 approximates \$8,032 million.

(Canadian dollars in millions)	Remainder of 2016	2017	2018	2019	2020	Thereafter	Total
Projected committed expenditures	\$ 181	\$ 1,945	\$ 1,653	\$ 1,300	\$ 1,347	\$ 1,606	\$ 8,032
Projected planned but uncommitted expenditures	29	321	364	371	332	Not available	Not available
Projected planned but uncommitted capitalized maintenance <sup>(1)</sup>	46	151	119	111	115	Not available	Not available
<b>Total projected expenditures <sup>(2)</sup></b>	<b>\$ 256</b>	<b>\$ 2,417</b>	<b>\$ 2,136</b>	<b>\$ 1,782</b>	<b>\$ 1,794</b>	<b>Not available</b>	<b>Not available</b>

(1) Future capitalized maintenance amounts for 2020 and beyond are not yet determinable however an estimate of \$115 million has been made for 2020.

(2) U.S. dollar amounts are converted using the September 30, 2016 closing exchange rate of US\$1 = C\$1.3117. 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.

## 6.6. Pension Funding Obligations

As at January 1, 2016, the aggregate solvency surplus in Air Canada's domestic registered pension plans was \$1.3 billion. Based on the results of the actuarial valuations, as at January 1, 2016, all Canadian domestic registered pension plans are in a surplus position on both a solvency and going-concern basis. No contributions are required or permitted to any plan for past service. For current service, depending on the level of surplus on a going concern basis, a contribution in respect of each plan (other than a small one) is either not permitted or is optional, depending on applicable pension rules. Air Canada does not intend to make current service cost payments for 2016 for all plans for which it is allowed to not do so. Taking this into account, on a cash basis, total pension funding contributions for 2016 are forecasted to be \$94 million versus total pension funding contributions of \$312 million in 2015.

As at September 30, 2016, taking into account the effect of financial instrument risk management tools, approximately 75% of Air Canada's pension liabilities were matched to fixed income products to mitigate a significant portion of the interest rate (discount rate) risk. Air Canada may continue to increase the percentage of fixed income products matched to pension liabilities, subject to favourable market conditions.

For additional information on Air Canada's pension funding obligations, refer to section 9.7 "Pension Funding Obligations" of Air Canada's 2015 MD&A.

## 6.7. 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 its refinancing 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, undrawn US\$300 million 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 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, \$61 million in premium costs were paid, and a write-off of transaction costs and discounts of \$21 million was recorded, both of which will be reported as a special interest charge in the fourth quarter of 2016.

The table below provides Air Canada's contractual obligations as at September 30, 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. The table below also includes the impact of the refinancing transaction described above.

(Canadian dollars in millions)	2016	2017	2018	2019	2020	Thereafter	Total
<i><u>Principal</u></i>							
Long-term debt obligations	\$ 121	\$ 658	\$ 662	\$ 1,695	\$ 895	\$ 2,768	\$ 6,799
Finance lease obligations	9	40	48	46	49	87	279
<b>Total principal obligations</b>	<b>\$ 130</b>	<b>\$ 698</b>	<b>\$ 710</b>	<b>\$ 1,741</b>	<b>\$ 944</b>	<b>\$ 2,855</b>	<b>\$ 7,078</b>
<i><u>Interest</u></i>							
Long-term debt obligations	\$ 82	\$ 322	\$ 277	\$ 245	\$ 136	\$ 326	\$ 1,388
Finance lease obligations	6	23	19	14	10	24	96
<b>Total interest obligations</b>	<b>\$ 88</b>	<b>\$ 345</b>	<b>\$ 296</b>	<b>\$ 259</b>	<b>\$ 146</b>	<b>\$ 350</b>	<b>\$ 1,484</b>
<b>Total long-term debt and finance lease obligations</b>	<b>\$ 218</b>	<b>\$ 1,043</b>	<b>\$ 1,006</b>	<b>\$ 2,000</b>	<b>\$ 1,090</b>	<b>\$ 3,205</b>	<b>\$ 8,562</b>
<b>Operating lease obligations</b>	<b>\$ 155</b>	<b>\$ 539</b>	<b>\$ 483</b>	<b>\$ 400</b>	<b>\$ 290</b>	<b>\$ 688</b>	<b>\$ 2,555</b>
<b>Committed capital expenditures</b>	<b>\$ 181</b>	<b>\$ 1,945</b>	<b>\$ 1,653</b>	<b>\$ 1,300</b>	<b>\$ 1,347</b>	<b>\$ 1,606</b>	<b>\$ 8,032</b>
<b>Total contractual obligations before the impact of the C\$1.25 billion refinancing transaction <sup>(1)</sup></b>	<b>\$ 554</b>	<b>\$ 3,527</b>	<b>\$ 3,142</b>	<b>\$ 3,700</b>	<b>\$ 2,727</b>	<b>\$ 5,499</b>	<b>\$ 19,149</b>



