2013

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

February 12, 2014

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1. HIGHLIGHTS

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

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

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

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

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

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

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

(6) Free cash flow (cash flows from operating activities less additions to property, equipment and intangible assets) is a non-GAAP financial measure. Refer to section 9.5 of this MD&A for additional information.

(7) Adjusted net debt (total debt less cash, cash equivalents and short-term investments plus capitalized operating leases) is a non-GAAP financial measure. Refer to section 9.3 of this MD&A for additional information.

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

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

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

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

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

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

2. INTRODUCTION AND KEY ASSUMPTIONS

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers, as the context may require, to Air Canada and/or one or more of Air Canada's subsidiaries, including its wholly-owned operating subsidiaries, Touram Limited Partnership ("Air Canada Vacations") and Air Canada *rouge* LP doing business under the trade name Air Canada *rouge*™ ("Air Canada *rouge*"). This MD&A provides the reader with a review and analysis, from the perspective of management, of Air Canada's financial results for the fourth quarter and the full year 2013. This MD&A should be read in conjunction with Air Canada's audited consolidated financial statements and notes for 2013. All financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), as set out in the CPA Canada Handbook – Accounting ("CPA Handbook"), which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), except for any financial information specifically denoted otherwise.

Except as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 21 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of February 11, 2014. Certain comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year. Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 18 "Risk Factors" of this MD&A. Air Canada issued a news release dated February 12, 2014 reporting on its results for the fourth quarter and the full year 2013. This news release is available on Air Canada's website at **www.aircanada.com** and on SEDAR's website at **www.sedar.com**. For further information on Air Canada's public disclosures, including Air Canada's Annual Information Form, consult SEDAR at **www.sedar.com**.

CAUTION REGARDING FORWARD-LOOKING INFORMATION

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

Forward-looking statements, by their nature, are based on assumptions, including those described herein and are subject to important risks and uncertainties. Forward-looking statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, industry, market, credit and economic conditions, the ability to reduce operating costs and secure financing, energy prices, currency exchange and interest rates, competition, employee and labour relations, pension issues, war, terrorist acts, epidemic diseases, environmental factors (including weather systems and other natural phenomena and factors arising from man-made sources), insurance issues and costs, changes in demand due to the seasonal nature of the business, supply issues, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties as well as the factors identified throughout this MD&A and, in particular, those identified in section 18 "Risk Factors" of this MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of February 11, 2014 (or as of the date they are otherwise stated to be made), and are subject to change after such date. However, Air Canada disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

KEY ASSUMPTIONS

Assumptions were made by Air Canada in preparing and making forward-looking statements. As part of its assumptions, Air Canada assumes Canadian GDP growth of 2.0% to 3.0% for 2014. In addition, Air Canada expects that the Canadian dollar will trade, on average, at C$1.10 per U.S. dollar in the first quarter of 2014 and the full year 2014 and that the price of jet fuel will average 93 cents per litre for the first quarter of 2014 and 92 cents per litre for the full year 2014.

3. ABOUT AIR CANADA

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

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

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

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

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

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

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

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

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

4. STRATEGY

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

Key Priorities

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

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

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

Cost Transformation and Revenue Improvement

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

Key achievements in 2013

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

- Received approval by the Office of the Superintendent of Financial Institutions (OSFI) to implement previously announced amendments to its Canadian defined benefit pension plans, effectively lowering the pension solvency deficit under these plans.

- Concluded a private offering of enhanced equipment trust certificates (EETCs), having a face amount of US$715 million to finance five high-density Boeing 777 aircraft on favourable terms.

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

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

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

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

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

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

Air Canada *rouge*

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

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

Introduction of High-Density Boeing 777 Aircraft

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

Introduction of Fuel-Efficient Boeing 787 Aircraft

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

Narrow-Body Fleet Renewal Program

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

Regional Airline Diversification

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

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

Other Revenue Optimization and Cost Reduction Initiatives

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

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

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

Pension

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

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

International Expansion

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

Key achievements in 2013

- Introduced service from Toronto to Seoul and from Toronto to Istanbul, increased frequencies to Beijing from Toronto and Vancouver, and upgraded service between Calgary and Tokyo Narita to offer daily departures.
- Announced a major expansion of international services to Europe from Toronto, Montreal, Vancouver and Calgary, including from Toronto to Milan, the only non-stop service between Canada and Milan.
- Announced the introduction of daily flights between Toronto-Pearson and Tokyo-Haneda, the only non-stop flight between Canada and Tokyo-Haneda.
- Announced the introduction of seasonal non-stop flights by Air Canada *rouge* between Toronto-Lisbon, Toronto-Manchester, Montreal-Barcelona and Montreal-Nice. Air Canada also announced a year-round service from Toronto to Dublin, Ireland.
- Concluded a number of new codeshare agreements, including with Turkish Airlines, Etihad and Aer Lingus.

