

**March 18, 2005**

**2004**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**ACE AVIATION HOLDINGS INC.**

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## **PREFACE**

ACE Aviation Holdings Inc. (ACE) was incorporated on June 29, 2004 for the purposes of becoming the parent company of Air Canada and its subsidiaries upon the implementation of the consolidated plan of reorganization, compromise and arrangement (the Plan). On September 30, 2004, ACE became the successor and parent holding company of the reorganized Air Canada and its subsidiaries. This Management's Discussion and Analysis (MD&A) covers ACE's operations and financial results for the period ended December 31, 2004. From the date of ACE's incorporation until September 29, 2004, the day preceding the implementation of the Plan, ACE did not issue any equity securities, acquire any assets, assume any liabilities of Air Canada, did not carry on any operations or have cash flows. Consequently, ACE's consolidated results for the period ended December 31, 2004 represents three months of operations. The MD&A section entitled "Fourth Quarter Results of Operations – 2004 versus 2003" compares ACE's operations and financial results for the three months ended December 31, 2004 to Air Canada's operations and financial results for the three months ended December 31, 2003.

References to "Successor Company" refer to ACE and its subsidiaries on and after June 29, 2004. References to "Predecessor Company" refer to Air Canada and its subsidiaries prior to September 30, 2004. ACE adopted fresh start reporting on September 30, 2004. In accordance with Section 1625 of the CICA Handbook, Comprehensive Revaluation of Assets and Liabilities (CICA 1625), prior period financial information has not been restated to reflect the impact of fair value adjustments and, accordingly, certain amounts in the Predecessor Company are not directly comparable. See Note 5 to the 2004 Annual Consolidated Financial Statements for additional information on fresh start reporting.

The MD&A section entitled "Annual Supplementary Non-GAAP Combined Analysis of Results – 2004 versus 2003" is provided for the purpose of allowing a year-over-year comparison of results of operations and cash flows. This discussion uses 2004 Non-GAAP information which is the combination of financial results for the nine months ended September 30, 2004 of the Predecessor Company and financial results for the period ended December 31, 2004 of the Successor Company. Such combination is for illustrative purposes only. This annual supplementary Non-GAAP Combined information (Combined) will be referred to in the relevant sections of the MD&A as Combined information. As a result of the application of fresh start reporting, application of new accounting policies, the effectiveness of certain lease

contracts on emergence of CCAA and the debt and equity transactions that occurred on September 30, 2004, the Successor financial statements are not comparable to those prepared for Air Canada prior to the emergence. The presentation of the financial information of Air Canada for periods prior to October 1, 2004 and the combination of the financial information of Air Canada and ACE for the year ended December 31, 2004 should not be viewed as a continuum because the financial statements of Air Canada for periods prior to October 1, 2004 and the financial statements of ACE for the period ended December 31, 2004 are those of different reporting entities and are prepared using different bases of accounting and different accounting policies and, therefore, are not comparable. Similarly, the financial information presented in the analysis of the Fourth Quarter Results of Operations - 2004 versus the fourth quarter of 2003 is not comparable for the reasons stated above.

The financial statements are prepared using the accounting policies as described in Note 4 to the 2004 Annual Consolidated Financial Statements. All amounts are expressed in Canadian currency unless indicated otherwise. This Management Discussion and Analysis is as of March 18, 2005.

For further information on ACE's and Air Canada's public disclosure file, please consult [www.sedar.com](http://www.sedar.com).

### **CAUTION REGARDING FORWARD-LOOKING INFORMATION**

*ACE's communications often contain written or oral forward-looking statements which are included in the MD&A and may be included in filings with securities regulators in Canada and the United States. These 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. All such statements are made pursuant to the "safe harbour" provisions of the governing US securities legislation. Such statements may involve but are not limited to comments with respect to strategies, expectations, planned operations or future actions.*

*Forward-looking statements, by their nature, are based on assumptions and are subject to important risks and uncertainties. Any forecasts or forward-looking predictions or statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Results indicated in forward-looking statements may differ materially from actual results for a number of reasons, including without limitation, energy prices, general industry, market and economic conditions, war, terrorist attacks, changes in demand due to the seasonal nature of the business, the ability to reduce operating costs and employee counts, employee relations, labour negotiations or disputes, restructuring, pension issues, currency exchange and interest rates, changes in laws, adverse regulatory developments or proceedings, pending litigation and actions by third parties. The forward-looking statements contained in this discussion represent ACE's expectations as of March 18, 2005, and are subject to change after such date. However, ACE disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise.*

**ACE AVIATION HOLDINGS INC.**  
**2004**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS**

**EXPLANATORY NOTES**

**Glossary of Terms**

**Revenue Passenger Miles (RPMs)**

A measure of passenger traffic calculated by multiplying the total number of revenue passengers carried by the miles they are carried.

**Available Seat Miles (ASMs)**

A measure of passenger capacity calculated by multiplying the total number of seats available for revenue traffic by the miles flown.

**Passenger Load Factor**

A measure of passenger capacity utilization derived by expressing revenue passenger miles as a percentage of available seat miles.

**Passenger Revenue per Revenue Passenger Mile (yield per RPM)**

Average passenger revenue per revenue passenger mile.

**Passenger Revenue per Available Seat Mile (RASM)**

Average passenger revenue per available seat mile.

“Corporation” refers to, as the context may require, ACE and its subsidiaries collectively, ACE and one or more of its subsidiaries, one or more of ACE’s subsidiaries, or ACE itself.

“Subsidiary” or “subsidiaries” refers to, in relation to ACE, any entity, including a corporation, trust partnership or limited partnership, which is controlled, directly or indirectly, by ACE.

**Comparative Figures**

Certain comparative figures have been reclassified to conform with the financial statement presentation adopted in the current year.

## **Mainline or Mainline-related Operations**

As a result of the restructuring, the Corporation's businesses are operated through four reportable segments: transportation services, loyalty program, technical services and regional operations. Refer to page 9 of the MD&A and Note 21 of the 2004 Annual Consolidated Financial Statements for additional information. Segment information is reported on a prospective basis from the date of the restructuring (September 30, 2004). In order to allow the reader to compare certain financial and statistical information to prior years, the MD&A will continue to contain references to "Mainline" or "Mainline-related" operations until such time as the information is comparable to prior years. "Mainline" or "Mainline-related" operations refer to the unconsolidated operations of Air Canada but include, as the context may require, the operations of Aeroplan Limited Partnership (Aeroplan), a premier loyalty program which offers miles accumulation and redemption as an incentive to the Corporation's and other partners' customers; ZIP Air Inc. (ZIP), a wholly-owned airline which ceased operations in September 2004; Destina.ca Inc. (Destina), a web based travel company; Air Canada Capital Ltd., a wholly-owned subsidiary whose main business is the leasing of aircraft to Air Canada, Air Canada Jazz and to third party airlines operating under capacity purchase agreements; and other smaller related subsidiaries of ACE. Also included are the following stand-alone limited partnerships which were established on implementation of the Plan: AC Online, an online travel site offering customers both air and non-air products; Air Canada Technical Services (ACTS) that, together with Air Canada, provides technical services; AC Cargo that, together with Air Canada, provides cargo services; and Air Canada Ground Handling Services (ACGHS) which provides ground handling services. Mainline or Mainline-related operations exclude the operations of Jazz LP (Air Canada Jazz or Jazz), ACE's regional airline; third party airlines operating under capacity purchase agreements; Wingco Leasing Inc. (Wingco), a wholly-owned subsidiary whose main business was the leasing of regional aircraft to Air Canada Jazz and to third party airlines operating under capacity purchase agreements; Touram Inc. (Air Canada Vacations); and other non-airline subsidiaries of ACE. Wingco was amalgamated into Air Canada Capital Ltd. on September 30, 2004.

## **Non-GAAP Earnings (Losses)**

Due to the significant events facing the Predecessor Company in prior years, Management reviews financial results on a normalized basis after adjusting certain items. Significant items, such as reorganization and restructuring items, which are not reflective of the underlying financial performance of the Predecessor Company from ongoing operations, have been removed from reported earnings (losses) for the purposes of adjusted or non-GAAP earnings (losses).

Net income (loss) adjusted for restructuring and reorganization items is not a recognized measure for financial statement presentation under GAAP. Non-GAAP earnings measures do not have a standardized meaning and are therefore not likely to be comparable to similar measures presented by other public companies. Readers should consider the adjusted net income (loss) measures in the context of the Corporation's and Air Canada's GAAP results.

Net income (loss) before reorganization and restructuring items in 2003 and 2004 is reconciled to net income (loss) as follows:

(\$ millions)	2003	Predecessor Company Air Canada	Successor Company ACE	Combined 2004
		Nine Months ended Sept 30, 2004	Period ended Dec 31, 2004	
GAAP net income (loss)	(1,867)	(895)	15	(880)
Add back:				
Reorganization and restructuring items	1,050	871	-	871
Net income (loss) adjusted for reorganization and restructuring items	(817)	(24)	15	(9)

EBITDAR (earnings before interest, taxes, depreciation, amortization and obsolescence and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before aircraft rent and ownership costs as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other asset acquisitions.

EBITDAR is not a recognized measure for financial statement presentation under GAAP and does not have a standardized meaning and is therefore not likely to be comparable to similar measures presented by other public companies. EBITDAR before reorganization and restructuring items and EBITDAR before non-recurring labour expenses are reconciled to operating income before reorganization and restructuring items and to EBITDAR before non-recurring labour expenses, as follows:

(\$ millions)	2002	2003	Predecessor Company Air Canada	Successor Company ACE	Combined 2004 (1)
			Nine Months ended Sept 30, 2004	Period ended Dec 31, 2004	
GAAP operating income (loss)	(192)	(684)	120	(3)	117
before undernoted items:					
Reorganization and restructuring items					
Non-recurring labour expenses					
Add back:					
Depreciation, amortization and obsolescence	372	366	312	85	397
Aircraft rent	1,109	1,008	521	111	632
EBITDAR, before non-recurring labour expenses and reorganization and restructuring items	1,289	690	953	193	1,146
EBITDAR margin (%) (2)	13.1	8.2	13.9	9.4	12.9

(1) Refer to page 2 of this MD&A for additional information.

(2) EBITDAR margin is calculated as EBITDAR divided by operating revenues.

### Loyalty Program

As a result of the application of fresh start reporting, the outstanding loyalty program mileage credits (Miles) were adjusted to reflect the estimated fair value of Miles to be redeemed in the future. As a consequence of this fair value adjustment and the evolving nature of the Aeroplan loyalty program, the Successor Company changed the accounting policy as of September 30, 2004 for the recognition of its obligations relating to the loyalty program. The Predecessor Company recognized the obligation related to Miles earned through transportation services based on the incremental cost of providing future transportation services. On a prospective basis from the date of fresh start reporting, Miles earned by members through transportation services provided by the Corporation and the transportation services are treated as multiple elements. Miles are recorded at fair values with the residual allocated to transportation services. Consistent with the accounting policy of the Predecessor Company, the proceeds from the sale of Miles to loyalty program partners are deferred.

Revenues from Miles issued to members are recognized at the time the Miles are redeemed except for breakage as noted below. Effective September 30, 2004, Miles redeemed for air travel on Air Canada and Jazz are included in passenger revenue and miles redeemed for



other than travel are included in other revenue. Under the previous accounting policy in the Predecessor Company, Aeroplan redemption revenues from Miles earned by members through loyalty program partners were included in other revenue. These revenues amounted to \$173 million for the nine months ended September 30, 2004 (\$177 million for the twelve months ended December 31, 2003). Based on historical experience and current program policies, the Successor Company estimates the percentage of Miles that may never be redeemed, defined as breakage. The amount allocated to breakage is recognized on a straight line basis over a period of 30 months in other revenue. The Corporation performs regular evaluations of the breakage estimate which may result in certain adjustments.

Also, effective September 30, 2004, the Corporation commenced deferring passenger revenues equivalent to the fair value of Miles earned through air travel on the Corporation's services based upon the cost of purchasing the mileage credits from Aeroplan. These deferred passenger revenues will be recognized in a future period when the Miles are redeemed. The sum of passenger revenues from Miles redeemed for air travel on Air Canada and Jazz and the above noted deferred revenues are referred to as Aeroplan passenger revenues (Aeroplan passenger revenues).

The current portion of loyalty program deferred revenues of \$497 million (\$192 million at December 31, 2003 as recorded under the previous accounting policy) are reported in Advance ticket sales and Loyalty program deferred revenues. The determination of the current portion is based on Management's estimate as to the portion of the liabilities that will be redeemed in the next twelve months. The remainder of the liabilities is carried in Other long-term liabilities.

## **OVERVIEW AND GENERAL BUSINESS SUMMARY**

### **Summary**

ACE Aviation Holdings Inc. (ACE) was incorporated on June 29, 2004 for the purpose of becoming the parent company of Air Canada and its subsidiaries upon the implementation of the consolidated plan of reorganization, compromise and arrangement (the Plan) as further described in Note 2 to the 2004 Annual Consolidated Financial Statements. From the date of ACE's incorporation until the day preceding the implementation of the Plan, ACE did not issue any equity securities, acquire any assets, assume any liabilities of Air Canada, did not carry on any operations or have cash flows.

In accordance with the implementation of the Plan involving Air Canada as the Predecessor Company, and certain subsidiaries pursuant to the provisions of the Companies' Creditors Arrangement Act (Canada) (CCAA), on September 30, 2004, ACE became the successor and parent holding company of the reorganized Air Canada and each of its subsidiaries. As part of the Plan, in addition to Aeroplan, Jazz, Destina and Air Canada Vacations, which were already established as separate legal entities, Air Canada Technical Services (ACTS), AC Cargo, Air Canada Ground Handling Services and AC Online were established as stand-alone limited partnerships under ACE. In addition, Jazz was reorganized into Jazz Limited Partnership.

As described in Note 21 to the 2004 Annual Consolidated Financial Statements, ACE's businesses are operated through four reporting segments which include:

### **Transportation Services**

Transportation services include the Corporation's principal passenger and cargo transportation services covering Air Canada and related ancillary services and, effective September 30, 2004, the Corporation records the transportation revenues earned on Jazz operations and the fees related to Jazz operations as provided for under a capacity purchase agreement.

Air Canada is Canada's largest domestic and international full-service airline and the largest provider of scheduled passenger services in the domestic market, the Canada-US market as well as Canada-International markets. Through Air Canada's global route network, virtually every major market throughout the world is served either directly or through the Star

Alliance which is the world's largest airline network. Jazz is the largest regional airline in Canada.

Destina and AC Online manage Air Canada's commercial web sites in addition to operating an online travel site offering customers both air and non-air products.

Air Canada Vacations is a major Canadian tour operator providing vacation packages.

Air Canada and Air Canada Cargo provide air cargo services on domestic, transborder and international flights. Air Canada Cargo is a major domestic air cargo carrier and manages the entire cargo capacity on aircraft operated by Air Canada and Jazz on domestic and transborder routes. Air Canada continues to offer cargo services on its international passenger flights.

Air Canada Ground Handling Services provides passenger handling services to Air Canada, Jazz and other airlines with a primary focus on Canadian stations. Services covered include "above and below the wing" passenger and baggage handling services and ancillary services such as deicing, ground support and equipment maintenance.

#### Loyalty Program

Aeroplan is a premier loyalty program which offers miles accumulation and redemption as an incentive to the Corporation's and other partners' customers. Accumulated mileage may be redeemed for travel rewards or for goods and services from non-airline partners.

#### Technical Services

ACTS provides technical services and competes on a global basis as an aircraft maintenance, repair and overhaul service provider.

#### Regional Operations

Jazz is responsible for regional airline operations and provides service throughout Canada and to certain destinations in the United States under a Capacity Purchase Agreement (CPA) between Air Canada and Jazz that came into effect on September 30, 2004. Under the CPA, Jazz focuses on airline operations and customer service and Air Canada is responsible for scheduling, marketing and pricing and related commercial activities of the regional operations. Under this agreement, Jazz records revenues from Air Canada based upon fees

relating to flight operations performed, passengers carried and other items covered by the CPA. These intercompany transactions are eliminated in the consolidated financial statements.

Refer to Note 21 to the 2004 Annual Consolidated Financial Statements for additional information on ACE's operating segments.