**Impact of the C\$1.25 billion refinancing transaction completed October 6, 2016**

(Canadian dollars in millions)	2016	2017	2018	2019	2020	Thereafter	Total
<u>Principal</u>							
Old Notes / Term Loan	\$ (1)	\$ (4)	\$ (4)	\$ (1,200)	\$ (394)	\$ -	\$ (1,603)
New Notes / Term Loan	-	3	10	10	10	1,216	1,249
<u>Interest</u>							
Old Notes / Term Loan	(27)	(108)	(108)	(89)	(9)	-	(341)
New Notes / Term Loan	11	50	50	50	49	134	344
<b>Total contractual obligations after the impact of the C\$1.25 billion refinancing transaction <sup>(1)</sup></b>	<b>\$ 537</b>	<b>\$ 3,468</b>	<b>\$ 3,090</b>	<b>\$ 2,471</b>	<b>\$ 2,383</b>	<b>\$ 6,849</b>	<b>\$ 18,798</b>

(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.

## 6.8. Share Information

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

	September 30, 2016	December 31, 2015
<b>Issued and outstanding shares</b>		
Variable voting shares	100,714,092	98,059,765
Voting shares	172,085,738	184,722,413
<b>Total issued and outstanding shares</b>	<b>272,799,830</b>	<b>282,782,178</b>
<b>Class A variable voting and Class B voting shares potentially issuable</b>		
Stock options	9,812,053	8,735,634
<b>Total shares potentially issuable</b>	<b>9,812,053</b>	<b>8,735,634</b>
<b>Total outstanding and potentially issuable shares</b>	<b>282,611,883</b>	<b>291,517,812</b>

### Issuer Bid

In May 2016, Air Canada approved a new normal course issuer bid for its Class A variable voting shares and Class B voting shares (collectively the "Shares"), authorizing, between May 30, 2016 and May 29, 2017, the purchase of up to 22,785,511 Shares, representing 10% of the public float of 227,855,112 Shares 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 Air Canada purchased and cancelled a total of 11,300,000 Shares, since May 29, 2015, for aggregate consideration of \$110 million.

In the third quarter of 2016, Air Canada purchased, for cancellation, 3,454,400 Shares at an average cost of \$8.97 per Share for aggregate consideration of \$31 million (10,368,465 Shares at an average cost of \$8.60 per Share for aggregate consideration of \$89 million for the nine months ended September 30, 2016). At September 30, 2016, a total of 18,733,111 Shares remained available for repurchase under the existing normal course issuer bid.