- Announced the expansion of a long-standing commercial cooperation agreement with Air China.
- Increased sixth freedom revenue (international to international, including U.S.) connecting at Toronto Pearson by almost 3% from 2012;
- Concluded an enhanced cooperation agreement with the GTAA to grow global connecting traffic at Toronto Pearson Airport.

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

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

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

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

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

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

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

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

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

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

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

cooperation agreement with Air China which will enable seamless bookings and connections for customers and their bags via the carriers' Vancouver, Toronto and Beijing hubs to six new China destinations and six new destinations in Canada.

Customer Engagement

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

Key achievements in 2013

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

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

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

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

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

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

In addition, Air Canada launched a new program entitled "Air Canada Corporate Rewards" that offers powerful online tools to help businesses of all sizes better manage their travel, reduce costs and earn rewards to enhance travel. The Air Canada

Corporate Rewards program is designed to make it simpler for companies of any size to track their travel investment, obtain savings and also earn rewards for flying with Air Canada. Members are eligible to receive offers for discounts on Air Canada flights and services along with rewards such as complimentary eUpgrades, Maple Leaf Lounge access, advance seat selection and other exclusive special offers. This program, along with other attributes, such as the airline's expansive global network, International Business Class service, Maple Leaf Lounges and Aeroplan and Altitude loyalty programs, are designed to further boost Air Canada's leading position as the carrier of choice among Canadian business travellers.

Fostering Positive Culture Change

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

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

- Entrepreneurship
- Engagement
- Empowerment
- Earnings for Performance

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

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

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

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

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

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

To encourage the development of a corporate culture, which is focused on transformation and performance, Air Canada has a profit sharing program in place which allows eligible employees to be rewarded for their contributions and share in the financial success of the airline. The profit sharing pool under the program is established based on 7.5% of adjusted profits (a financial measure similar to the adjusted net income measure reported by Air Canada) for the first 7% of Air Canada's adjusted profit margin, plus 25% of all adjusted profits above a 7% adjusted profit margin. Based on the financial results for

the year ended December 31, 2013, the profit sharing program will pay out $31 million in early 2014. In addition, to further encourage employees to become owners of Air Canada, Air Canada employees have the ability to participate in the airline's Employee Share Ownership Plan, which has recently been refreshed to provide more flexibility for enrollment and a better company contribution. As at December 31, 2013, in aggregate, 23,698,796 shares or almost 8% of total issued and outstanding shares were held by Air Canada employees and unions under various programs, including 17,647,059 shares under a trust arrangement in connection with pension arrangements concluded in 2009.

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

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

5. OVERVIEW

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

Full Year 2013 Financial Summary

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

- Operating revenues of $12,382 million, an increase of $268 million or 2% from 2012.

- Passenger revenues of $11,021 million, an increase of $284 million or 2.6% from 2012, on traffic growth of 2.1% and a yield improvement of 0.5%.

- An ASM capacity increase of 1.9% from 2012, slightly below the 2.0% to 2.5% full year 2013 ASM capacity growth projected in Air Canada's news release dated November 8, 2013. The lower than projected ASM capacity growth was due to minor adjustments in the flying schedule versus what Air Canada had assumed in its forecast.

- RASM growth of 0.6% from 2012, mainly reflecting the yield improvement of 0.5%.

- An adjusted CASM reduction of 1.5% from 2012, in line with the 1.5% to 2.0% decrease projected in Air Canada's news release dated November 8, 2013. Refer to section 20 "Non-GAAP Financial Measures" for additional information.

- Operating income of $619 million compared to operating income of $442 million in 2012, an improvement of $177 million. In 2012 and 2013, Air Canada recorded operating expense reductions related to benefit plan amendments of $127 million and $82 million, respectively, as a result of amendments to defined benefit pension plans determined in accordance with new collective agreements concluded in 2011 and 2012 and changes to non-unionized employee pension plans.