## **NEW BUSINESS STRATEGY**

In order to respond to a rapidly changing landscape, including increasing competition from low-cost carriers, in 2003 and 2004, Air Canada fundamentally changed its business strategy and redesigned its business process. The Corporation designed and embarked on a new business plan to: (i) solidify its domestic market position through a superior product offering at a competitive cost; (ii) provide a solid foundation for its growing international markets; and (iii) maximize the value inherent in ACE's non-airline subsidiaries.

The Corporation's new business strategy is based on the following four major components, each of which is further described below:

- (i) a competitive cost structure;
- (ii) a redesigned network to maximize efficiency and leverage international growth opportunities;
- (iii) a customer driven revenue model for passenger services; and
- (iv) a new corporate structure to maximize the value of its subsidiaries.

### **Competitive Cost Structure**

The foundation of the new business strategy is a competitive cost structure. As a result of the CCAA restructuring process, the Corporation was in a position to restructure its costs. The Corporation believes that its new cost structure will allow it to compete more effectively with other industry players in each of its targeted market segments. The Corporation's focus on cost reductions is reflected in all components of the new business strategy, and includes:

- (i) an important reduction in labour costs resulting from higher productivity, a rationalized work force and lower average salaries;
- (ii) the repudiation and renegotiation of various contractual obligations, including those related to aircraft, real estate and suppliers;
- (iii) a fleet simplification through the elimination of older, less efficient aircraft and the increased utilization of new large regional jet aircraft with lower trip costs in order to better match capacity with demand, as well as a reduction in the number of aircraft types in order to lower maintenance, inventory and pilot training costs; and
- (iv) the increasing use of technology in order to reduce costs.

Unlike its low-cost competitors, the Corporation incurs costs related to the offer of value-added transportation services, such as Executive Class services and other non-air services. The Corporation believes that these costs are offset by a revenue premium, driven primarily by higher passenger yield and passenger load factor, increased international connecting traffic and increased Aeroplan and cargo revenues. The Corporation expects to maintain this revenue premium by continuing to leverage its key competitive advantages, including:

- (i) a more extensive route network, greater flight frequency and greater market presence;
- (ii) value-added services, for which customers are willing to pay a premium, including unlimited schedule changes, same day stand-by, advance seat selection, full Aeroplan mileage, concierge service and Executive Class service; and
- (iii) higher yielding international (including transborder) connections, which currently represent approximately 30 per cent of the Corporation's domestic traffic.

### **Redesigned Network to Maximize Efficiency and Leverage International Growth Opportunities**

The Corporation's objective is to become the customer's clear choice in all the markets in which it competes by offering a better scheduled product at a competitive price. To this end, the Corporation's redesigned network focuses on offering high flight frequency on key domestic and transborder routes, while maintaining competitive frequency on other domestic and transborder routes, and reducing the average seating capacity per departure.

To this end, Jazz, the Corporation's regional carrier, forms an integral part of Air Canada's domestic and transborder market strategy. The Corporation expects to achieve its objectives through the increased use of large regional jet aircraft which have lower trip costs. This initiative, for which deliveries commenced in October 2004, will see Air Canada and Jazz add 90 new regional jet aircraft to their fleet by 2008. In addition, as a result of agreements reached with Air Canada's and Jazz's unions during Air Canada's restructuring under the CCAA, all of the Corporation's Bombardier CRJ aircraft will be operated out of Jazz's regional operations. The Corporation expects that the lower trip costs of these regional jet aircraft will enable the Corporation to compete more effectively with low-cost carriers. This strategy should

allow the Corporation to operate its network more efficiently by better matching capacity with demand and by facilitating connections in a timely fashion.

Since international services generally produce higher margins than domestic and transborder services, the Corporation also intends to expand its existing services to international destinations and serve new international destinations. The Corporation believes that it is well positioned to grow its international services and increase its current market share by leveraging the following competitive advantages:

- (i) its superior international network;
- (ii) its widely recognized brand and its strong position in the market for trans-Atlantic and trans-Pacific travel to and from Canada and more recently the Canada-South America market;
- (iii) its competitive position with respect to labour costs as compared to major international legacy carriers, which results in part from the restructuring process; and
- (iv) its ability to capitalize on the relative speed and convenience associated with having its hubs located in Canada which, unlike the United States, does not currently require a visa from residents of certain countries transiting through the country.

For domestic, transborder and international services, the Corporation will continue to leverage the strengths of its Aeroplan program.

### **Customer Driven Revenue Model for Passenger Services**

The Corporation's new revenue model for passenger services is aimed at improving customer satisfaction and retention by focusing on simplicity, value, choice, transparency and flexibility for the customer and is resulting in greater passenger volume, higher passenger load factors and increased cost efficiency for Air Canada and Jazz.

The new revenue model is based on five simple fare types ranging from low one-way fares, substantially similar to those offered by low-cost carriers, to Executive Class fares. The new fares are based on a different combination of product attributes, including the ability to make changes to reservations, seat selection and Aeroplan mileage. The new model provides

transparency by allowing customers to compare prices and travel options and select the most suitable fare. The Corporation believes that this establishes a clear link between price and value and will be a key driver in achieving customer loyalty.

The new revenue model was introduced in Air Canada's and Jazz's domestic markets in May 2003. In February 2004, the new revenue model was expanded to most destinations in the continental United States served by Air Canada and Jazz in cooperation with United Airlines, one of Air Canada's Star Alliance partners. The Corporation believes that its increasing use of the internet to improve its distribution network has facilitated market acceptance of its new revenue model. Air Canada also intends to implement a similar fare structure for its international services.

### **New Corporate Structure to Maximize the Value of Subsidiaries**

In connection with the implementation of the Plan, a new corporate structure was established pursuant to which the various business segments that were formerly within Air Canada became stand-alone subsidiaries of ACE. The new corporate structure was designed to:

- (i) put in place separate management and business plans for each subsidiary to better focus their strategic direction and profit making efforts;
- (ii) align management, capital and human resource needs within each individual business;
- (iii) facilitate the development of each business segment to its fullest individual potential including, where appropriate, through the pursuit of third party sources of business; and
- (iv) maximize subsidiaries' value that was not fully recognized when the business segments were part of Air Canada.

ACE's subsidiaries are at varying stages of their corporate development and maximizing value at these entities is a priority in the efforts of ACE's senior management. ACE's value enhancement strategy in respect of its stand-alone subsidiaries includes considering stand-alone financings, sales or distributions of equity interests and involving outside investors for these and other purposes. ACE is examining a range of alternatives to maximize the value of its investment in Aeroplan for the benefit of all its shareholders.



From time to time, ACE reviews acquisition opportunities in respect of businesses or assets that may be complementary to its own. Where appropriate, to increase shareholder value, ACE may consider entering into acquisitions and joint ventures, although no decision has been made in respect of any such acquisition or joint venture opportunity.

In addition, ACE is pursuing internal growth opportunities at its various subsidiaries. In particular, Aeroplan intends to grow its revenues through greater access to Air Canada's network for mileage redemption and the addition of new partners across various retail segments. ACTS intends to leverage its unused capacity by developing its third party customer base, including US carriers that have recently increased their outsourcing of maintenance repair and overhaul work (MRO).

## **FOURTH QUARTER RESULTS OF OPERATIONS – 2004 VERSUS 2003**

The following table sets out the 2004 results of operations for ACE, the Successor Company, as compared to the fourth quarter 2003 results of operations for Air Canada, the Predecessor Company. From the date of ACE's incorporation until September 29, 2004, the day preceding the implementation of the Plan, ACE did not issue any equity securities, acquire any assets, assume any liabilities of Air Canada, carry on any operations or have cash flows. Because ACE had no significant transactions from June 29, 2004 to September 29, 2004, hereafter in this discussion, we will describe ACE's 2004 results of operations as quarterly operations and these results will be compared to the results of operations of Air Canada for the fourth quarter of 2003. As a result of the application of fresh start reporting, application of new accounting policies, the effectiveness of certain lease contracts on emergence from CCAA and the debt and equity transactions that occurred on September 30, 2004, the Successor's financial statements are not comparable to those prepared for Air Canada prior to emergence.

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 high number of leisure travelers and their preference for travel during the spring and summer months. The Corporation has substantial fixed costs that do not meaningfully fluctuate with passenger demand in the short-term. Seasonably low passenger demand results in significantly lower operating cash flow and margins in the first and fourth quarters for each calendar year compared to the second and third quarters.

**ACE Aviation Holdings Inc.**  
**Consolidated Statement of Operations**

(\$ millions, except per share figures) (Unaudited)	Successor Company ACE	Predecessor Company Air Canada
	Period ended Dec 31, 2004	Three Months ended Dec 31, 2003
Operating revenues		
Passenger	1,681	1,615
Cargo	151	131
Other	230	231
	<u>2,062</u>	<u>1,977</u>
Operating expenses		
Salaries, wages and benefits	596	633
Aircraft fuel	432	290
Aircraft rent	111	210
Airport and navigation fees	198	168
Aircraft maintenance, materials and supplies	78	78
Communications and information technology	66	93
Food, beverages and supplies	76	76
Depreciation, amortization and obsolescence	85	94
Commissions	65	58
Other	358	354
	<u>2,065</u>	<u>2,054</u>
Operating income (loss) before reorganization and restructuring items	(3)	(77)
Reorganization and restructuring items	-	(560)
Non-operating income (expense)		
Interest income	11	4
Interest expense	(60)	(19)
Interest capitalized	2	-
Loss on sale of and provisions on assets	-	(118)
Other	(20)	1
	<u>(67)</u>	<u>(132)</u>
Loss before foreign exchange on non- compromised long-term monetary items and income taxes	(70)	(769)
Foreign exchange gain (loss) on non-compromised long-term monetary items	98	(7)
Income (loss) before income taxes	28	(776)
Recovery of (provision for) income taxes	(13)	8
Income (loss)	<u>15</u>	<u>(768)</u>
Earnings (loss) per share (1)		
- Basic	0.17	(6.39)
- Diluted	0.17	(6.39)

(1) Pursuant to the Plan as further described in Note 2 to the 2004 Annual Consolidated Financial Statements, all issued and outstanding options of Air Canada and warrants were cancelled without payment or consideration. In addition, a new share capital was established under ACE, as further described in Notes 19 and 20 to the 2004 Annual Consolidated Financial Statements.

### **Comparison of Fourth Quarter Results**

For the quarter ended December 31, 2004, ACE reported an operating loss of \$3 million, an improvement of \$74 million compared to Air Canada's operating loss before reorganization and restructuring items of \$77 million recorded in the same quarter of 2003. Operating revenues were up \$85 million or 4 per cent. Despite a fuel expense increase of \$142 million, operating expenses increased by only \$11 million on an ASM capacity decrease of 2 per cent.

Net income for the quarter was \$15 million compared to a net loss of \$768 million in the fourth quarter of 2003. The fourth quarter of 2003 included reorganization and restructuring items amounting to \$560 million.

### **Operating Revenues**

Passenger revenues were up \$66 million or 4 per cent from 2003 and included Aeroplan passenger revenues of \$41 million in the fourth quarter of 2004.

Beginning in October 2004, Aeroplan redemption revenues related to points redeemed for air travel on Air Canada and Jazz are recorded in passenger revenue and passenger revenues are being deferred equivalent to the fair value of Miles earned through air travel on the Corporation's services (Aeroplan passenger revenues). Previously, Aeroplan redemption revenues were included in other revenue. As a result of the inclusion of Aeroplan passenger revenues in passenger revenues starting in October 2004, passenger revenues, RASM and yield per RPM are not directly comparable to the previous years. The following discussion will provide the reader with variances that include Aeroplan passenger revenues. However, for comparative purposes, passenger revenues, RASM and yield per RPM will also provide the reader with variances excluding these revenues.

The table below describes, by major market, quarter-over-quarter percentage changes in passenger revenues, capacity as measured by available seat miles (ASMs), traffic as measured by revenue passenger miles (RPMs), passenger load factor as measured by RPMs divided by ASMs, yield as measured by passenger revenue per RPM, and RASM as measured by passenger revenue per ASM.

### Operating Statistics – Quarter 4, 2004 versus Quarter 4, 2003

	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield per RPM % Change	RASM % Change
Canada	0	(8)	2	8.1	(2)	9
US	(17)	(16)	(5)	8.1	(12)	(1)
Atlantic	4	(4)	(3)	0.3	8	9
Pacific	35	24	23	(0.9)	10	9
Other	22	16	18	1.6	3	5
System (excl. Aeroplan)	1	(2)	4	4.7	(3)	4
System (incl. Aeroplan)	4	(2)	4	4.7	0	6

For the 2004 quarter, system passenger traffic increased 4 per cent on a decrease of 2 per cent in ASM flying capacity producing a 4.7 percentage point improvement in load factor. Excluding Aeroplan passenger revenues, yield per RPM decreased 3 per cent. The yield per RPM decrease was mainly due to increased low-cost competition, a weak transborder market and a greater proportion of longer haul flying which has a lower yield per RPM. However, with the major improvement in load factor, system RASM, excluding Aeroplan passenger revenues, rose 4 per cent over the fourth quarter of 2003.

Fourth quarter domestic passenger revenues were up \$16 million or 2 per cent and included Aeroplan passenger revenues of \$18 million in the 2004 quarter. Domestic passenger traffic was up 2 per cent and capacity was reduced by 8 percent resulting in a passenger load factor improvement of 8.1 percentage points. Reflecting the improvement in passenger load factor, excluding Aeroplan passenger revenues, domestic RASM rose 9 per cent above the 2003 level.

US transborder passenger revenues were down \$51 million or 14 per cent and included Aeroplan passenger revenues of \$11 million in the 2004 quarter. In response to increased capacity from US carriers, US transborder ASM capacity was reduced by 16 per cent. As a result, traffic declined 5 per cent resulting in a passenger load factor improvement of 8.1 percentage points. Excluding Aeroplan passenger revenues, yield per RPM declined 12 per cent reflecting increased capacity in the US transborder market. Excluding Aeroplan passenger revenues, US transborder RASM was down 1 per cent as the improvement in passenger load factor did not fully offset the yield decrease.

Other international passenger revenues were \$101 million or 18 per cent above the fourth quarter of 2003 and included Aeroplan passenger revenues of \$12 million in the 2004 quarter. Atlantic revenues, including Aeroplan passenger revenues of \$6 million, increased \$19 million or 6 per cent, reflecting an 8 per cent increase in yield per RPM, excluding Aeroplan passenger revenues. Excluding Aeroplan passenger revenues, RASM increased 9 per cent. Pacific revenues were up \$55 million or 37 per cent and included Aeroplan passenger revenues of \$2 million. This increase, excluding Aeroplan passenger revenues, reflected a 10 per cent increase in yield per RPM. As a result, excluding Aeroplan passenger revenues, RASM increased 9 per cent. South Pacific, Caribbean, Mexico and South America revenues increased \$27 million or 28 per cent and included Aeroplan passenger revenues of \$4 million. Traffic increased 18 per cent on an ASM capacity increase of 16 per cent resulting in a passenger load factor improvement of 1.6 percentage points. Excluding Aeroplan passenger revenues, yield per RPM increased 3 per cent over the fourth quarter of 2003. Excluding Aeroplan passenger revenues, RASM increased 5 per cent due to both the passenger load factor improvement and the yield per RPM increase. The growth in these markets is mainly from increased capacity to traditional leisure destinations as well as the addition of new routes to South America and other destinations.

Cargo revenues increased \$20 million or 15 per cent due to higher traffic mainly in the Pacific and Atlantic markets as well as higher yield due in part to surcharges. Cargo freighter operations commenced in the domestic market in June 2004 and in the international market in November 2004 to replace Boeing 747-400 Combi aircraft which were retired. The fourth quarter of 2004 includes revenues of \$14 million from freighter operations.

Other revenues were down \$1 million. As a result of the change in accounting policy for the loyalty program as described above, commencing in October 2004, Aeroplan passenger revenues are recorded in passenger revenue. These passenger revenues amounted to \$41 million in the fourth quarter of 2004. Previously, Aeroplan redemption revenues were recorded in other revenue. This change resulted in a \$17 million reduction to Aeroplan other revenue versus the fourth quarter of 2003. Excluding the impact of this change, Aeroplan revenues rose \$24 million due partially to an increase in non-air redemption revenues. Third party aircraft maintenance revenues also increased by approximately \$25 million reflecting higher heavy and engine maintenance activity.