## 7. QUARTERLY FINANCIAL DATA

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

(Canadian dollars in millions, except where indicated)	2014	2015				2016		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Passenger	\$ 2,755	\$ 2,786	\$ 3,082	\$ 3,716	\$ 2,836	\$ 2,864	\$ 3,143	\$ 4,106
Cargo	133	129	123	119	135	116	111	130
Other	216	334	209	188	211	363	204	215
<b>Operating revenues</b>	<b>3,104</b>	<b>3,249</b>	<b>3,414</b>	<b>4,023</b>	<b>3,182</b>	<b>3,343</b>	<b>3,458</b>	<b>4,451</b>
Aircraft fuel	680	592	648	697	527	446	527	708
Regional airlines expense								
Aircraft fuel	111	86	97	95	81	64	77	96
Other	460	466	497	489	468	505	501	543
Wages, salaries & benefits	560	568	568	598	590	608	611	658
Airport and navigation fees	178	185	201	223	193	198	211	247
Aircraft maintenance	187	188	190	192	203	217	239	227
Depreciation, amortization and impairment <sup>(2)</sup>	130	153	177	165	160	182	202	220
Sales and distribution costs	123	154	152	157	145	182	170	179
Ground package costs	74	181	84	63	87	231	85	72
Aircraft rent	76	82	84	89	98	112	112	118
Food, beverages and supplies	70	62	80	91	81	77	86	104
Communications and IT	51	57	52	52	50	67	59	56
Special items	30	-	(23)	-	31	-	-	-
Other	268	275	284	297	310	300	301	327
<b>Operating expenses</b>	<b>2,998</b>	<b>3,049</b>	<b>3,091</b>	<b>3,208</b>	<b>3,024</b>	<b>3,189</b>	<b>3,181</b>	<b>3,555</b>
<b>Operating income</b>	<b>106</b>	<b>200</b>	<b>323</b>	<b>815</b>	<b>158</b>	<b>154</b>	<b>277</b>	<b>896</b>
Foreign exchange gain (loss)	(115)	(408)	56	(251)	(159)	50	(17)	(42)
Interest income	10	9	12	12	13	10	13	12
Interest expense	(83)	(90)	(94)	(106)	(112)	(102)	(99)	(97)
Interest capitalized	9	9	21	20	20	23	15	12
Net financing expense relating to employee benefits	(32)	(25)	(25)	(28)	(27)	(18)	(17)	(17)
Gain (loss) on financial instruments recorded at fair value	9	1	5	(20)	(3)	(10)	(1)	6
Gain on sale and leaseback of assets	-	-	-	-	-	-	19	-
Other	(4)	(5)	(2)	(5)	(6)	(6)	(4)	(2)
<b>Total non-operating expense</b>	<b>(206)</b>	<b>(509)</b>	<b>(27)</b>	<b>(378)</b>	<b>(274)</b>	<b>(53)</b>	<b>(91)</b>	<b>(128)</b>
Income (loss) before income taxes	\$ (100)	\$ (309)	\$ 296	\$ 437	\$ (116)	\$ 101	\$ 186	\$ 768
Income taxes	-	-	-	-	-	-	-	-
<b>Net income (loss)</b>	<b>(100)</b>	<b>\$ (309)</b>	<b>\$ 296</b>	<b>\$ 437</b>	<b>\$ (116)</b>	<b>\$ 101</b>	<b>\$ 186</b>	<b>\$ 768</b>
<b>Diluted earnings (loss) per share</b>	<b>\$ (0.35)</b>	<b>\$ (1.08)</b>	<b>\$ 1.00</b>	<b>\$ 1.48</b>	<b>\$ (0.41)</b>	<b>\$ 0.35</b>	<b>\$ 0.66</b>	<b>\$ 2.74</b>
<b>EBITDAR <sup>(1)</sup></b>	<b>\$ 319</b>	<b>\$ 442</b>	<b>\$ 591</b>	<b>\$ 1,076</b>	<b>\$ 425</b>	<b>\$ 460</b>	<b>\$ 605</b>	<b>\$ 1,248</b>
<b>Adjusted net income <sup>(2)</sup></b>	<b>\$ 67</b>	<b>\$ 122</b>	<b>\$ 250</b>	<b>\$ 734</b>	<b>\$ 116</b>	<b>\$ 85</b>	<b>\$ 203</b>	<b>\$ 821</b>
<b>Adjusted earnings per share – diluted <sup>(2)</sup></b>	<b>\$ 0.23</b>	<b>\$ 0.41</b>	<b>\$ 0.85</b>	<b>\$ 2.50</b>	<b>\$ 0.40</b>	<b>\$ 0.30</b>	<b>\$ 0.72</b>	<b>\$ 2.93</b>

(1) EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

(2) Adjusted net income (loss) and adjusted earnings (loss) per share – diluted are non-GAAP financial measures. Refer to section 14 "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.

System	2014	2015				2016		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Passenger PRASM (cents)	15.6	14.9	15.0	15.5	14.7	14.1	13.8	14.2
CASM (cents)	17.2	16.6	15.4	13.6	16.0	16.1	14.2	12.5
Adjusted CASM (cents) <sup>(1)</sup>	12.1	11.9	11.3	10.0	12.2	12.3	11.2	9.4
Economic fuel price per litre (cents) <sup>(2)</sup>	80.7	66.3	66.9	61.4	58.6	48.1	52.2	55.2

(1) Adjusted CASM is a non-GAAP financial measure. Refer to section 14 "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 4 "Results of Operations" of this MD&A for additional information.