- Net income of $10 million or $0.02 per diluted share compared to a net loss of $136 million or $0.51 per diluted share in 2012. The net income in 2013 included foreign exchange losses of $120 million due to a weaker Canadian dollar, an interest charge of $95 million pertaining to the purchase of the airline's senior secured notes which were to become due in 2015 and 2016, an impairment charge of $30 million, and the favourable impact of benefit plan amendments of $82 million. The net loss in 2012 included foreign exchange gains of $106 million, the favourable impact of benefit plan amendments of $127 million as described above, a loss on the airline's investment in Aveos of $65 million and a net loss from discontinued operations – Aveos of $55 million.

- EBITDAR (excluding benefit plan amendments) of $1,433 million compared to EBITDAR (excluding benefit plan amendments) of $1,320 million in 2012, an increase of $113 million. Refer to section 20 "Non-GAAP Financial Measures" for additional information.

- Adjusted net income of $340 million or $1.20 per diluted share compared to adjusted net income of $55 million or $0.20 per diluted share in 2012, an improvement of $285 million or $1.00 per diluted share. Refer to section 20 "Non-GAAP Financial Measures" for additional information.

- Negative free cash flow of $231 million, a decline of $430 million from 2012. While operating cash flows improved year-over-year, which was consistent with the improvement in operating earnings, free cash flow was impacted by the addition of four Boeing 777-300ER aircraft delivered in 2013. Free cash flow (cash flows from operating activities less additions to property, equipment and intangible assets) is a non-GAAP financial measure. Refer to section 9.5 of this MD&A for additional information.

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

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

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

Fourth Quarter 2013 Financial Summary

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

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

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

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

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

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

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

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

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

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

- Negative free cash flow of $276 million, a decline of $255 million from the fourth quarter of 2012. While operating cash flows improved year-over-year, which was consistent with the improvement in operating earnings, free cash flow was impacted by the addition of two Boeing 777-300ER aircraft delivered in the fourth quarter of 2013. Free cash flow (cash flows from operating activities less additions to property, equipment and intangible assets) is a non-GAAP financial measure. Refer to section 9.5 of this MD&A for additional information.

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

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

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

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

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

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

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

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

System passenger revenues increased 2.6% from 2012

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

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

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

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

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

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

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

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

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

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

Domestic passenger revenues increased 1.4% from 2012

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

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

- The 2.3% traffic increase which reflected traffic growth on all major domestic services with the exception of regional routes within Ontario and Quebec where capacity was reduced year-over-year.
- Domestic yield decreased 0.8% which reflected declines on all major domestic routes with the exception of transcontinental routes, linking Toronto, Montreal and Ottawa with major western Canadian cities, and on routes within western Canada. Rapidair™ routes, linking Toronto and Montreal/Ottawa, regional routes within Ontario and Quebec, and routes to the Maritimes were impacted by increased industry capacity and aggressive pricing activities.

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

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

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

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

- The traffic increase of 1.7% which reflected traffic growth on all major U.S. transborder services with the exception of certain services, such as western Canada-western U.S. and Hawaii, where capacity was reduced year-over-year.
- A year-over-year increase in baggage fee revenues.
- The 0.1% yield increase which reflected yield growth on U.S. long-haul routes and on routes to Florida and Hawaii, which was largely offset by the impact of increased industry capacity and aggressive pricing activities on U.S. short-haul routes, such as Boston, New York and Washington, D.C., as well as the impact of a higher proportion of longer-haul flying when compared to 2012. A favourable foreign currency impact of $11 million in 2013 was a contributing factor in the yield improvement year-over-year.

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

Atlantic passenger revenues increased 7.1% from 2012

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

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

- The 5.0% yield increase which reflected yield growth on all major Atlantic services. A favourable currency impact of $22 million also contributed to the yield increase in 2013.

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

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

Pacific passenger revenues increased 3.2% from 2012

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

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

- The 4.3% traffic increase which reflected traffic growth on all major Pacific services with the exception of Australia and, to a lesser extent, Japan.

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

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

Other passenger revenues decreased 2.7% from 2012

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

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

- The overall 3.2% traffic decrease which reflected traffic declines on all major services in the Other markets.

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

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

Cargo revenues decreased 2.9% from 2012

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

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

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

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

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

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

- The 3.4% yield decrease which reflected yield declines in all markets. Despite favourable currency impacts, cargo yields in 2013 were negatively impacted by aggressive pricing activities in an effort to stimulate traffic.