The analysis of other revenue in the above comparisons has been provided based on the products and services offered by the Corporation for Aeroplan, Air Canada Technical Services and Air Canada Vacations. This is consistent with prior year's reporting with the exception of Aeroplan redemption revenues which are recorded in passenger revenues beginning in the fourth quarter of 2004. As a result of the restructuring, effective September 30, 2004, the Corporation's businesses are operated through four reportable segments: transportation services, loyalty program, technical services and regional operations. This segment reporting is applied on a prospective basis from the date of fresh start reporting. Refer to Note 21 of 2004 Consolidated Financial Statements and to page 76 of this MD&A for additional information.

### **Operating Expenses**

For the quarter, total operating expenses increased \$11 million or 1 per cent compared to the fourth quarter of 2003 despite an increase in fuel expense of \$142 million or 49 per cent. Unit cost increased 3 per cent from the 2003 level (excluding fuel expense, down 5 per cent). Excluding fuel expense, operating expenses decreased \$131 million from the fourth quarter of 2003 on a 2 per cent reduction to ASM capacity.

Salaries and wage expense declined \$27 million or 5 per cent reflecting a reduction of an average of over 1,000 full-time equivalent (FTE) employees or 3 per cent from 2003 as well as salary reductions for unionized and non-unionized labour groups. Compared to the fourth quarter of 2002, average FTE employees were down over 8,000 employees or 20 per cent.

Employee benefits expense decreased \$10 million or 8 per cent from the fourth quarter of 2003 due largely to lower pension expense resulting from the elimination of unamortized actuarial losses and prior service costs resulting from fresh start reporting which accounted for approximately \$22 million of the decrease. In the fourth quarter of 2003, a \$10 million favourable adjustment was recorded relating to an updated actuarial valuation of worker's compensation liability.

Fuel expense increased \$142 million or 49 per cent. The average base fuel price increase of \$179 million or 66 per cent was partially offset by a reduction of \$31 million due to the favourable impact of a stronger Canadian dollar and reduced flying.

Aircraft rent expense decreased \$99 million or 47 per cent and included the reclassification of certain operating leases to capital leases, renegotiated lease rates, the

elimination of deferred changes and deferred credits as well as the impact of aircraft repudiations/returns. The stronger Canadian dollar was also a favourable factor for aircraft leases denominated in US dollars.

Airport and navigation fees increased \$30 million or 18 per cent mainly due to rate increases. In addition, 2003 included a favourable adjustment of \$17 million reversing charges related to fees in foreign locations in 2002.

Aircraft maintenance materials and supplies expense was unchanged from the 2003 quarter.

Communications and information technology expense was down \$27 million or 29 per cent largely as a result of increased direct passenger sales via the internet, renegotiated contract rates for information technology and communication services, a decrease in information technology maintenance costs and the favourable impact of a stronger Canadian dollar.

Depreciation expense decreased \$9 million or 10 per cent largely due to the impact of fresh start reporting including lower software amortization and computer, aircraft and other depreciation costs. This decrease was partially offset by an increase due to the reclassification of certain operating leases to capital leases of approximately \$5 million and the amortization of intangible assets recorded at fresh start of \$17 million.

Commission expense was up \$7 million or 12 per cent reflecting, in part, increased passenger revenues partially offset by revised rates for Web and Global Distribution System (GDS) bookings.

The other operating expense category increased \$4 million or 1 per cent. Expense increases included an increase relating to higher volume of tour packages by Air Canada Vacations as well as higher advertising and promotion expenses, customer maintenance materials and Aeroplan liability expenses. These increases were largely offset by reductions in insurance, credit card fees, terminal handling, crew expenses and numerous other expense reductions.

Unit cost was 3 per cent above the fourth quarter of 2003 on an ASM capacity decrease of 2 per cent (excluding fuel expense, down 5 per cent).



## Non-Operating Expense

Non-operating expense amounted to \$67 million in the quarter, a \$65 million decrease from the fourth quarter of 2003. Net interest expense increased \$32 million primarily due to the reclassification of certain operating leases to capital leases as well as interest expense relating to new long-term debt resulting from the restructuring process. In 2003, Air Canada did not record interest expense on unsecured debt subject to compromise.

There was no loss on sale of assets in the 2004 quarter. In the fourth quarter of 2003, a loss on sale of assets of \$118 million was recorded mainly relating to provisions recorded on non-operating aircraft, inventory and other investments.

## Foreign Exchange Gains

Gains from foreign exchange on long-term monetary items amounted to \$98 million in the fourth quarter of 2004. The gains recorded in the quarter included \$79 million related to capital lease obligations.

## Fleet Status

### Operating Fleet

Air Canada's Mainline operating fleet, excluding Jazz aircraft, at December 31, 2004, was as described below:

	Number of Operating Aircraft (1)	Average Age of Operating Aircraft (Years)	Owned	Capital Lease	Operating Lease
<b>Widebody Aircraft</b>					
Airbus A340-500	2	0.5	2 (2)	-	-
Airbus A340-300	9	7.5	-	8	1
Airbus A330-300	8	4.2	-	8	-
Boeing 767-300	30	11.4	1	2	27
Boeing 767-200	12	18.5	12	-	-
<b>Narrowbody Aircraft</b>					
Airbus A321	13	3.9	-	-	13
Airbus A320	52	11.8	-	-	52
Airbus A319	48	6.0	-	17	31
Canadair Regional Jet CRJ100	25	9.2	-	-	25
<b>Total Aircraft</b>	<b>199</b>	<b>9.3</b>	<b>15</b>	<b>35</b>	<b>149</b>

(1) Excludes three owned Boeing 747-200, one owned Boeing 747-400, three owned Boeing 737-200, eight owned Boeing 767-200 and 16 owned DC-9 aircraft which were permanently removed from service.

(2) These aircraft are 100 per cent financed under conditional sales agreements.

In 2004, Air Canada took delivery of two Airbus A340-500 aircraft. During 2004, one Boeing 747-400 aircraft was returned to the lessor. Two Boeing 747-400 aircraft were purchased from General Electric Capital Corporation (GECC) of which one Boeing 747-400 aircraft was sold and one Boeing 747-400 aircraft was removed from service. The Boeing 747-400 aircraft which was removed from service was sold in January 2005. In addition, one Boeing 767-200 aircraft was removed from service and all remaining 13 Boeing 737-200 aircraft were returned to the lessor or repudiated. The average age of the Mainline operating fleet was 9.3 years as at December 31, 2004.

Jazz's operating fleet at December 31, 2004 was as described below:

	Number of Operating Aircraft (1)	Average Age of Operating Fleet (Years)	Total Owned Operating Aircraft (2)	Total Operating Leased Aircraft (2)
<b>Jazz</b>				
Canadair Regional Jet CRJ200	18	3.5	-	18
British Aerospace BAe 146	2	15.7	-	2
de Havilland DHC-8-300	26	14.8	17	9
de Havilland DHC-8-100	45	16.7	42	3
<b>Total Aircraft</b>	<b>91</b>	<b>13.5</b>	<b>59</b>	<b>32</b>

- (1) Excludes four BAe 146 and one Dash 8-100 aircraft which have been parked, pending return to lessors and two BAe 146 aircraft which were available as operational spares.
- (2) Excludes five owned Beech 1900D aircraft which have been leased by Air Canada Capital Inc. to third party airlines operating under capacity purchase agreements and 27 Fokker F28 aircraft of which have been permanently retired.

During 2004, eight Dash 8-100 aircraft were returned to lessors, one Dash 8-100 aircraft was sold and two BAe 146 aircraft were returned to lessors. The two operating BAe 146 aircraft were retired from active service in 2005 and all BAe 146 aircraft are planned to be returned to lessors by June 2005. In 2004, Jazz took delivery of eight CRJ-200 aircraft.

The average age of Jazz's operating fleet was 13.5 years as at December 31, 2004.

## **Employees**

The Corporation concluded new long-term collective agreements with all union groups which expire in 2009. These collective agreements provide for a process to revise wage levels in 2006 by negotiation or, failing negotiation, by mediation or arbitration without resort to strike or lock-out.

The implementation of the unionized workforce reduction plan emanating from the Corporation's new collective agreements and the implementation of the workforce reduction

plan pertaining to the Corporation's non-unionized workforce were substantially completed by the end of 2004. Further workforce reductions in some areas are anticipated with the introduction of new technology and a voluntary separation plan and additional non-unionized workforce reductions in some areas are planned to occur in 2005.

A significant reduction of full-time equivalent (FTE) employees has been achieved through the implementation of these workforce reduction plans. In the fourth quarters of 2002 and 2003, the Corporation had an average of 39,996 and 33,124 FTE employees, respectively. In the fourth quarter of 2004, the Corporation had an average of 31,991 FTE employees, a 20 per cent decrease from the fourth quarter of 2002, as shown in the table below:

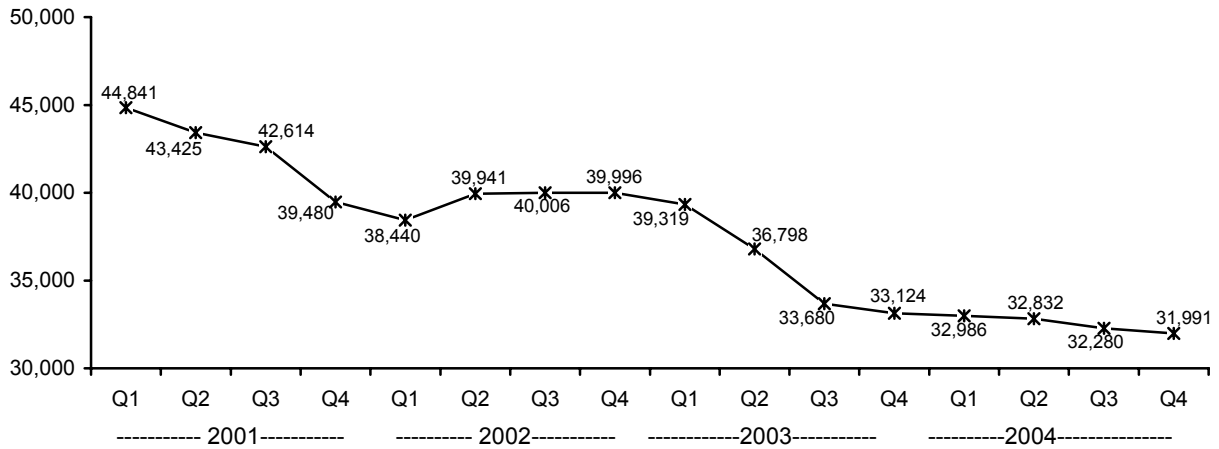
<u>Employee Group</u>	<u>Union<sup>(1)</sup></u>	<u>FTE Employees 4th Quarter 2004</u>	<u>FTE Employees 4th Quarter 2003</u>	<u>FTE Employees 4th Quarter 2002</u>	<u>Agreement(s) Expiry Date</u>
<b>Mainline-related</b>					
Management & Administrative Support employees	-	3,390	3,614	4,723	-
Pilots	ACPA	2,563	2,830	3,100	2009 <sup>(2)</sup>
Flight Attendants	CUPE	5,838	5,898	6,789	2009 <sup>(2)</sup>
Customer Sales & Service Agents	CAW/IBT	4,908	4,899	6,303	2009 <sup>(2)</sup>
Ramp & Cargo Employees	IAMAW	4,736	4,769	5,428	2009 <sup>(2)</sup>
Technical Services Maintenance Employees	IAMAW/other	5,093	5,459	6,830	2009 <sup>(2)</sup>
U.K. unionized employees	AMICUS/TGWU	729	743	850	2009 <sup>(2)</sup>
Other unionized employees	Various	608	681	820	2009 <sup>(2)</sup>
Other	-	331	305	362	2009 <sup>(2)</sup>
<b>Total Mainline-related</b>		<b>28,196</b>	<b>29,198</b>	<b>35,205</b>	
Jazz and other subsidiaries	Various	3,795	3,926	4,791	
<b>Total Consolidated</b>		<b>31,991</b>	<b>33,124</b>	<b>39,996</b>	

<sup>(1)</sup> ACPA: Air Canada Pilots' Association; CUPE: Canadian Union of Public Employees; CAW: National Automobile, Aerospace, Transportation and General Workers Union of Canada; IBT: International Brotherhood of Teamsters; IAMAW: International Association of Machinists and Aerospace Workers; and TGWU: Transport and General Workers Union.

<sup>(2)</sup> Although the collective agreements will expire in 2009, wages may be subject to renegotiations in 2006.

The table below reflects the significant reduction in average quarterly FTE employee levels from 2001 to 2004:

### Average Number of FTE Employees



## **Balance Sheet**

The consolidated balance sheet as of December 31, 2004 represents the accounts of ACE and its subsidiaries on a post-emergence fresh start reporting basis. The consolidated balance sheets as of December 31, 2003 and 2002 represent the accounts of Air Canada and its subsidiaries. In accordance with CICA 1625, prior period financial information has not been restated to reflect the impact of fair value adjustments and, accordingly, amounts in the Predecessor Company are not comparable.

<b>As at December 31 (\$ millions)</b>	<b>Predecessor Company Air Canada 2002</b>	<b>Predecessor Company Air Canada 2003</b>	<b>Successor Company ACE 2004</b>
<b>ASSETS</b>			
Current			
Cash and cash equivalents	558	670	1,632
Other current assets	1,204	1,041	1,063
	<u>1,762</u>	<u>1,711</u>	<u>2,695</u>
Property and equipment	2,152	1,700	3,696
Deferred charges	1,774	2,340	167
Goodwill	510	510	-
Intangible Assets	231	164	2,691
Other assets	983	485	137
	<u>7,412</u>	<u>6,910</u>	<u>9,386</u>
<b>LIABILITIES</b>			
Current liabilities	2,592	2,402	2,491
Long-term and subordinated perpetual debt and capital lease obligations	4,314	332	2,328
Convertible preferred shares	-	-	132
Future income taxes	28	11	243
Pension and other benefit liabilities	837	964	2,344
Other long-term liabilities	568	1,216	1,645
Deferred credits	1,361	827	-
	<u>9,700</u>	<u>5,752</u>	<u>9,183</u>
Liabilities subject to compromise	-	5,313	-
	<u>9,700</u>	<u>11,065</u>	<u>9,183</u>
<b>SHAREHOLDERS' EQUITY</b>	<u>(2,288)</u>	<u>(4,155)</u>	<u>203</u>
	<u>7,412</u>	<u>6,910</u>	<u>9,386</u>
Weighted average common shares outstanding (millions)			
- basic (1)	120	120	89
- diluted (1) (2)	120	120	90

- (1) Pursuant to the Plan, all issued and outstanding options and warrants of Air Canada were cancelled without payment or consideration. In addition, a new share capital was established under ACE, as further described in Notes 19 and 20 to the 2004 Annual Consolidated Financial Statements. As a result, the weighted average common shares for the Predecessor Company are not directly comparable.
- (2) Excludes shares having the potential effect of being anti-dilutive for the purposes of calculating earnings per share. If these shares were included at December 31, 2004, diluted shares would be 99 million. Refer to Note 20 to the 2004 Annual Consolidated Financial Statements.

As a result of the implementation of the Plan and the application of fresh start reporting, a revaluation adjustment of \$3,342 million has been recorded as a credit to the Predecessor's Shareholders' Equity and the deficit and contributed surplus of Air Canada as at September 30, 2004 has been reclassified to the Predecessor's Shareholders' Equity. The resulting deficit of \$2,700 million, net of contributed surplus of \$175 million, was reclassified to the Predecessor's share capital and other equity. The fair values of the consolidated assets and liabilities of the Successor Company have been based on Management's best estimates and on valuation techniques as of September 30, 2004. As the result of the application of fresh start accounting (whereby the liabilities of the Corporation exceed the total assets of the Corporation excluding any implied goodwill) and the financing transactions that occurred on September 30, 2004, the Successor's Shareholders' Equity is \$186 million as at September 30, 2004. Fresh start values reported in Note 5 to the unaudited Interim Third Quarter 2004 Consolidated Financial Statements were preliminary estimates; valuations have now been finalized and are reflected in these statements. The impact of changes since the unaudited Third Quarter 2004 Consolidated Financial Statements is an increase to assets of \$876 million and an increase to liabilities of \$79 million, resulting in an increase to Shareholders' Equity of \$797 million for an adjusted Shareholders' Equity of \$186 million.