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

System	2014	2015				2016		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
RPMs (millions)	14,090	14,937	16,845	20,462	15,301	16,092	18,418	24,328
ASMs (millions)	17,403	18,335	20,132	23,535	18,869	19,833	22,344	28,458
Passenger load factor (%)	81.0%	81.5%	83.7%	86.9%	81.1%	81.1%	82.4%	85.5%

#### Domestic

RPMs (millions)	4,191	3,805	4,525	5,606	4,291	3,960	4,717	6,068
ASMs (millions)	5,023	4,657	5,433	6,649	5,222	4,952	5,678	7,066
Passenger load factor (%)	83.4%	81.7%	83.3%	84.3%	82.2%	80.0%	83.1%	85.9%

#### U.S. transborder

RPMs (millions)	2,479	3,191	2,804	2,992	2,768	3,376	3,107	3,613
ASMs (millions)	3,122	3,883	3,384	3,539	3,493	4,278	3,799	4,223
Passenger load factor (%)	79.4%	82.2%	82.9%	84.5%	79.2%	78.9%	81.8%	85.6%

#### Atlantic

RPMs (millions)	3,256	2,938	4,864	6,792	3,719	3,401	5,394	8,270
ASMs (millions)	4,124	3,860	5,839	7,640	4,755	4,383	6,805	9,785
Passenger load factor (%)	79.0%	76.1%	83.3%	88.9%	78.2%	77.6%	79.3%	84.5%

#### Pacific

RPMs (millions)	2,967	3,026	3,432	3,877	3,202	3,218	3,902	5,002
ASMs (millions)	3,649	3,621	4,000	4,318	3,773	3,732	4,496	5,821
Passenger load factor (%)	81.3%	83.6%	85.8%	89.8%	84.9%	86.2%	86.8%	85.9%

#### Other

RPMs (millions)	1,197	1,977	1,220	1,195	1,322	2,137	1,298	1,375
ASMs (millions)	1,485	2,314	1,476	1,389	1,626	2,488	1,566	1,563
Passenger load factor (%)	80.6%	85.4%	82.6%	86.0%	81.3%	85.8%	82.9%	87.9%

## 8. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Air Canada's financial instruments and risk management practices are summarized in section 12 of Air Canada's 2015 MD&A. There have been no material changes to Air Canada's financial instruments and risk management practices from those disclosed at that time. Additional information on Air Canada's risk management practices and financial instruments is discussed in Note 8 of Air Canada's third quarter 2016 interim unaudited condensed consolidated financial statements.

## 9. ACCOUNTING POLICIES AND CRITICAL ACCOUNTING ESTIMATES

Air Canada's accounting policies and critical accounting estimates are as disclosed in Air Canada's 2015 MD&A. There have been no material changes to Air Canada's accounting policies and critical accounting estimates from those disclosed at that time.

## 10. OFF-BALANCE SHEET ARRANGEMENTS

Information on Air Canada's off-balance sheet arrangements is disclosed in section 15 "Off-Balance Sheet Arrangements" of Air Canada's 2015 MD&A. There have been no material changes to Air Canada's off-balance sheet arrangements from those disclosed at that time.

## 11. RELATED PARTY TRANSACTIONS

At September 30, 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.

## 12. RISK FACTORS

For a detailed description of risk factors associated with Air Canada and its business, refer to section 17 "Risk Factors" of Air Canada's 2015 MD&A. Air Canada is not aware of any significant changes to its risk factors from those disclosed at that time. However, the risk factor in Air Canada's 2015 MD&A related to Regulatory Matters and the European Union ("EU") legislation for an emissions trading system ("ETS"), is updated by the addition of the following:

On October 6, 2016, the International Civil Aviation Organization ("ICAO") Assembly adopted a resolution on a Global Market-Based Measure Scheme ("MBM"). This MBM includes emissions from international flights and seeks to address the annual increase in total CO<sub>2</sub> emissions above 2020 levels. 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. Only flights to and from covered countries will be subject to the carbon offset requirements of the MBM. Canada is among the countries having voluntarily adopted the first phase. The European Commission responded favourably to the ICAO agreement on MBM and is expected to report back to the European Parliament in the coming months; however, it is uncertain at this time what recommendations the European Commission may make or whether the European Parliament will decide to continue to exempt flights between Europe and third countries from the ETS. Management also cannot yet predict the impact the MBM will have on Air Canada.