- The 0.5% traffic increase which reflected traffic growth in the U.S. transborder and Pacific markets. Weaker demand for cargo services and increased competition were the main reasons for the traffic declines in the domestic, Atlantic and Other markets. The Atlantic market was also impacted by weaker economic conditions.

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

Other revenues decreased $2 million from 2012

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

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

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

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

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

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

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

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

Operating expenses increased 1% from 2012

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

Fuel expense decreased 1% from 2012

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

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

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

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

(2) The economic cost of fuel is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning, and may not be comparable to similar measures presented by other public companies. Air Canada uses this measure to calculate its cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period and premium costs associated with those derivatives.

Wages, salaries and benefits expense amounted to $2,247 million in 2013, an increase of $137 million or 6% from 2012

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

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

Capacity purchase costs increased 5% from 2012

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

Airport and navigation fees decreased 1% from 2012

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

Aircraft maintenance expense decreased 6% from 2012

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

Sales and distribution costs increased 2% from 2012

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

Depreciation, amortization and impairment expense decreased 14% from 2012

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

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

Aircraft rent expense decreased 5% from 2012

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

Other operating expenses increased 3% from 2012

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

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

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

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

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

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

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

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

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

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

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

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

In 2012, Air Canada recorded a loss on its investment in Aveos' parent holding company as a result of Aveos' filing for court protection pursuant to the CCAA and ceasing operations in March 2012. As a result, Air Canada reduced the carrying value of its investment in Aveos' parent holding company as well as the carrying value of a long term note receivable from Aveos to nil, and recorded an aggregate loss on investments of $65 million. In addition, in 2012, Air Canada recorded a liability of $55 million, which was charged to Discontinued Operations, related to Air Canada's commitment under an employee separation program. In 2013, a cash outflow of $29 million (a cash outflow of $26 million in 2012) was incurred in relation to this separation program.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- The 4.0% traffic increase which reflected traffic growth on all major U.S. transborder services with the exception of services to Hawaii where capacity was reduced year-over-year.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- The overall 6.5% yield improvement which reflected higher fares on routes to traditional sun destinations and on services to South America.

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

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

Cargo revenues increased 1.6% from the fourth quarter of 2012

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

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

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

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

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

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

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

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

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

Other revenues increased 3% from the fourth quarter of 2012

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

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

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

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

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

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

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

Operating expenses decreased 1% from the fourth quarter of 2012

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

Fuel expense increased 1% from the fourth quarter of 2012

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

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

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

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

(2) The economic cost of fuel is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning, and may not be comparable to similar measures presented by other public companies. Air Canada uses this measure to calculate its cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period and premium costs associated with those derivatives.

Wages, salaries and benefits expense amounted to $553 million in the fourth quarter of 2013, an increase of $25 million or 5% from the fourth quarter of 2012

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

8. FLEET

Mainline and Air Canada *rouge*

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

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

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

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

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

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

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

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

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

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

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

Air Canada Express

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

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

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

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

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

9. FINANCIAL AND CAPITAL MANAGEMENT

9.1. Liquidity

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

Liquidity needs are primarily related to meeting obligations associated with financial liabilities, capital commitments, ongoing operations, contractual and other obligations (including pension funding obligations), and covenants in credit card and other agreements. Refer to sections 9.6, 9.7 and 9.8 of this MD&A for information on Air Canada's capital commitments, pension funding obligations and contractual obligations. Air Canada monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as well as those assets being used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. Air Canada's principal objective in managing liquidity risk is to maintain a minimum unrestricted liquidity level of $1.7 billion. This minimum target level was determined in conjunction with Air Canada's liquidity risk management strategy and replaces the previous target of maintaining at least 15% of 12 month trailing revenues. At December 31, 2013, unrestricted liquidity amounted to $2,364 million or 19% of annual operating revenues, comprised of cash and short-term investments of $2,208 million and undrawn lines of credit of $156 million. This compared to unrestricted liquidity of $2,018 million (comprised of cash and short-term investments of $1,973 million and undrawn lines of credit of $45 million) or 17% of annual operating revenues at December 31, 2012.