## FINANCIAL MANAGEMENT – SUCCESSOR COMPANY

### ACE Aviation Holdings Inc. Consolidated Statement of Cash Flow

	<b>Successor Company ACE</b>	<b>Predecessor Company Air Canada</b>
<b>(in millions of Canadian dollars)</b>	<b>Period ended Dec 31/04</b>	<b>Three months ended Dec 31/03</b>
<b>Cash flows from (used for)</b>		
<b>Operating</b>		
Income (loss) for the period	15	(768)
<u>Adjustments to reconcile to net cash provided by operations</u>		
Reorganization and restructuring items	-	528
Depreciation, amortization and obsolescence	85	94
Loss on sale of and provisions on assets	-	118
Foreign exchange	(98)	7
Future income taxes	11	(4)
Employee future benefit funding less than expense	(52)	(33)
Decrease (increase) in accounts receivable	269	36
Decrease (increase) in spare parts, materials & supplies	(30)	3
Increase (decrease) in accounts payable & accrued liabilities	(256)	(85)
Increase (decrease) in advance ticket sales, net of restricted cash	(103)	8
Aircraft lease payments (in excess of) less than rent expense	(14)	78
Other	61	(2)
Cash flows from (used for) operating activities before undernoted items	(112)	(20)
Settlement of lease obligations	(290)	-
Rebate on lease settlement	33	-
Payment of restructuring obligation	(45)	-
Fees conditional on emergence	(12)	-
	(426)	(20)
<b>Financing</b>		
GE DIP financing	(300)	-
Drawdown of Exit Financing	527	-
Reduction of long-term debt and capital lease obligations	(67)	(108)
Preferred shares issued to Cerberus for cash	238	-
Shares issued for cash under Rights Offering	852	-
Issue of share capital	1	-
Other	-	5
	1,251	(103)
<b>Investing</b>		
Additions to property and equipment	(129)	(18)
Cash collateralization of lines of credit	(21)	-
Other	-	1
	(150)	(17)
<b>Increase (decrease) in cash and cash equivalents</b>	<b>675</b>	<b>(140)</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>-</b>	<b>810</b>
<b>Cash and cash equivalents transferred to the Successor Company</b>	<b>957</b>	<b>-</b>
<b>Cash and cash equivalents, end of period</b>	<b>1,632</b>	<b>670</b>

## **Cash Flows from (used for) Operations**

The consolidated statement of cash flow for ACE reflect cash flows on September 30, 2004 upon emergence and implementation of the Plan and for the period ended December 31, 2004. The consolidated statement of cash flow for the three months ended December 31, 2003 represents the cash flows of the Predecessor Company, Air Canada.

The fourth quarter of 2004 cash flows used for operations amounted to \$426 million and included \$314 million of net payments made on implementation of the Plan, relating mainly to the settlement of restructuring obligations. Before these payments, cash flows used for operations amounted to \$112 million in the fourth quarter of 2004. This compared to cash flows used for operations of \$20 million in the fourth quarter of 2003, a deterioration of \$92 million. Improved operating results in the fourth quarter of 2004 were more than offset by the cash flow benefit in 2003 resulting from the moratorium on aircraft lease payments and stay of proceedings under the CCAA. Components of the cash flow change are further described below:

- advance ticket sales was a use of funds of \$103 million in the fourth quarter of 2004 versus a source of funds of \$8 million in the fourth quarter of 2003. The change in advance ticket sales is consistent with the trend seen in sales. The trend is indicative of travelers booking later and at lower average fares.
- employee future benefit funding was a use of funds of \$52 million in the fourth quarter of 2004 versus a use of funds of \$33 million in the fourth quarter of 2003, an increase of \$19 million.
- the change in spare parts, materials and supplies was a use of funds of \$30 million in the fourth quarter versus a source of funds of \$3 million in the fourth quarter of 2003, a deterioration of \$33 million, largely due to higher fuel inventories, including the impact of higher fuel costs in fuel inventories.
- aggregate aircraft lease payments (in excess of) less than rent expense were a use of funds of \$14 million in the fourth quarter of 2004 versus a source of \$78 million in the fourth quarter of 2003, a deterioration of \$92 million in relation to 2003. 2003 was favourably impacted by the moratorium on aircraft lease payments allowed under the Court order. Aircraft lease payments (in excess of) less than rent expense represents the difference between actual cash lease payments, either at the inception or during the



term of a lease, and amounts recorded for aircraft rent expense which are expensed on a straight line basis over the term of the lease.

- net accounts receivable and accounts payable and accrued liabilities was a source of funds of \$13 million in the fourth quarter of 2004. This compared to a use of funds of \$49 million in the fourth quarter of 2003, an improvement of \$62 million.
- other cash from operations was \$61 million in the fourth quarter of 2004 versus a use of funds of \$2 million in the fourth quarter of 2003 reflecting mainly the repatriation of various deposits made while under CCAA.

In the fourth quarter of 2004, reduction of long-term debt and capital lease obligations amounted to \$67 million of which \$44 million related to capital lease obligations, \$12 million related to repayments made on the credit facility with Amex Bank of Canada (Amex) and \$8 million pursuant to the Lufthansa Cooperation agreement. In the fourth quarter of 2003, repayments of long-term debt and capital lease obligations amounted to \$108 million of which \$95 million related to the repayment of the non-revolving term borrowing facility with the Canadian Imperial Bank of Commerce (CIBC).

### Exit Financing Transactions

Upon implementation of the Plan on September 30, 2004, the following equity, financing and other transactions were consummated for cash proceeds totaling \$982 million as follows:

	<u>(\$ Millions)</u>
Global Restructuring Agreement	
▪ B747 purchase	(290)
▪ Exit financing facility (net)	527
▪ DIP repayment	(300)
▪ Other	(45)
	<u>(108)</u>
Rights offering and standby purchase agreement (net)	852
Investment agreement (net)	238
	<u>982</u>

Prior to filing for CCAA on April 1, 2003, Air Canada had payment and purchase obligations in respect of two Boeing 747 aircraft with GECC. As a condition of the Global Restructuring Agreement (GRA), on September 30, 2004, Air Canada acquired these two aircraft, with a fair market value of \$63 million, from GECC for an aggregate amount of \$353

million. GECC provided financing in the amount of US\$50 million, of which US\$25 million was repaid during the three months ended December 31, 2004 upon the sale of one of the aircraft. The difference of \$290 million was paid to GECC on September 30, 2004, under the terms of the GRA. This one-time payment of \$290 million has been classified as a cash flow used for the operating activities of ACE.

GECC provided ACE with an Exit Facility in the amount of \$540 million before fees of \$13 million. Cash proceeds received under the Exit Facility have been reduced by the amount drawn under the DIP Loan Agreement as at September 30, 2004 of \$300 million. In addition, ACE provided cash collateralization of certain outstanding letters of credit totaling \$21 million. This amount is recorded under other assets. The Corporation further paid an amount of \$45 million to GECC related to restructuring certain obligations with GECC. An amount of \$37 million has been allocated to certain ongoing lease arrangements and \$8 million to standby financing with GECC in the Successor Company. As a result of this payment, the warrants as outlined in the GRA were not issued.

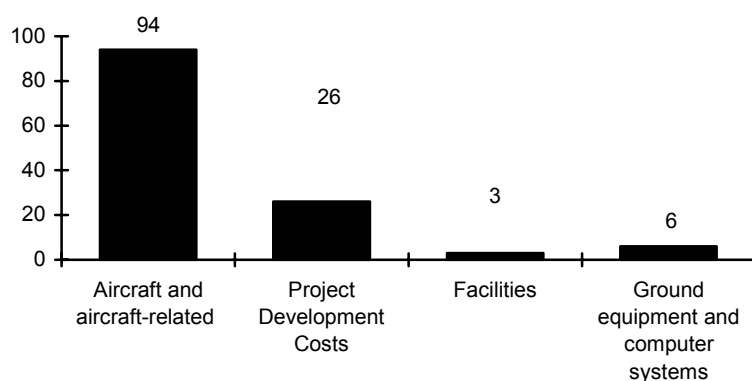
As part of the Plan, the affected unsecured creditors were entitled to subscribe for up to 42,500,000 ACE Class B Voting Shares and/or ACE Class A Variable Voting Shares or approximately 42.06% of the Fully Diluted Equity of ACE as of September 30, 2004 pursuant to the Rights Offering. In accordance with a Standby Purchase Agreement (the Standby Purchase Agreement) entered into with Deutsche Bank Securities Inc. (DB), ACE completed the issuance of 42,500,000 shares under its rights offering for proceeds of \$865 million before fees of \$13 million. As part of such issuance, DB and its participants acquired, as standby purchasers, 9,829,339 Class A Variable Voting Shares relating to unexercised rights. In addition, the unsecured creditors claims were settled for 46,250,000 shares in ACE.

In accordance with an investment agreement with Cerberus ACE Investment, LLC and Promontoria Holding III B.V., affiliates of Cerberus Capital Management L.P. (collectively, Cerberus), ACE issued 12,500,000 Convertible Preferred Shares for an aggregate consideration of \$250 million before fees of \$12 million.

## Cash Flows used for Investing Activities

In the fourth quarter of 2004, additions to property and equipment amounted to \$129 million of which \$86 million related to progress payments on the Embraer and Bombardier aircraft and \$26 million related to system developments costs.

### 2004 Capital Expenditures of the Corporation \$M



## Liquidity

As at December 31, 2004, ACE had cash and cash equivalents of \$1,632 million and positive working capital of \$204 million. As at December 31, 2003, Air Canada had cash and cash equivalents of \$670 million and a working capital deficiency of \$691 million. As a result of the CCAA filing on April 1, 2003, the Court stayed most actions, including actions to collect pre-filing indebtedness of the Predecessor Company. The Court stay order also enabled a moratorium on all aircraft lease payments and payments of interest and principal on substantially all debt. As a result of these actions and non-payment of certain accounts payable subject to compromise, Air Canada's cash from operations for 2003 was higher than it would have been had the CCAA filing not occurred.

Debt repayment obligations in the future are expected to be met from cash flows from operations. In 2005, ACE plans to normalize its banking and financing relationships to ensure its liquidity requirements will be fully met.

Additional sources of liquidity will include normal bank lines of credit which are being arranged. The Corporation could also potentially realize additional funding through the monetization of or sale of interests in certain divisions or subsidiaries.

## **Debt Obligations**

As at December 31, 2004, ACE had long-term debt and capital lease obligations of \$2.5 billion, including current portion, with a cash and cash equivalents balance of \$1,632 million. As at December 31, 2003, Air Canada had debt and capital lease obligations of \$505 million, including current portion, and a cash and cash equivalents balance of \$670 million. As at December 31, 2003, a significant portion of Air Canada's long-term and subordinated perpetual debt and capital lease obligations (including current portion) had been reclassified under "liabilities subject to compromise". As at December 31, 2003, liabilities subject to compromise amounted to an estimated \$5.3 billion. These represent liabilities incurred prior to April 1, 2003 which have been dealt with as claims under CCAA as well as claims arising out of renegotiated and repudiated leases and contracts.

Effective January 1, 2005 ACE will adopt Accounting Guideline 15 – Consolidation of Variable Interest Entities (AcG 15). Under AcG15, ACE anticipates consolidating leasing structures and other entities resulting in additional debt obligations recorded of approximately \$1.3 billion as further described in Note 4 to the 2004 Annual Consolidated Financial Statements.

## **Lease Obligations**

In addition to long-term debt described above, as at December 31, 2004, ACE had the obligation to make lease payments under operating leases relating to aircraft and other property. As disclosed in Note 22 to the 2004 Annual Consolidated Financial Statements, the undiscounted future minimum lease payments under these operating leases amounted to \$3.3 billion, of which \$2.9 billion related to operating leases of aircraft. The amount of lease payments made under these operating leases is an operating expense for ACE.

The table below summarizes ACE's major long-term debt and lease obligations as at December 31, 2004, as described in Notes 12 and 22 to the 2004 Annual Consolidated Financial Statements, as well as projections for aircraft expenditures, net of aircraft financing and projected pension funding obligations which in the aggregate amount to \$6.8 billion over the next five years.

<b>(\$ millions) (1)</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
<b>Long-Term Debt and Capital Lease Obligations (2)</b>					
- Long-term debt principal obligations (Note 12)	75	33	128	181	160
- Capital lease principal obligations (Note 12)	143	144	180	180	87
	<u>218</u>	<u>177</u>	<u>308</u>	<u>361</u>	<u>247</u>
<b>Operating Leases</b>					
- Future minimum lease payments under existing operating leases of aircraft (Note 22) (2)	498	452	441	326	322
- Future minimum lease payments under existing leases for other property (Note 22)	96	57	48	46	33
	<u>594</u>	<u>509</u>	<u>489</u>	<u>372</u>	<u>355</u>
<b>Capital Expenditures</b>					
- Projected committed aircraft expenditures (Note 22)	1,003	561	718	28	0
- Projected aircraft financing (3)	(942)	(477)	(653)	(28)	0
- Projected committed aircraft expenditures, net of aircraft financing	<u>61</u>	<u>84</u>	<u>65</u>	<u>0</u>	<u>0</u>
<b>Planned and committed expenditures for aircraft engines, inventory, modifications and refurbishments (4)</b>					
	231	198	145	28	39
Other planned and committed property and equipment expenditures (4)	189	157	160	134	120
Total planned and committed expenditures for aircraft engines, inventory, modifications and refurbishments	<u>420</u>	<u>355</u>	<u>305</u>	<u>162</u>	<u>159</u>
Projected pension funding obligations	259	336	340	329	308

- (1) US dollar amounts for projected committed aircraft expenditures are converted using the December 31, 2004 noon day rate of CDN\$1.2036. Projected aircraft expenditures are based on aircraft delivery prices that have been escalated at 3 per cent per annum.
- (2) Effective January 1, 2005, Accounting Guideline 15 – Consolidation of Variable Interest Entities (AcG 15) will be adopted. This could have an impact on the classification of the debt, capital lease and operating lease amounts reflected above. Refer to Note 4 of the 2004 Annual Consolidated Financial Statements for additional information.
- (3) See page 38 for a projection of debt payments and operating lease payments relating to the financing of these committed aircraft deliveries.
- (4) Capital expenditure amounts are subject to change between categories.

Long-term debt and capital lease obligations as at December 31, 2004 combined with the estimated present value of committed future aircraft lease payments for the period to the

end of the lease term and estimated future purchase options, net of cash balances, amounted to approximately \$4 billion compared to approximately \$12 billion at December 31, 2002, prior to filing for creditor protection under CCAA. As previously discussed, the adoption of Accounting Guideline 15 – Consolidation of Variable Interest Entities effective January 1, 2005, is expected to result in the Corporation consolidating leasing structures and other entities with additional debt obligations being recorded.

In 2004, Air Canada signed definitive purchase agreements with Empresa Brasileira de Aeronautica S.A. (Embraer) and Bombardier Inc. (Bombardier) with scheduled aircraft deliveries as described below:

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
<u>Air Canada</u>				
Embraer 175	15	0	0	0
Embraer 190	2	18	24	1
	<u>17</u>	<u>18</u>	<u>24</u>	<u>1</u>
<u>Jazz</u>				
Bombardier CRJ200	7	0	0	0
Bombardier CRJ705	15	0	0	0
	<u>22</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total	<u>39</u>	<u>18</u>	<u>24</u>	<u>1</u>

The agreement with Embraer covers firm orders for 45 Embraer 190 series aircraft as well as 15 Embraer 175 series aircraft. The purchase agreement also contains rights to exercise options for up to 60 additional Embraer 190 series aircraft as well as providing for conversion rights to other Embraer models. Deliveries of the Embraer 175 series aircraft are scheduled to begin in July 2005, with the Embraer 190 series deliveries scheduled to commence in November 2005. The agreement with Bombardier covers firm orders for 15 Bombardier CRJ700 Series 705 aircraft and 30 Bombardier CRJ200 aircraft of which 15 of the Bombardier CRJ200 may be cancelled without penalty. The purchase agreement also contains options for an additional 45 aircraft. Deliveries of the 50-seat Bombardier CRJ200 commenced in October 2004, with the 75-seat CRJ700 Series 705 deliveries scheduled to begin in May 2005. The first eight of the CRJ200 aircraft were delivered in 2004. The estimated aggregate cost of the future firm deliveries approximates US\$1.9 billion excluding the 15 Bombardier CRJ200 aircraft which may be cancelled without penalty. The Corporation has received financing commitments from the manufacturers and a third party.