## 13. CONTROLS AND PROCEDURES

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

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

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

In the Corporation's 2015 filings, the Corporation's CEO and CFO certified, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design and effectiveness of the Corporation's disclosure controls and procedures and the design and effectiveness of internal controls over financial reporting.

In the Corporation's third quarter 2016 filings, the Corporation's CEO and CFO certified, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design of the Corporation's disclosure controls and procedures and the design of internal controls over financial reporting.

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

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

There have been no changes to the Corporation's internal controls over financial reporting during the quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

## 14. 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.

EBITDAR is reconciled to operating income as follows:

(Canadian dollars in millions)	Third Quarter			First Nine Months		
	2016	2015	\$ Change	2016	2015	\$ Change
<b>Operating income – GAAP</b>	\$ 896	\$ 815	\$ 81	\$ 1,327	\$ 1,338	\$ (11)
<b>Add back (as reflected on Air Canada's consolidated statement of operations):</b>						
Depreciation, amortization and impairment	220	165	55	604	495	109
Aircraft rent	118	89	29	342	255	87
<b>Add back (included in Regional airlines expense):</b>						
Depreciation, amortization and impairment	6	4	2	17	12	5
Aircraft rent	8	3	5	23	9	14
<b>EBITDAR</b>	<b>\$ 1,248</b>	<b>\$ 1,076</b>	<b>\$ 172</b>	<b>\$ 2,313</b>	<b>\$ 2,109</b>	<b>\$ 204</b>

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

Adjusted net debt to trailing 12-month EBITDAR leverage 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 6.2 of this MD&A for a reconciliation of this non-GAAP financial measure to the nearest measure under GAAP.

### 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 how much 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 6.4 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.

Therefore, 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)	Third Quarter			First Nine Months		
	2016	2015	\$ Change	2016	2015	\$ Change
<b>Operating expense – GAAP</b>	<b>\$ 3,555</b>	<b>\$ 3,208</b>	<b>\$ 347</b>	<b>\$ 9,925</b>	<b>\$ 9,348</b>	<b>\$ 577</b>
<b>Adjusted for:</b>						
Aircraft fuel expense (as reflected on Air Canada's consolidated statement of operations)	(708)	(697)	(11)	(1,681)	(1,937)	256
Aircraft fuel expense (included in Regional airlines expense)	(96)	(95)	(1)	(237)	(278)	41
Special items	-	-	-	-	23	(23)
Impairment charges	-	-	-	-	(14)	14
Ground package costs at Air Canada Vacations	(72)	(63)	(9)	(388)	(328)	(60)
<b>Operating expense, adjusted for the above-noted items</b>	<b>\$ 2,679</b>	<b>\$ 2,353</b>	<b>\$ 326</b>	<b>\$ 7,619</b>	<b>\$ 6,814</b>	<b>\$ 805</b>
<b>ASMs (millions)</b>	<b>28,458</b>	<b>23,535</b>	<b>20.9%</b>	<b>70,635</b>	<b>62,002</b>	<b>13.9%</b>
<b>Adjusted CASM (cents)</b>	<b>¢ 9.41</b>	<b>¢ 10.00</b>	<b>(5.9)%</b>	<b>¢ 10.79</b>	<b>¢ 10.99</b>	<b>(1.9)%</b>

## 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.

(Canadian dollars in millions, except per share values)	Third Quarter			First Nine Months		
	2016	2015	\$ Change	2016	2015	\$ Change
<b>Net income (loss) attributable to shareholders of Air Canada</b>	<b>\$ 768</b>	<b>\$ 435</b>	<b>\$ 333</b>	<b>\$ 1,055</b>	<b>\$ 420</b>	<b>\$ 635</b>
<b>Adjusted for:</b>						
Special items	-	-	-	-	(23)	23
Impairment charges	-	-	-	-	14	(14)
Foreign exchange loss	42	251	(209)	9	603	(594)
Special interest charges related to the prepayment of debt associated with the disposal of Embraer 190 aircraft	-	-	-	7	-	7
Gain on sale and leaseback of assets	-	-	-	(19)	-	(19)
Net financing expense relating to employee benefits	17	28	(11)	52	78	(26)
Loss (gain) on financial instruments recorded at fair value	(6)	20	(26)	5	14	(9)
<b>Adjusted net income</b>	<b>\$ 821</b>	<b>\$ 734</b>	<b>\$ 87</b>	<b>\$ 1,109</b>	<b>\$ 1,106</b>	<b>\$ 3</b>
Weighted average number of outstanding shares used in computing diluted income per share (in millions)	280	294	(14)	283	293	(10)
<b>Adjusted earnings per share – diluted</b>	<b>\$ 2.93</b>	<b>\$ 2.50</b>	<b>\$ 0.43</b>	<b>\$ 3.92</b>	<b>\$ 3.77</b>	<b>\$ 0.15</b>