9.2. Financial Position

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

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

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

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

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

9.3. Adjusted Net Debt

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

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

(1) Adjusted net debt is a non-GAAP financial measure used by Air Canada and may not be comparable to measures presented by other public companies. Adjusted net debt is a key component of the capital managed by Air Canada and provides management with a measure of its net indebtedness. Air Canada includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7.0. This definition of capitalized operating leases is used by Air Canada and may not be comparable to similar measures presented by other public companies. Aircraft rent was $318 million for the twelve months ended December 31, 2013 and $336 million for the twelve months ended December 31, 2012.

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

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

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

9.4. Working Capital

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

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

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

9.5. Consolidated Cash Flow Movements

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

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

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

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

(1) Free cash flow is a non-GAAP financial measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada considers free cash flow to be an indicator of the financial strength and performance of its business because it shows how much cash is generated from the business after investing in capital assets, which is available to meet ongoing financial obligations, including repaying debt and reinvesting in Air Canada.

Free cash flow

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

Net cash flows from (used in) financing activities

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

9.6. Capital Expenditures and Related Financing Arrangements

Private Offering of Enhanced Equipment Trust Certificates

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

Boeing

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

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

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

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

Capital Commitments

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

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

(1) *The table above includes certain maintenance events which are capitalized under IFRS. Future capitalized maintenance amounts for 2016 and beyond are not yet determinable however an estimate of $123 million has been made.*

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

9.7. Pension Funding Obligations

Air Canada maintains several pension plans, including defined benefit and defined contribution pension plans and plans providing other retirement and post-employment benefits to its employees. The Canadian registered pension plans solvency deficit at January 1, 2013 was $3.7 billion. The next required valuations to be made as at January 1, 2014, will be completed in the first half of 2014, but as described below, they will not increase the 2014 pension past service cost funding obligations. Based on preliminary estimates, in aggregate, the domestic registered pension plans are estimated to be in a small surplus position on a solvency basis as at January 1, 2014.

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

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

over the mid-term, assuming appropriate market conditions, to match 100% of the pension liabilities with fixed income products.

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

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

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

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

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

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

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

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

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

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

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

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

9.8. Contractual Obligations

Private Offerings of Senior Secured Notes and Senior Secured Credit Facility

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

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

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

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

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

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

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

Covenants in Credit Card Agreements

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

The terms of Air Canada's principal credit card processing agreements for credit card processing services in North America are in effect for another four years each, and the agreements contain triggering events upon which the Corporation is required to provide the credit card processor with cash deposits. The obligation to provide cash deposits

and the required amount of deposits are each based upon a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio for Air Canada and the unrestricted cash and short-term investments of the Corporation. In 2013, Air Canada made no cash deposits under these agreements (nil in 2012).

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

Ratings

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

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

Moody's Ratings

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

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

Standard & Poor's Ratings

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

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

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

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

Fitch Ratings

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

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

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

DBRS Ratings

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

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

9.9. Share Information

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

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

Earnings per Share

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

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

Warrants

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

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

Air Canada has no warrants left outstanding.

10. QUARTERLY FINANCIAL DATA

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

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

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

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

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

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

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

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

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

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

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

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

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

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

11. SELECTED ANNUAL INFORMATION

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

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

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

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

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

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

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

12. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

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

The following is a summary of "gain (loss) on financial instruments recorded at fair value" included in non-operating income (expense) on Air Canada's consolidated statement of operations for the periods indicated:

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

Risk Management

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

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

Interest Rate Risk Management

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

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

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

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

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

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

Foreign Exchange Risk

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

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

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

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

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

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

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

Fuel Price Risk Management

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

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

In 2013:

- Air Canada recorded a loss of $6 million in Loss on financial instruments recorded at fair value on Air Canada's consolidated statement of operations related to fuel derivatives ($43 million loss in 2012).

- Air Canada purchased crude-oil and refined products-based call options and call spreads covering a portion of 2013 and 2014 fuel exposure. The cash premium related to these contracts was $39 million ($51 million in 2012 for 2012 and 2013 exposures).

- Fuel derivative contracts cash settled with a fair value of $29 million in favour of Air Canada ($3 million in favour of Air Canada in 2012).