In early March 2005, the Embraer 190 series aircraft delivery schedule was modified and Air Canada now expects to receive four of these aircraft in 2005 (instead of two aircraft previously) and 16 aircraft in 2006 (instead of 18 aircraft previously).

The projected aircraft financing amounts are calculated on the basis of debt and lease financing. Debt financing is up to approximately 85 per cent of the purchase price of committed aircraft expenditures. A number of aircraft will be financed under operating lease arrangements which provide for a higher net financing of the purchase price.

The table below summarizes ACE's projected debt payments and operating lease payments relating to the projected financing of committed aircraft deliveries as at December 31, 2004 as well as projected depreciation on debt financed aircraft:

**Projected Debt Payments, Operating Lease Payments and Aircraft Depreciation Expense for Committed Aircraft Deliveries (Debt and Lease Financed Aircraft)**

(\$ millions) (2)	2005	2006	2007	2008	2009
Principal repayment on aircraft-related long-term debt (1)	0	22	48	75	81
Interest payments on aircraft-related long-term debt (1)	0	43	90	130	125
Future minimum aircraft lease payments (1)	13	56	56	56	56
Aircraft depreciation expense	5	27	53	67	67
Projected debt payments, operating lease payments and aircraft depreciation expense for committed aircraft deliveries	18	148	247	328	329

(1) Based on 10-year US treasury rate and swap rate as at December 31, 2004.

(2) US dollar amounts for projected committed aircraft expenditures are converted using the December 31, 2004 noon day rate of CDN\$1.2036. Projected aircraft expenditures are based on aircraft delivery prices that have been escalated at 3 per cent per annum.

In addition, to support the expansion of international operations, the Corporation plans to take delivery of four used widebody aircraft in 2005 under operating leases including one Airbus A340-300 and three Boeing 767-300 aircraft. Two previously parked Boeing 767-200 aircraft have been reintroduced into active service in early 2005. The Corporation is also planning to add eight used Bombardier CRJ200 aircraft to Jazz's fleet in 2005, under operating leases. As a result of the planned delivery of these 12 additional leased aircraft, future minimum aircraft lease payments are expected to increase by approximately \$21 million in 2005, \$35 million per year in each of 2006 and 2007, \$32 million in 2008 and \$18 million in 2009. In 2005, the Corporation also plans to expand its international cargo freighter aircraft operations through a lease agreement for an additional MD-11 Cargo freighter aircraft. The Corporation expects to

order up to 15 additional 75-100 seat aircraft in 2008/2009 to replace leased aircraft which are terminating in this period.

As at March 17, 2005, ACE's consolidated cash balance, measured on the basis of unrestricted cash in its bank accounts, amounted to approximately \$1.7 billion.



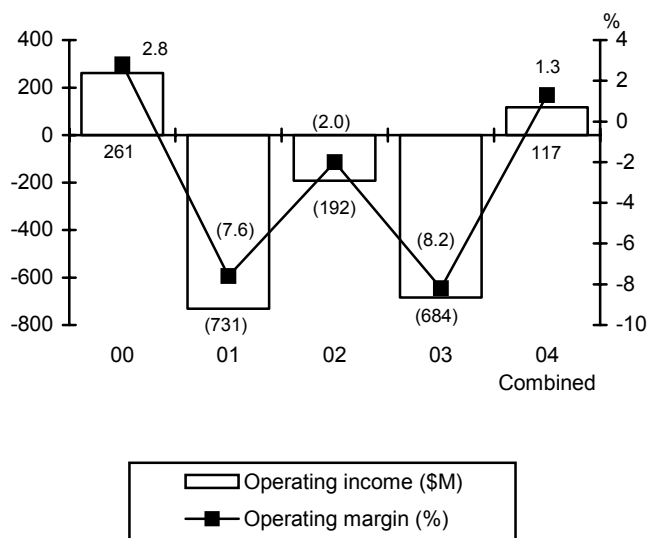
## **ANNUAL SUPPLEMENTARY NON-GAAP COMBINED ANALYSIS OF RESULTS – 2004 VERSUS 2003**

### **Performance at a Glance**

This section provides year-over-year comparisons for the previous five years using Annual Supplementary Non-GAAP Combined information for the year 2004 which is the combination of financial results for the nine months ended September 30, 2004 of the Predecessor Company and financial results for the period ended December 31, 2004 of the Successor Company. As a result of the application of fresh start reporting, application of new accounting policies, the effectiveness of certain lease contracts on emergence of CCAA and the debt and equity transactions that occurred on September 30, 2004, the Successor financial statements are not comparable to those prepared for Air Canada prior to the emergence. The presentation of the financial information of Air Canada for periods prior to October 1, 2004 and the combination of the financial information of Air Canada and ACE for the year ended December 31, 2004 should not be viewed as a continuum because the financial statements of Air Canada for periods prior to October 1, 2004 and the financial statements of ACE for the period ended December 31, 2004 are those of different reporting entities and are prepared using different bases of accounting and different accounting policies, and therefore, are not comparable.

**Operating Income (loss) before reorganization and restructuring items and Operating Income (loss) before non-recurring labour expenses and Operating Margin**

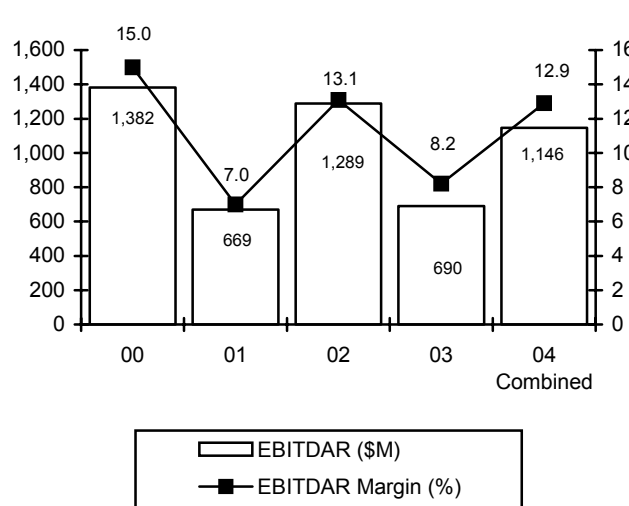
Operating income (loss) before reorganization and restructuring items and Operating Income (loss) before non-recurring labour expenses (\$M)  
Operating margin (%)



- Combined operating income before reorganization and restructuring items of \$117 million, an \$801 million improvement from 2003.
- Passenger revenues up \$451 million or 7 per cent over 2003, reflecting a rebound from a SARS impacted 2003.
- Operating expenses down \$274 million or 3 per cent versus 2003, despite a \$353 million or 28 per cent increase in fuel expense.
- Unit cost, as measured by operating expense per ASM, was down 7 per cent (excluding fuel expense, down 12 per cent) versus 2003.

**EBITDAR before reorganization and restructuring items and EBITDAR before non-recurring labour expenses**

EBITDAR (\$M)  
EBITDAR margin (%)

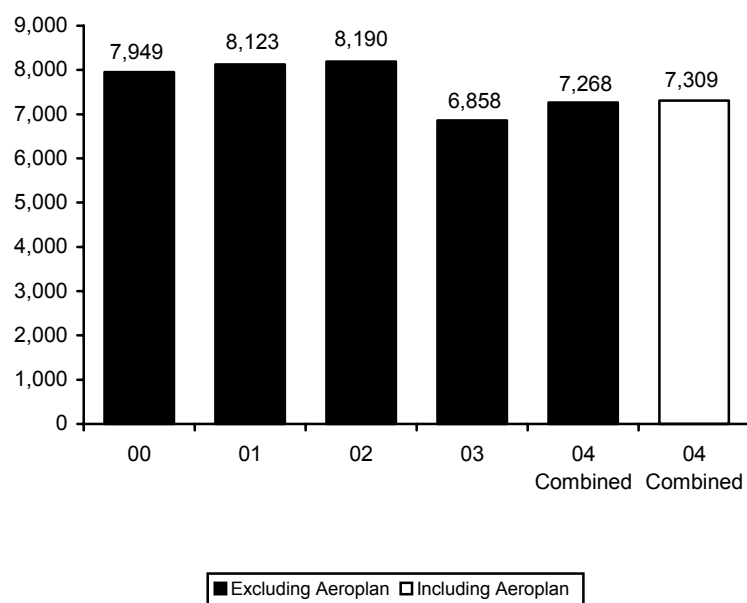


- Combined EBITDAR, before reorganization and restructuring items, increased \$456 million from 2003 to \$1,146 million in 2004 despite an increase in fuel expense of \$353 million or 28 per cent over 2003.
- EBITDAR margin, before reorganization and restructuring items, rose 4.7 percentage points over 2003.

EBITDAR is a non-GAAP measure calculated as operating income before depreciation, amortization, obsolescence and aircraft rent. Refer to page 5 of this MD&A for additional information.

## Passenger Revenue Change

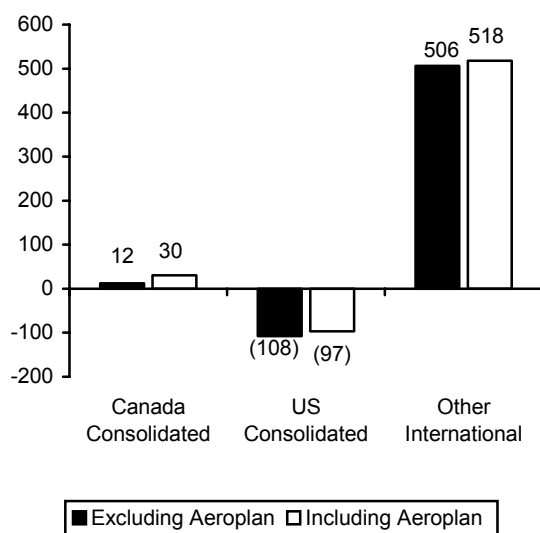
### Passenger revenues \$M



- In 2004, Combined passenger revenues increased \$451 million or 7 per cent on a traffic increase of 10 per cent and on a 4 per cent increase in ASM capacity.
- In 2004, passenger revenues increased in all markets with the exception of the US transborder market.
- Beginning in October 2004, Aeroplan passenger revenues are included in passenger revenue and these amounted to \$41 million in the fourth quarter of 2004.

More information on pages 50 to 56.

### Passenger revenue change by service \$M change Combined 2004 vs 2003

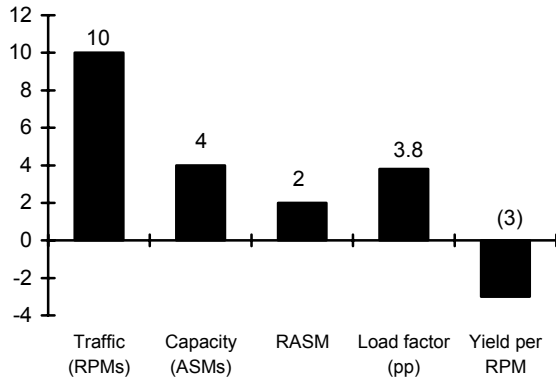


- Canada passenger revenues up \$30 million or 1 per cent, including Aeroplan passenger revenues of \$18 million.
- US transborder revenues down \$97 million or 6 per cent, including Aeroplan passenger revenues of \$11 million in the fourth quarter of 2004.
- Other international revenues showed considerable growth over 2003, rising \$518 million or 22 per cent, including Aeroplan passenger revenues of \$12 million in the fourth quarter of 2004. This improvement reflected a rebound from a SARS impacted 2003.

More information on pages 50 to 56.

## Passenger Revenue Performance

Components of passenger revenues  
(excludes Aeroplan passenger revenues)  
% change Combined 2004 vs 2003

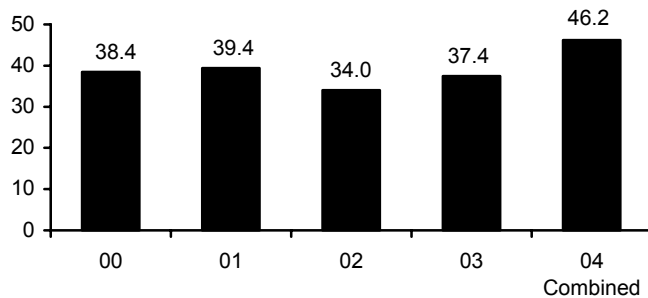


- RASM improved 2 per cent year-over-year due to a 3.8 percentage point improvement in passenger load factor.
- 2004 system traffic was up 10 per cent on a 4 per cent increase in ASM capacity.
- Passenger yield per RPM declined 3 per cent reflecting lower yield per RPM in the North American market as well as a greater proportion of long-haul international flying which has a lower yield per RPM.

More information on page 50 to 56.

## Aircraft Fuel

Fuel price per litre  
Cents

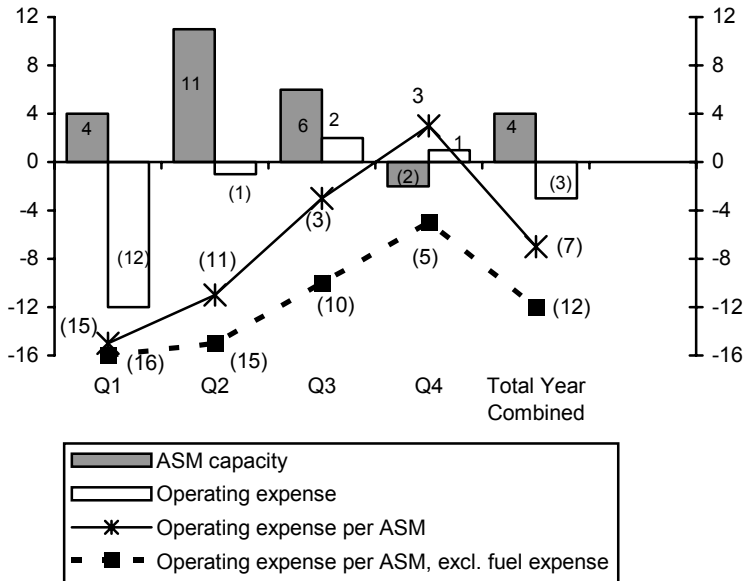


- With record high fuel prices, Combined aircraft fuel expense was up \$353 million or 28 per cent on a 4 per cent capacity increase from 2003.
- The average base price of fuel increased 32 per cent or \$405 million. This was partly offset by a decrease of \$124 million due to the favourable impact of a stronger Canadian dollar.
- Average fuel price per litre increased 24 per cent over 2003.

More information on page 60.

## Operating Cost Performance

Changes in operating expense, ASM capacity, unit cost (1) and unit cost (excluding fuel expense) (2)  
% change Combined 2004 vs 2003



- For the full year 2004, Combined unit cost was down 7 per cent.
- Excluding fuel expense, unit cost was down 12 per cent
- ASM capacity increased 4 per cent year-over-year.

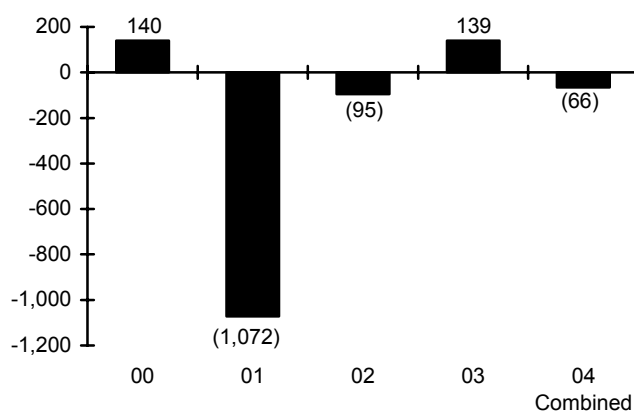
(1) Unit cost is calculated as operating expense divided by ASMs.