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

(in millions)	Third Quarter		First Nine Months	
	2016	2015	2016	2015
<b>Weighted average number of shares outstanding – basic</b>	<b>275</b>	<b>287</b>	<b>278</b>	<b>286</b>
Effect of dilution	5	7	5	7
<b>Weighted average number of shares outstanding – diluted</b>	<b>280</b>	<b>294</b>	<b>283</b>	<b>293</b>



## 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).

(Canadian dollars in millions, except where indicated)	12 Months Ended		
	September 30, 2016	September 30, 2015	\$ Change
<b>Net income for the period attributable to shareholders of Air Canada</b>	<b>\$ 938</b>	<b>\$ 319</b>	<b>\$ 619</b>
<b>Remove:</b>			
Special items <sup>(1)</sup>	31	7	24
Impairment charges <sup>(2)</sup>	-	14	(14)
Foreign exchange loss	168	718	(550)
Special interest charges related to the prepayment of debt associated with the disposal of Embraer 190 aircraft	20	-	20
Gain on sale and leaseback of assets <sup>(3)</sup>	(19)	-	(19)
Net financing expense relating to employee benefits	79	110	(31)
Loss on financial instruments recorded at fair value	8	5	3
<b>Adjusted net income</b>	<b>\$ 1,225</b>	<b>\$ 1,173</b>	<b>\$ 52</b>
<b>Adjusted for:</b>			
Interest expense <sup>(4)</sup>	390	373	17
Implicit interest on operating leases <sup>(5)</sup>	229	168	61
<b>Adjusted income before interest</b>	<b>\$ 1,844</b>	<b>\$ 1,714</b>	<b>\$ 130</b>
<b>Invested capital:</b>			
Working capital, excluding current portion of long-term debt and finance leases	1,040	840	200
Long-term assets, excluding pension assets	8,698	7,353	1,345
Maintenance provisions	(899)	(840)	(59)
Other operating long-term liabilities	(182)	(239)	57
Capitalized operating leases <sup>(6)</sup>	3,276	2,401	875
<b>Invested capital</b>	<b>\$ 11,933</b>	<b>\$ 9,515</b>	<b>\$ 2,418</b>
<b>Return on invested capital (%)</b>	<b>15.5%</b>	<b>18.0%</b>	<b>(2.5) pp</b>

(1) Special items for the 12 months ended September 30, 2016 included one-time payments totaling \$62 million related to Air Canada's contract on collective agreement terms with CUPE and the IAMAW and a \$30 million recovery related to cargo investigations for a fine that was previously paid. Special items for the 12 months ended September 30, 2015 included one-time payments totaling \$30 million related to Air Canada's contract on collective agreement terms with ACPA and favourable tax-related provision adjustments of \$23 million.

(2) In the 12 months ended September 30, 2015, Air Canada recorded impairment charges of \$14 million related to the planned disposal of two Airbus A340-300 aircraft in the second half of 2015 (neither of which was operated by Air Canada).

(3) In the 12 months ended September 30, 2016, Air Canada recorded a gain of \$19 million on the sale and leaseback of two Boeing 787 aircraft.

(4) Interest expense excludes the special interest charges related to the disposal of Embraer 190 aircraft.

(5) 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.

(6) Capitalized operating leases are calculated by multiplying the trailing 12 months of aircraft rent by 7. Aircraft rent totaled \$468 million for the 12 months ended September 30, 2016 and \$343 million for the 12 months ended September 30, 2015 (includes aircraft rent related to regional operations).

## 15. GLOSSARY

**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 14 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 14 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 and the United Arab Emirates.

**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.

**CASM** – Refers to operating expense per ASM.

**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 14 of this MD&A for additional information.

**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 6.4 and 14 of this MD&A for additional information.

**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 leverage ratio (calculated by dividing adjusted net debt by trailing 12-month EBITDAR). Leverage ratio is a non-GAAP financial measure. Refer to sections 6.2 and 14 of this MD&A for additional information.

**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 14 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** – Refer to those items 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.

**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).