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

13. CRITICAL ACCOUNTING ESTIMATES

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

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

Employee Future Benefits

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

Assumptions

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

Financial Assumptions

Discount Rate

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

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

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

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

Actuarial assumptions

Mortality rates

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

Sensitivity Analysis

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

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

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

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

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

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

Impairment Considerations of Long-Lived Assets

Long-lived assets include property and equipment, definite lived intangible assets, indefinite lived intangible assets and goodwill. Assets that have an indefinite useful life, including goodwill, are tested annually for impairment or when events or circumstances indicate that the carrying value may not be recoverable. Assets that are subject to depreciation

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

Depreciation and Amortization Period for Long-Lived Assets

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

Maintenance Provisions

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

14. ACCOUNTING POLICIES

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

IFRS 9 – Financial Instruments

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

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

Amendments to IAS 32 – Financial Instruments: Presentation

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

15. OFF-BALANCE SHEET ARRANGEMENTS

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

Guarantees

Performance Obligations Relating to Aircraft Leasing Agreements

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

Guarantees in Fuel Facilities Arrangements

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

Indemnification Agreements

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

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

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

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

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

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

16. RELATED PARTY TRANSACTIONS

At December 31, 2013, Air Canada had no transactions with related parties as defined in the CICA Handbook – Part 1, except those pertaining to transactions with key management personnel in the ordinary course of their employment or directorship agreements.

17. SENSITIVITY OF RESULTS

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

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

(1) Excludes the impact of fuel surcharges and fuel hedging. Refer to section 12 of this MD&A for information on Air Canada's fuel derivative instruments.
(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 of this MD&A for additional information.

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

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

18. RISK FACTORS

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

Risks Relating to Air Canada

Operating Results

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

Leverage

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

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

Need for Additional Capital and Liquidity

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

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

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

Foreign Exchange

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

Economic and Geopolitical Conditions

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

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

Fuel Costs

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

surcharges, foreign exchange rates and fuel hedging), assuming flying capacity remained unchanged and that refining spreads between WTI crude oil and jet fuel as well as foreign exchange rates remained constant.

Competition

North America

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

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

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

International

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

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

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

Labour Costs and Labour Relations

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

Most of Air Canada's employees are unionized. In 2011, tentative collective agreements with the CAW, the union representing Air Canada's customer service employees at airports and call centres, as well as with CUPE, the union representing Air Canada's flight attendants, were concluded and, respectively, ratified or conclusively settled through arbitration. The agreement with the CAW is in effect until February 28, 2015 and the agreement with CUPE is in effect until March 31, 2015. In 2011, Air Canada also entered into a collective agreement with UNITE, the union representing the airline's London Heathrow-based employees. In the first quarter of 2012, Air Canada concluded agreements with the CAW, in relation to in-flight crew schedulers and flight operations crew schedulers, and with CALDA, in relation to flight dispatchers. In June 2012, the decision of the arbitrator was issued in respect of the IAMAW final offer selection

arbitration conducted in accordance with the process legislated by the federal government in the *Protecting Air Service Act*. The arbitrator's final offer selection concluded a new five-year collective agreement between Air Canada and the IAMAW which is in effect until March 31, 2016. In July 2012, the decision of the arbitrator was issued in respect of the ACPA final offer selection arbitration conducted in accordance with the process legislated by the federal government in the *Protecting Air Service Act*. The arbitrator's final offer selection concluded a new five-year collective agreement between Air Canada and ACPA which is in effect until April 1, 2016.

ACPA and the IAMAW have, each, independently, instituted proceedings to contest the constitutional validity of the legislation which referred to arbitration the resolution of the issues that had not been resolved in bargaining. Air Canada is not currently a party to these proceedings. Air Canada expects that in both cases the legislation (and therefore the collective agreements concluded through the arbitration process) will be upheld.

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

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

Pension Plans

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

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

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

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

Revenue and Alliance Environment

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

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

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

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

Limitations Due to Restrictive Covenants

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

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

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

Strategic, Business, Technology and Other Important Initiatives

In order to operate its business, achieve its goals and remain competitive, Air Canada continuously seeks to identify and devise, invest in, implement and pursue strategic, business, technology and other important initiatives, such as those relating to participation in the low-cost market (including the launch and planned growth of Air Canada *rouge*), the aircraft fleet restructuring (including the scheduled delivery of Boeing 787 aircraft and the planned re-fleeting of narrow-body aircraft with Boeing 737 MAX aircraft), business processes, information technology, revenue management