(2) Unit cost, excluding fuel expense, is calculated as operating expense, removing fuel expense, divided by ASMs.

More information on page 58 to 61.

## Combined Cash Flows from (used for) Operations

Cash flows from (used for) operations  
\$M



- Combined Cash flows used for operations amounted to \$66 million in 2004, compared to cash flows from operations of \$139 million in 2003.
- 2003 cash flows benefited from a moratorium on aircraft lease payments pending renegotiation of revised financial arrangements for the use of the aircraft. In addition, Air Canada ceased making payments of principal and interest on substantially all debt as well as on pre-petition accounts payable subject to compromise. As a result, cash from operations was higher in 2003 than it would have been had the CCAA filing not occurred.
- 2004 Combined cash flows used for operations included \$314 million of net payments made on September 30, 2004. These payments related mainly to settlement of restructuring obligations.
- Removing the impact of these payments, Combined cash from operations in 2004 amounted to \$248 million, an improvement of \$109 million from 2003.

More information on page 67 to 70.

## Combined Results of Operations

The following table combines the Consolidated Statement of Operations of Air Canada for the nine months ended September 30, 2004 and that of ACE for the period ended December 31, 2004. The addition of these two periods provides a Combined full year 2004 which is used for year-over-year comparisons. As a result of the application of fresh start reporting, application of new accounting policies, the effectiveness of certain lease contracts on emergence of CCAA and the debt and equity transactions that occurred on September 30, 2004, the Successor's financial statements are not comparable to those prepared for Air Canada prior to the emergence. The presentation of the financial information of Air Canada for periods prior to October 1, 2004 and the combination of the financial information of Air Canada and ACE for the year ended December 31, 2004 should not be viewed as a continuum because the financial statements of Air Canada for periods prior to October 1, 2004 and the financial statements of ACE for the period ended December 31, 2004 are those of different reporting entities and are prepared using different bases of accounting and different accounting policies and, therefore, are not comparable.

(\$ millions)	ACE Period ended Dec 31, 2004	Air Canada Nine months ended Sept 30, 2004	Combined 2004 (1)
Operating Revenues			
Passenger	1,681	5,628	7,309
Cargo	151	405	556
Other	230	805	1,035
	2,062	6,838	8,900
Operating Expenses			
Salaries, wages and benefits	596	1,989	2,585
Aircraft fuel	432	1,174	1,606
Aircraft rent	111	521	632
Other	926	3,034	3,960
	2,065	6,718	8,783
Operating income (loss) before restructuring and reorganization items	(3)	120	117
Reorganization and restructuring items	-	(871)	(871)
Non-operating expense	(67)	(248)	(315)
Foreign exchange gain on non-compromised long-term monetary items	98	106	204
Recovery of (provision for) income taxes	(13)	(2)	(15)
Income (loss)	15	(895)	(880)

(1) Refer to page 2 of this MD&A for additional information.

The following table compares the Consolidated Statement of Operations of Air Canada for 2002 and 2003 to the Combined Consolidated Statement of Operations of Air Canada for the nine months ended September 30, 2004 and that of ACE for the period ended December 31, 2004.

	<b>Combined</b>			<b>% Var</b>	<b>% Var</b>
	<b>2002</b>	<b>2003</b>	<b>2004 (1)</b>	<b>'04 vs '03</b>	<b>'04 vs '02</b>
	<b>(\$ millions, except per share figures)</b>				
<b>Operating Revenues</b>					
Passenger	8,190	6,858	7,309	7	(11)
Cargo	585	519	556	7	(5)
Other	1,051	996	1,035	4	(2)
	<u>9,826</u>	<u>8,373</u>	<u>8,900</u>	<u>6</u>	<u>(9)</u>
<b>Operating Expenses</b>					
Salaries, wages and benefits	3,099	2,828	2,585	(9)	(17)
Aircraft fuel	1,288	1,253	1,606	28	25
Aircraft rent	1,109	1,008	632	(37)	(43)
Airport and navigation fees	772	743	814	10	5
Aircraft maintenance materials	508	385	343	(11)	(32)
Communications and I.T.	459	390	302	(23)	(34)
Food, beverages and supplies	395	334	340	2	14
Depreciation, amortization and obsolescence	372	366	397	8	7
Commissions	369	273	305	12	(17)
Other	1,647	1,477	1,459	(1)	(11)
	<u>10,018</u>	<u>9,057</u>	<u>8,783</u>	<u>(3)</u>	<u>(12)</u>
Operating income (loss) before the under noted items:	(192)	(684)	117		
Non-recurring labour expenses	(26)	-	-		
Reorganization and restructuring items	-	(1,050)	(871)		
Non-operating expense	(166)	(282)	(315)		
Foreign exchange on non-compromised long-term monetary items	(60)	137	204		
Recovery of (provision for) income taxes	(384)	12	(15)		
Loss for the year	<u>(828)</u>	<u>(1,867)</u>	<u>(880)</u>		
Loss per share - Basic and diluted	(6.89)	(15.53)	nm		
Weighted average common shares outstanding (millions) - basic and diluted (2)	120	120	90		

(1) Refer to page 2 of this MD&A for additional information.

(2) Pursuant to the Plan, all issued and outstanding options and warrants of Air Canada were cancelled on September 30, 2004, without payment or consideration. In addition, a new share capital was established under ACE, as further described in Notes 19 and 20 to the 2004 Annual Consolidated Financial Statements. As a result, the weighted average common shares for the Predecessor Company are not directly comparable.



	2002	2003	Combined 2004 (1)	% Var '04 vs '03	% Var '04 vs '02
	(\$ millions)				
Revenue Passenger Miles (millions)	44,707	39,565	43,427	10	(3)
Available Seat Miles (millions)	60,169	54,160	56,536	4	(6)
Passenger Load Factor (%)	74.3%	73.1%	76.8%	3.7 pp	2.5 pp
Passenger revenue per available seat mile (RASM) (cents) (excl. Aeroplan)	13.6	12.7	12.8	1	(6)
Passenger revenue per available seat mile (RASM) (cents) (incl. Aeroplan)	13.6	12.7	12.9	2	(5)
Operating expense per available seat mile (CASM) (cents)	16.6	16.7	15.5	(7)	(7)
Operating expense per available seat mile excluding fuel expense (cents)	14.5	14.4	12.7	(12)	(12)

(1) Refer to page 2 of this MD&A for additional information.

### **Comparison of Results – Combined 2004 versus 2003**

Combined passenger revenues increased \$451 million or 7 per cent from 2003 largely due to a progressive recovery in all markets with the exception of the US transborder market. In 2003, passenger revenues were negatively impacted by lower domestic and international demand for travel resulting from the SARS crisis, the war in Iraq and increased competition by both domestic low-cost airlines and US airlines operating on the US transborder market.

Combined operating expense was reduced by \$274 million or 3 per cent compared to 2003 despite an increase in fuel expense of \$353 million or 28 per cent on an increase of 4 per cent in capacity as measured in available seat miles (ASM). Unit cost for 2004, as measured by operating expense per ASM, was 7 per cent below the 2003 level. Excluding fuel expense, unit cost was 12 per cent below 2003. Unit cost reductions were achieved in essentially all controllable categories including salaries and wages, aircraft rent, aircraft maintenance materials and supplies, communications and information technology. The unit cost improvements reflect the cost reduction initiatives undertaken under the restructuring process which largely came into effect beginning in the third quarter of 2003.

For 2004, the Corporation reported Combined operating income before reorganization and restructuring items of \$117 million compared to an operating loss before reorganization and restructuring items of \$684 million in 2003, an improvement of \$801 million.

Since its CCAA filing on April 1, 2003 through to September 30, 2004, significant reorganization and restructuring items directly associated with the rearranging of its business affairs were recorded. For 2004, reorganization and restructuring items amounted to \$871 million compared to \$1,050 million in 2003. These mainly non-cash items related primarily to lease deficiency claims, labour-related items and professional fees. Air Canada emerged from CCAA proceedings on September 30, 2004.

Combined foreign exchange gains on non-compromised long-term monetary items totalled \$204 million in 2004 attributable to a stronger Canadian dollar versus the US dollar at December 31, 2004 compared to December 31, 2003. Similar gains of \$137 million were recorded in 2003.

The Combined net loss for 2004, which included reorganization and restructuring items of \$871 million, was \$880 million versus a net loss of \$1,867 million in 2003, which included \$1,050 million of reorganization and restructuring items. The Combined net loss, adjusted to remove reorganization and restructuring items (Non-GAAP measure), amounted to \$9 million in 2004, an improvement of \$808 million from the 2003 net loss of \$817 million also adjusted to remove reorganization and restructuring items. Refer to Non-GAAP Earnings (Losses) on pages 5 to 7 of this MD&A for additional information.

#### **RASM**

Passenger revenue per available seat mile (RASM) is a common industry measure of passenger revenue performance providing a yardstick of revenue generation per unit of capacity offered. RASM is influenced by two key components:

- Load factor
- Yield per RPM

The first component is load factor which represents passenger traffic expressed in relation to the capacity offered (i.e. revenue passenger miles (RPMs) to available seat miles (ASMs)). The second component is the yield per revenue passenger mile (or average fare paid per occupied seat mile flown). If an airline can improve its load factor on a particular flight (i.e. the number of revenue passengers) or its yield per revenue passenger mile (i.e. the average fare per mile paid by each passenger) then the passenger revenue per available seat mile (RASM) will increase leading to greater operating profitability on that flight. Depending on market conditions, airlines may periodically have a greater focus on improving load factor or yield, however, the interaction of both these factors will determine RASM. The higher the RASM, the more revenue is generated by the airline for each available seat.

Long-haul flights generally have a lower yield per RPM than short-haul flights. When measured on a per mile basis, the average fare paid on long-haul flights is relatively lower than on short-haul flights. Because the costs of ground handling and fees for take-off and landing are similar for both short and long-haul flights, unit costs per ASM are normally lower for long-haul flights due to the distance flown.

## Revenue Performance

### Combined 2004 versus 2003 Passenger Revenues

For the year 2004, Combined passenger revenues increased \$451 million or 7 per cent reflecting a progressive recovery in all markets with the exception of the US transborder. In 2003, passenger revenues were negatively impacted by reduced travel demand resulting from the SARS crisis, the war in Iraq and increased competition in Canada and on the US transborder market. As part of its new business model to compete more effectively, Air Canada introduced a simplified fare structure in Canada beginning in May 2003 and progressively in the United States in 2004. Further changes to the North American fare structure occurred in October 2004 with the elimination of round trip restricted fares. Beginning in the fourth quarter of 2004, Aeroplan passenger revenues are recorded in passenger revenue. For the fourth quarter of 2004, these revenues totaled \$41 million. Previously, Aeroplan redemption revenues were recorded in other revenue.

As a result of the inclusion of Aeroplan passenger revenues in passenger revenues starting October 1, 2004, passenger revenues, RASM and yield per RPM are not directly comparable to previous years. The following discussion will provide the reader with variances that include Aeroplan passenger revenues. However, for comparative purposes, passenger revenues, RASM and yield per RPM will also provide the reader with variances excluding these revenues.

The table below describes, by major market, year-over-year percentage changes in passenger revenues, capacity as measured by available seat miles (ASMs), traffic as measured by revenue passenger miles (RPMs), passenger load factor as measured by RPMs divided by ASMs, yield as measured by passenger revenue per RPM, and RASM as measured by passenger revenue per ASM.

**Operating Statistics – Combined 2004 versus 2003**

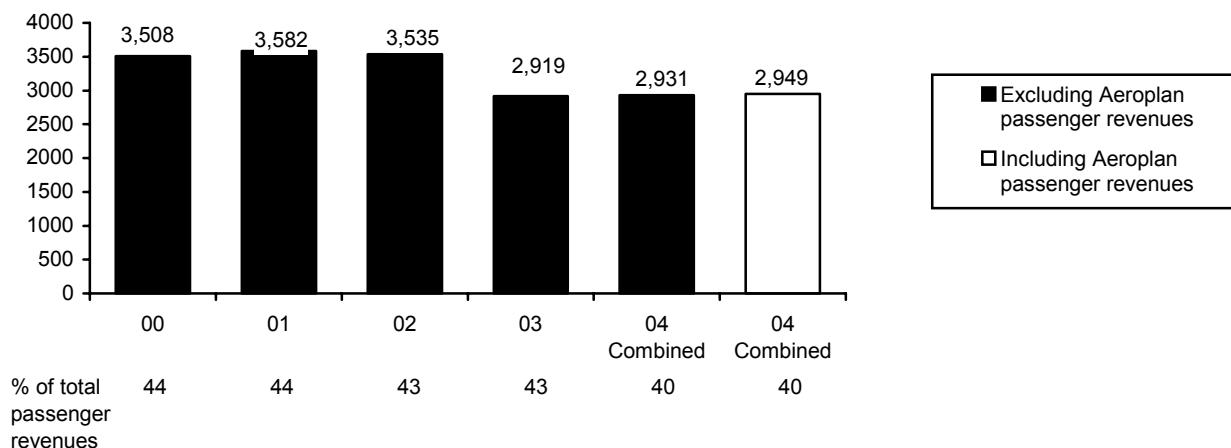
	<b>Passenger Revenue % Change</b>	<b>Capacity (ASMs) % Change</b>	<b>Traffic (RPMs) % Change</b>	<b>Passenger Load Factor pp Change</b>	<b>Yield per RPM % Change</b>	<b>RASM % Change</b>
Canada	0	(5)	3	5.8	(3)	5
US	(7)	(6)	0	4.0	(7)	(1)
Atlantic	4	(5)	(4)	0.6	8	8
Pacific	70	53	61	3.6	6	11
Other	26	29	30	0.6	(3)	(2)
System (excl. Aeroplan)	6	4	10	3.8	(3)	2
System (incl. Aeroplan)	7	4	10	3.8	(3)	2

**Domestic Passenger Revenues**

Combined domestic passenger revenues increased \$30 million or 1 per cent and included Aeroplan passenger revenues of \$18 million in the fourth quarter of 2004. In 2003, passenger revenues were negatively impacted by reduced travel demand resulting from the SARS crisis, increased capacity growth by low-cost competitors and, to a lesser extent, the war in Iraq.

A Combined revenue increase of 4 per cent was recorded on the transcontinental routes, linking Toronto, Montréal and Ottawa with major western Canada cities including Winnipeg, Calgary, Edmonton and Vancouver. This improvement reflected a recovery from the 2003 SARS crisis as well as an increase in traffic resulting from competitive pricing and better capacity management. These routes represented 47 per cent of Combined domestic passenger revenues in 2004. Revenues for commuter routes, including Rapidair operations between Toronto and Montréal/Ottawa, decreased 4 per cent from the prior year due to lower traffic resulting from increased competition from domestic low-cost airlines. Revenues from commuter routes accounted for 22 per cent of Combined domestic passenger revenues in 2004. Combined 2004 revenues on regional routes, which include operations within eastern and western Canada, were essentially unchanged from 2003.

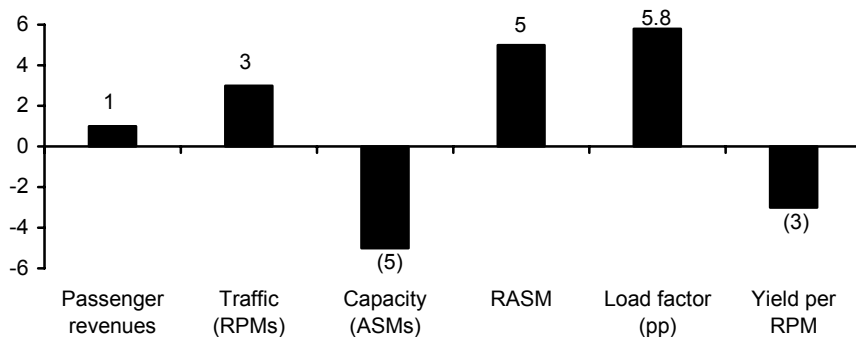
**Domestic Passenger Revenues**  
\$M



**Components of Domestic Revenue**

Combined domestic passenger revenues increased 1 per cent as higher traffic offset weaker pricing. Domestic traffic was up 3 per cent while ASM capacity was reduced by 5 per cent, resulting in a passenger load factor of 76.4 per cent, up 5.8 percentage points from 2003. Excluding Aeroplan passenger revenues, RASM increased 5 per cent reflecting the rise in passenger load factor. Excluding Aeroplan passenger revenues, domestic yield per RPM decreased 3 per cent mainly due to Air Canada’s response to aggressive pricing activities from low cost carriers. As part of its new business model to compete more effectively, Air Canada introduced a simplified fare structure beginning in May 2003.

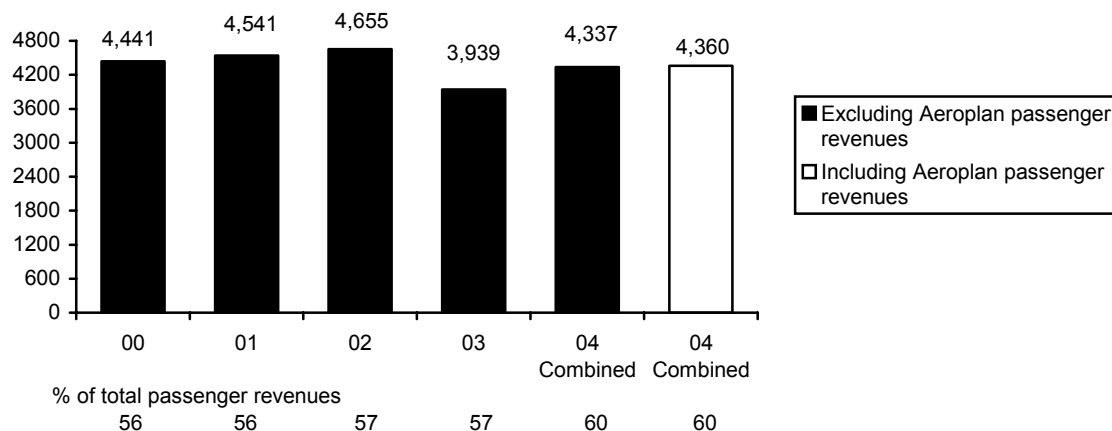
**Components of Consolidated Domestic Revenue**  
(excludes Aeroplan passenger revenues)  
% change Combined 2004 vs 2003



## International Passenger Revenues

Combined passenger revenues from international services, including US transborder services, rose \$421 million or 11 per cent and included Aeroplan passenger revenues of \$23 million in the fourth quarter of 2004. This increase was due to the strong performance on Pacific, South America, Atlantic and Caribbean services.

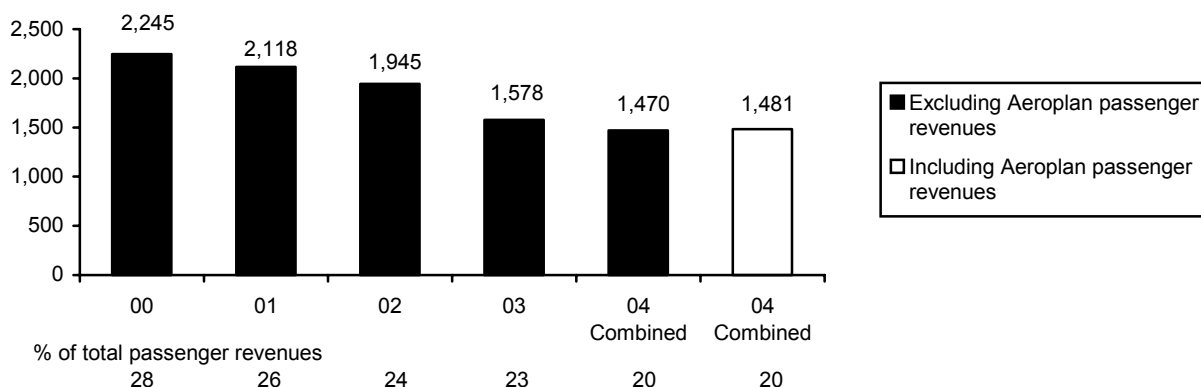
### International Passenger Revenues \$M



## Canada-US Transborder Passenger Revenues

Combined US transborder passenger revenues declined \$97 million or 6 per cent with a 6 per cent decline in ASM capacity and included \$11 million of Aeroplan passenger revenues in the fourth quarter of 2004. This reduction in Combined passenger revenue was mainly due to a decline in yield per RPM of 7 per cent, excluding Aeroplan passenger revenues, resulting from increased competition in the US transborder market, the introduction of transborder flights by Canadian low-cost carriers, an aggressive pricing environment and the impact of currency fluctuations. As part of its new business model to compete more effectively, Air Canada introduced a simplified fare structure progressively in 2004. All Canada-US transborder routes experienced reductions in Combined revenues with the exception of Las Vegas and California. US transborder Combined passenger revenues accounted for 20 per cent of total Combined passenger revenues in 2004.

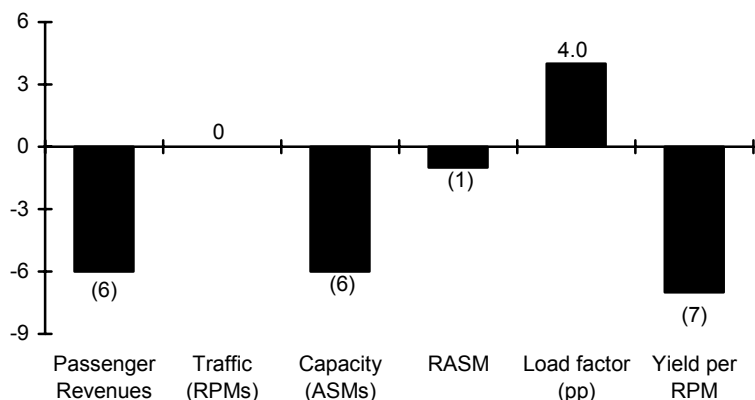
**Canada-US Transborder Passenger Revenues**  
\$M



**Components of Canada-US Transborder Revenue**

Combined US transborder passenger revenues were down \$97 million or 6 per cent and included Aeroplan passenger revenues of \$11 million in the fourth quarter of 2004. US transborder traffic was unchanged from the previous year on an decrease in ASM capacity of 6 per cent resulting in a passenger load factor of 68.5 per cent, an improvement of 4.0 percentage points from 2003. Excluding Aeroplan passenger revenues, US transborder yield per RPM was down 7 per cent reflecting a competitive market with increased US carrier capacity. As part of its new business model, Air Canada has responded to this environment by implementing a simplified fare structure in 2004 consistent with Air Canada's domestic fare strategy. Excluding Aeroplan passenger revenues, US transborder RASM was down 1 per cent as the higher load factors did not quite fully offset the lower yield per RPM.

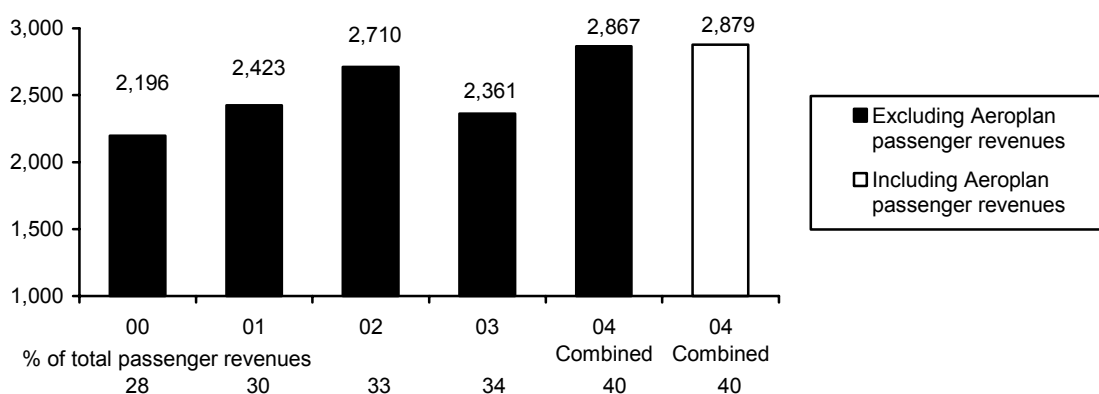
**Components of Canada-US Transborder Revenue**  
(excludes Aeroplan passenger revenues)  
% change Combined 2004 vs 2003



## Other International Passenger Revenues

Combined passenger revenues from other international routes, comprised of Atlantic and Pacific as well as South Pacific, Caribbean, Mexico, South America and other international routes, experienced strong revenue growth. Combined passenger revenues on these routes increased \$518 million or 22 per cent with traffic 18 per cent higher and ASM capacity up 16 per cent. Combined other international passenger revenues included Aeroplan passenger revenues of \$12 million in the fourth quarter of 2004. Excluding Aeroplan passenger revenues, RASM grew by 5 per cent reflecting a 1.3 percentage point improvement in passenger load factor and an increase in yield per RPM of 3 per cent from 2003. Combined other international routes accounted for 40 per cent of Combined system passenger revenues in 2004. Atlantic represented 21 per cent, Pacific represented 12 per cent, and South Pacific, Caribbean, Mexico and South America represented 7 per cent of total Combined passenger revenues.

### Other International Passenger Revenues \$M



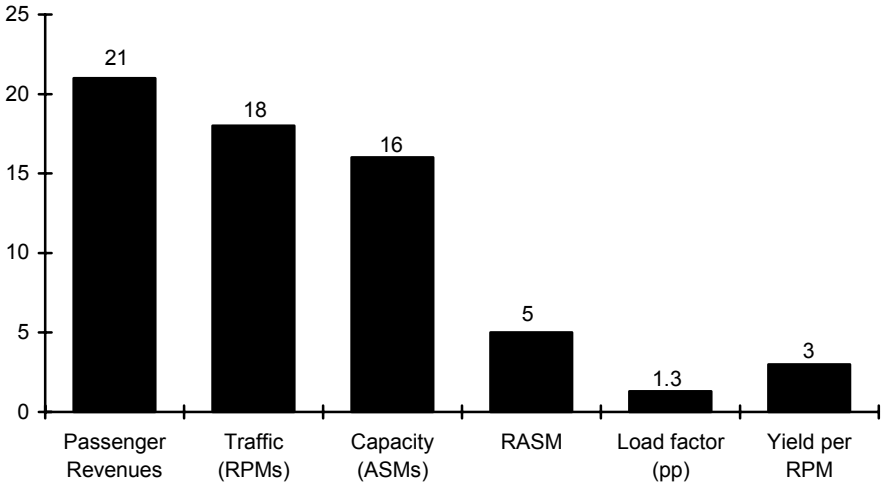
### Components of Other International Revenue

Combined Atlantic passenger revenues increased \$58 million or 4 per cent from 2003 and included Aeroplan passenger revenues of \$6 million in the fourth quarter of 2004. Excluding Aeroplan passenger revenues, Atlantic RASM rose 8 per cent on an 8 per cent increase in yield per RPM. Atlantic traffic was down 4 per cent due to a 5 per cent decrease in ASM capacity reflecting the suspension of service to Italy, Spain and Copenhagen. Combined Pacific passenger revenues increased \$352 million or 70 per cent and included Aeroplan passenger revenues of \$2 million in the fourth quarter of 2004. Excluding Aeroplan passenger revenues, RASM increased 11 per cent and, despite the negative impact of currency fluctuations, yield per RPM rose 6 per cent. Traffic grew 61 per cent on a 53 per cent higher ASM capacity resulting in an increase of 3.6 percentage points in passenger load factor. Hong



Kong and Japan recorded the largest traffic growth of the Pacific routes. In 2003, the Pacific market was severely adversely impacted by the SARS crisis which resulted in large reductions in traffic and ASM capacity. For South Pacific, Caribbean, Mexico and South America routes (other), passenger revenues increased \$108 million or 28 per cent and included Aeroplan passenger revenues of \$4 million in the fourth quarter of 2004. The growth in traffic of 30 per cent is mainly due to the addition of new routes to South America as well as to increased service to traditional leisure destinations. Excluding Aeroplan passenger revenues, other yield per RPM decreased 3 per cent reflecting a greater proportion of long-haul flying which has a lower yield per RPM. As a result, other RASM, excluding Aeroplan passenger revenues, was down 2 per cent versus 2003 due to the yield per RPM decrease.

**Components of Other International Revenue  
(excludes Aeroplan passenger revenues)  
% change Combined 2004 vs 2003**



**Cargo Revenues**

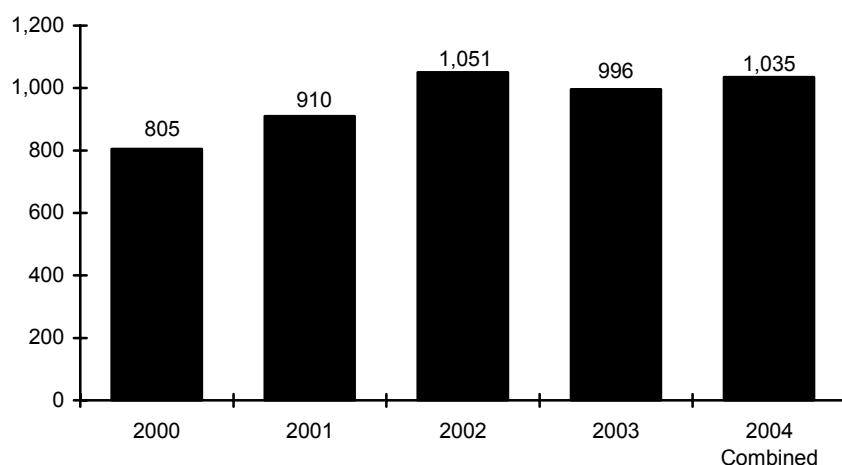
Combined cargo revenues rose \$37 million or 7 per cent in 2004. International cargo revenues recorded growth of \$39 million or 10 per cent mainly from Pacific markets due to a stronger demand out of Asia and higher cargo rates and surcharges. In 2003, cargo capacity on Pacific routes was reduced as a result of the SARS crisis. Cargo freighter operations commenced in the domestic market in June 2004 and in the international market in November 2004 following the retirement of the Boeing 747-400 Combi aircraft. 2004 revenues included \$16 million from freighter operations.

## Other Revenues

Combined other non-transportation revenues rose \$39 million or 4 per cent over 2003. Aeroplan revenues increased approximately \$42 million or 14 per cent, mainly due to higher point redemption revenues including non-air rewards. In the fourth quarter of 2004, \$41 million of Aeroplan passenger revenues were recorded in passenger revenue. Previously, Aeroplan redemption revenues were recorded in other revenue. Excluding the impact of this change, Aeroplan revenues rose \$83 million over 2003.

Air Canada Technical Services' revenues from maintenance services to third parties grew approximately \$21 million or 12 per cent. Air Canada Vacations revenues rose \$56 million or 27 per cent primarily as a result of increased capacity to Cuba, the Dominican Republic and Mexico. Other revenues decreased by \$25 million following a dilution in Air Canada's ownership interest in a subsidiary company (largely offset by a corresponding reduction in operating expenses) and \$15 million due to discontinuing amortization of deferred credits on certain agreements renegotiated under the restructuring process. The remaining \$40 million decrease from 2003 was due to lower employee passenger service charge revenues, reduced aircraft sublease revenues due to the termination of a sublease agreement and other miscellaneous reductions.