(including the planned implementation of Air Canada's revenue management system), cost transformation, improving premium passenger revenues, expansion of flying capacity (including in respect of new aircraft and routes), corporate culture transformation, initiatives seeking to ensure a consistently high quality customer service experience and others. These initiatives, including activities relating to their development and implementation, may be adversely impacted by a wide range of factors, many of which are beyond Air Canada's control. Such factors include the need to seek legal or regulatory approvals, the performance of third parties, including suppliers, the implementation and integration of such initiatives into Air Canada's other activities and processes as well as the adoption and acceptance of these initiatives by Air Canada's customers, suppliers, unions and personnel. A delay or failure to sufficiently and successfully identify and devise, invest in or implement these initiatives could adversely affect Air Canada's ability to operate its business, achieve its goals and remain competitive and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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

Airport User Fees and Air Navigation Fees

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

Dependence on Technology

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

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

Key Supplies and Suppliers

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

Aeroplan®

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

Regional Carriers

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

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

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

Star Alliance®

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

Interruptions or Disruptions in Service

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

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

Current Legal Proceedings

Investigations by Competition Authorities Relating to Cargo

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

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

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

Mandatory Retirement

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

Future Legal Proceedings

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

Key Personnel

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

Risks Relating to the Airline Industry

Terrorist Attacks and Security Measures

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

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

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

Casualty Losses

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

Seasonal Nature of the Business, Other Factors and Prior Performance

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

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

Regulatory Matters

The airline industry is subject to extensive Canadian and foreign government regulations relating to, among other things, security, safety, consumer rights, privacy, licensing, competition, environment (including noise levels and carbon emissions) and, in some measure, pricing. For example, new and proposed legislation have been considered or adopted concerning carbon emissions emanating from the aviation industry. Such legislative initiatives include, for example, market-based mechanisms called emissions trading systems, which are being proposed and implemented to reduce the amount of carbon emissions through the setting of emissions allowances and charging aircraft operators for a certain percentage of theses allowances. The implementation of additional regulations or decisions, including those relating to

carbon emissions, and others, whether by Transport Canada, the Competition Bureau and/or the Competition Tribunal, the Canadian Transportation Agency or other domestic or foreign governmental entities, may have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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

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

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

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

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

Availability of Insurance Coverage and Increased Insurance Costs

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

Third Party War Risk Insurance

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

19. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

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

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

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

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

Management's Report on Disclosure Controls and Procedures

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

Management's Report on Internal Controls over Financial Reporting

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

Changes in Internal Controls over Financial Reporting

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

20. NON-GAAP FINANCIAL MEASURES

Operating Income, Excluding the Impact of Benefit Amendments

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

Operating income, excluding benefit plan amendments is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning and may not be comparable to similar measures presented by other public companies.

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

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

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

EBITDAR

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

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

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

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

Adjusted CASM

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

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

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

Adjusted CASM is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning and may not be comparable to similar measures presented by other public companies.

Adjusted CASM is reconciled to GAAP operating expense as follows:

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

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

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

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

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

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

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

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

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

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

(5) In 2012, Air Canada recorded a liability of $55 million, which was charged to Discontinued Operations, related to Air Canada's commitment under an employee separation program.

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

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

Return on Invested Capital

Air Canada uses Return on invested capital to assess the efficiency with which it allocates its capital to generate returns. Return is based on Adjusted net income (loss) (as defined in the section above), excluding interest expense and implicit interest on operating leases. Invested capital includes average long-term debt, average finance lease obligations, the value of capitalized operating leases (calculated by multiplying annualized aircraft rent expense by 7) and the average market capitalization of Air Canada's outstanding shares. This measure is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning and may not be comparable to similar measures presented by other public companies.

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

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

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

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

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

(5) *In 2012, Air Canada recorded a liability of $55 million, which was charged to Discontinued Operations, related to Air Canada's commitment under an employee separation program.*

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

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

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

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

21. GLOSSARY

ACPA – Refers to the Air Canada Pilots Association.

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

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

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

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

CASM – Refers to operating expense per ASM.

CUPE – Refers to the Canadian Union of Public Employees.

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

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

EETCs – Refers to Enhanced Equipment Trust Certificates issued in connection with the financing of aircraft. See section 9.6 of this MD&A for additional information.

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

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

IATA – Refers to the International Air Transport Association.

Other passenger and cargo revenues – Refer to revenues from flights with origins and destinations principally in Central and South America and the Caribbean and Mexico.

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

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

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

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

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

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

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

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

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

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