### Other Revenues \$M



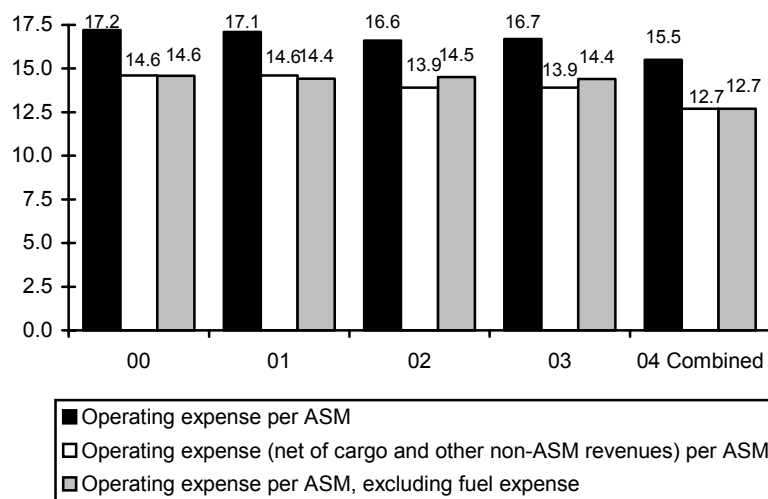
The analysis of Other revenues in the above comparisons has been provided based on the products and services offered by the Corporation for Aeroplan, Air Canada Technical Services and Air Canada Vacations. This is consistent with prior year's reporting with the exception of Aeroplan redemption revenues which are recorded in passenger revenue beginning in the fourth quarter of 2004. As a result of the restructuring, effective September 30, 2004, the Corporation's businesses are operated through four reportable segments: transportation services, loyalty program, technical services and regional operations. This segment reporting is applied on a prospective basis from the date of fresh start reporting. Refer to Note 21 of 2004 Consolidated Financial Statements and to page 76 of this MD&A for additional information.

### Operating Cost Performance – Combined 2004 versus 2003

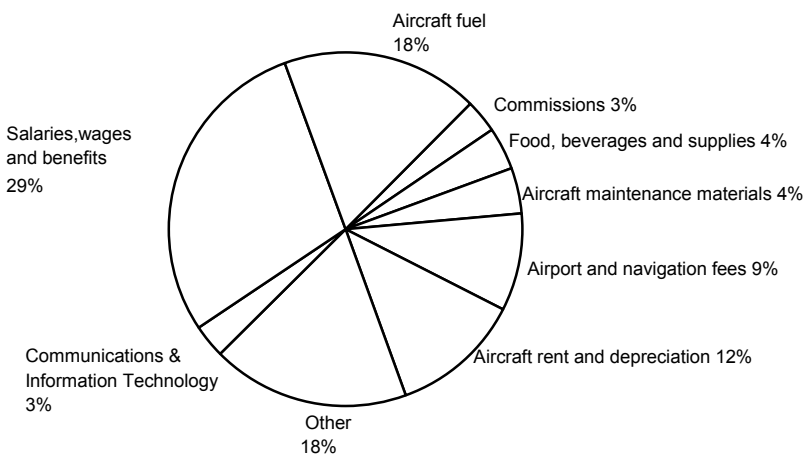
Combined operating expense declined \$274 million or 3 per cent from 2003 despite an increase in fuel expense of \$353 million or 28 per cent and an increase of 4 per cent in ASM capacity. Combined operating expenses, excluding fuel expense, declined \$627 million or 8 per cent from 2003.

Unit cost, as measured by operating expense per ASM, was 7 per cent below the 2003 level. Excluding fuel expense, unit cost was reduced by 12 per cent from 2003. Operating expense per ASM, net of cargo and other non-ASM producing revenues, was 9 per cent below 2003 levels.

#### Unit Cost Cents per ASM



**Combined 2004 Consolidated Operating Expenses (1)**  
**% of total**



(1) Refer to page 2 of this MD&A for additional information.

Combined salaries and wages expense totaled \$1,935 million in 2004, a decrease of \$250 million or 11 per cent from 2003, mainly due to a reduction of an average of 3,208 full-time equivalent (FTE) employees or 9 per cent as well as salary reductions for unionized and non-unionized labour groups. Salaries and wages expense per ASM was reduced by 15 per cent from 2003. Compared to 2002, salaries and wages expense decreased \$557 million or 22 per cent. Average FTE employees were down over 7,074 or 18 per cent and salaries and wages expense per ASM was reduced by 17 per cent. Fourth quarter 2004 FTE employees were down an average of 8,005 or 20 per cent versus the fourth quarter of 2002 and salaries and wages per ASM was reduced by 20 per cent.

Combined employee benefits expense amounted to \$650 million in 2004, an increase of \$7 million or 1 per cent from 2003. The increase was largely due to higher future employee benefits resulting from a higher volume of claims in the disability program and revised actuarial assumptions partially offset by the elimination of unamortized actuarial losses and past service costs resulting from fresh start reporting that commenced on September 30, 2004. This increase was mostly offset by lower pension expense in 2004 resulting from the elimination of unamortized items as a result of fresh start reporting as well as lower employee levels. 2003

included a favourable adjustment of \$10 million relating to an actuarial valuation of workers' compensation liability.

Combined aircraft fuel expense increased \$353 million or 28 per cent mainly due to record high fuel prices and a 4 per cent increase in ASM flying capacity versus 2003. The average base fuel price per litre increase of 32 per cent or \$405 million, the volume increase of 4 per cent or \$56 million and favourable hedging results of \$23 million in 2003 were partly offset by a reduction of \$124 million resulting from the favourable impact of a stronger Canadian dollar versus the US dollar.

Combined aircraft rent expense was down \$376 million or 37 per cent largely due to the reclassification of certain aircraft leases from operating leases to capital leases which accounted for approximately \$236 million of the decrease. Other reductions included the impact of aircraft returns of approximately \$56 million, the impact of renegotiated lease rates of approximately \$42 million as well as the impact of a stronger Canadian dollar for aircraft leases denominated in US dollars of approximately \$35 million. In addition, as a result of fresh start reporting, deferred charges and deferred credits related to operating leases were eliminated in the fourth quarter of 2004. This had the impact of reducing aircraft rent expense by approximately \$34 million during the fourth quarter of 2004. As a result of the reclassification of certain operating leases to capital leases, depreciation expense increased by approximately \$60 million and interest expense rose by approximately \$141 million over 2003. Aircraft rent expense was down \$477 million or 43 per cent from 2002.

Combined airport and navigation fees increased \$71 million or 10 per cent on a 2 per cent decrease in aircraft frequencies. Higher fees for air navigation services and higher landing and general terminal charges, primarily at Toronto's Pearson International Airport, were the main reasons for the increase. At Pearson, landing fees increased 26 per cent per metric tonne and general terminal charges rose 14 per cent per seat for domestic and international arrivals compared to 2003.

Combined aircraft maintenance materials and supplies expense declined \$42 million or 11 per cent. Most of the decline was due to the removal of aircraft from the Mainline and Jazz fleet through aircraft repudiations and returns and timing of engine maintenance activities.

Combined communications and Information Technology expense was down \$88 million or 23 per cent largely due to lower GDS fees resulting from increased direct passenger sales via the internet, renegotiated contract rates for information technology and communication services, a decrease in information technology maintenance costs and the favourable impact of a stronger Canadian dollar.

Combined food, beverages and supplies expense increased \$6 million or 2 per cent in spite of a 10 per cent increase in passenger traffic as measured by RPMs. The increase due to higher traffic was largely offset by decreases resulting from renegotiated contract rates as well as other cost reduction initiatives.

Combined commission expense increased \$32 million or 12 per cent on passenger and cargo revenue growth of 7 per cent and increased commissionable passenger sales by travel agents via the internet which has a higher commission rate. In the second half of the year, this volume related increase in commission expense was partly offset by lower rates as a result of a new commission structure introduced in July 2004 for web and GDS bookings. Commission as a per cent of passenger and cargo revenues increased from 3.7 per cent in 2003 to 3.9 per cent in 2004.

Combined depreciation expense increased \$31 million or 8 per cent mainly due to an increase of approximately \$60 million reflecting the reclassification of certain aircraft leases from operating to capital leases and due to the amortization of intangible assets recorded following fresh start of \$17 million. This was largely offset by lower depreciation and amortization expenses in other areas relating to aircraft, software development, deferred charges and other categories including the impact of fair value adjustments following the adoption of fresh start reporting.

The Combined other operating expense category decreased \$18 million or 1 per cent. Expense reductions were recorded in several categories including crew expenses, insurance, equipment rental, terminal handling, building rent and lower subsidiary expenses. Partially offsetting these expense declines was an increase of \$40 million primarily relating to a higher volume of tour packages by Air Canada Vacations.

## **Reorganization and Restructuring Items**

Since its CCAA filing on April 1, 2003 through to September 30, 2004, Air Canada has recorded significant reorganization and restructuring items directly associated with the rearranging of its business affairs while under the Court's protection. Air Canada emerged from CCAA proceedings on September 30, 2004.

Reorganization and restructuring items amounted to \$871 million for the first nine months of 2004 of which \$786 million represented non-cash items. In 2003, reorganization and restructuring items amounted to \$1,050 million of which \$986 million represented non-cash items.

These "reorganization and restructuring items" represent revenues, expenses, gains and losses and provisions for losses since the date of filing that can be directly associated with the reorganization and restructuring of the business under CCAA. A number of significant restructuring and reorganization items recorded in 2004 and 2003 relate to lease deficiency claims, labour-related items and professional fees.

## **Combined Non-Operating Expense**

As described in Note 3 to the 2004 Annual Consolidated Financial Statements, since Air Canada's filing under CCAA on April 1, 2003, interest expense was reported only to the extent that it would be paid under the plan of arrangement or that it was probable that it would be an allowed claim.

Combined non-operating expense was \$315 million, a \$33 million increase from 2003. Net interest expense rose \$124 million largely due to an increase of approximately \$141 million as a result of the reclassification of certain aircraft leases from operating to capital leases. In 2003, Air Canada did not record interest expense on unsecured debt subject to compromise.

Loss on sale of and provisions for losses on sale of assets of \$75 million were recorded in 2004 related to non-operating aircraft and inventory. The provisions reflect the excess of net book value over fair value. In 2003, loss on sale of and provisions for losses on sale of assets of \$168 million were recorded and included net provisions of \$165 million related to the write-down of non-operating aircraft and spare parts. Other non-operating expense amounted to \$30 million in 2004 compared to other non-operating expense of \$28 million in 2003.

## Foreign Exchange Gains

In 2004, Combined gains of \$204 million were recorded from foreign exchange on non-compromised long-term monetary items attributable to a stronger Canadian dollar versus the US dollar at December 31, 2004 compared to December 31, 2003. The gains recorded in 2004 included \$169 million relating to capital lease obligations. This compared to total gains of \$137 million recorded in 2003.

## Tax

On a consolidated basis, ACE has unrecognized net future tax assets of approximately \$2.3 billion. Future income tax assets are recognized to the extent that realization is considered more likely than not. Since the Corporation has determined that it is more likely than not that the future income tax assets are not recoverable, the net future tax assets have been offset by a valuation allowance. However, the future tax deductions underlying the future tax assets remain available for use in the future to reduce taxable income. The valuation allowance will reverse against the carrying value of the intangible assets on a pro rata basis and equity. For additional information, refer to Note 14 of the 2004 Annual Consolidated Financial Statements.

The table below describes pre-tax losses, tax recoveries, tax valuation allowances and net losses for the past three years.

\$ millions	2002	2003	Predecessor Company Air Canada	Successor Company ACE	Combined 2004 (1)
			Nine Months ended Sept 30, 2004	Period ended Dec 31, 2004	
Pre-tax loss	(444)	(1,879)	(893)	28	(865)
Tax recovery (provision) before valuation allowance	69	623	289	(12)	277
Valuation allowance – recovery offset	(53)	(611)	(291)	(1)-	(292)
Valuation allowance – asset write-off	(400)	0	-	-	0
Tax recovery (provision)	(384)	12	(2)	(13)	(15)
Net income (loss)	(828)	(1,867)	(895)	15	(880)

(1) Refer to page 2 of this MD&A for additional information.



## **Balance Sheet Analysis**

The consolidated balance sheet as of December 31, 2004 represents the accounts of ACE and its subsidiaries on a post-emergence fresh start reporting basis. The consolidated balance sheets as of December 31, 2003 and 2002 represent the accounts of Air Canada and its subsidiaries. ACE adopted fresh start reporting on September 30, 2004. As a result, all assets and liabilities of ACE have been reported at fair values except for future income taxes which are reported in accordance with the requirements of Section 3465 of the CICA Handbook, Income Taxes. In accordance with CICA 1625, prior information has not been restated to reflect the impact of fair value adjustments and, accordingly, amounts in the Predecessor Company are not comparable.

<b>As at December 31 (\$ millions)</b>	<b>Predecessor Company Air Canada 2002</b>	<b>Predecessor Company Air Canada 2003</b>	<b>Successor Company ACE 2004</b>
<b>ASSETS</b>			
Current			
Cash and cash equivalents	558	670	1,632
Other current assets	1,204	1,041	1,063
	1,762	1,711	2,695
Property and equipment	2,152	1,700	3,696
Deferred charges	1,774	2,340	167
Goodwill	510	510	-
Intangible Assets	231	164	2,691
Other assets	983	485	137
	7,412	6,910	9,386
<b>LIABILITIES</b>			
Current liabilities	2,592	2,402	2,491
Long-term and subordinated perpetual debt and capital lease obligations	4,314	332	2,328
Convertible preferred shares	-	-	132
Future income taxes	28	11	243
Pension and other benefits liabilities	837	964	2,344
Other long-term liabilities	568	1,216	1,645
Deferred credits	1,361	827	-
	9,700	5,752	9,183
Liabilities subject to compromise	-	5,313	-
	9,700	11,065	9,183
<b>SHAREHOLDERS' EQUITY</b>	(2,288)	(4,155)	203
	7,412	6,910	9,386
Weighted average common shares outstanding (millions)			
- basic (1)	120	120	89
- diluted (1) (2)	120	120	90

(1) Pursuant to the Plan, all issued and outstanding options and warrants of Air Canada were cancelled without payment or consideration. In addition, a new share capital was established under ACE, as further described in Notes 19 and 20 to the 2004 Annual Consolidated Financial Statements. As a result, the weighted average common shares for the Predecessor Company are not directly comparable.

- (2) Excludes shares having the potential effect of being anti-dilutive for the purposes of calculating earnings per share. If these shares were included at December 31, 2004, diluted shares would be 99 million. Refer to Note 20 to the 2004 Annual Consolidated Financial Statements.

As a result of the implementation of the Plan and the application of fresh start reporting, a revaluation adjustment of \$3,342 million has been recorded as a credit to the Predecessor's Shareholders' Equity and the deficit and contributed surplus of Air Canada as at September 30, 2004 has been reclassified to the Predecessor's Shareholders' Equity. The resulting deficit of \$2,700 million, net of contributed surplus of \$175 million, was reclassified to the Predecessor's share capital and other equity. The fair values of the consolidated assets and liabilities of the Successor Company have been based on Management's best estimates and on valuation techniques as of September 30, 2004. As the result of the application of fresh start accounting (whereby the liabilities of the Corporation exceed the total assets of the Corporation excluding any implied goodwill) and the financing transactions that occurred on September 30, 2004, the Successor's Shareholders' Equity is \$186 million as at September 30, 2004. Fresh start values reported in Note 5 to the unaudited Interim Third Quarter 2004 Consolidated Financial Statements were preliminary estimates; valuations have now been finalized and are reflected in these statements. The impact of changes since the unaudited Third Quarter 2004 Consolidated Financial Statements is an increase to assets of \$876 million and an increase to liabilities of \$79 million, resulting in an increase to Shareholders' Equity of \$797 million for an adjusted Shareholders' Equity of \$186 million.

In accordance with an investment agreement with Cerberus, ACE issued 12,500,000 Convertible Preferred Shares on September 30, 2004. In addition, as part of the Plan, the unsecured creditors were entitled to subscribe for up to 42,500,000 ACE Class B Voting Shares and/or ACE Class A Variable Voting Shares or approximately 42.06% of the fully diluted equity of ACE as of September 30, 2004 pursuant to the Rights Offering. In accordance with a standby purchase agreement entered into with Deutsche Bank Securities Inc. (DB), ACE completed the issuance of 42,500,000 shares under its rights offering. DB and its participants acquired, as standby purchasers, 9,829,339 Class A Variable Voting Shares relating to unexercised rights. In addition, the unsecured creditors claims were settled for 46,250,000 shares in ACE. The implied value, as at September 30, 2004, of the various classes of shares issued by ACE derived from these agreements is approximately \$2 billion. Shareholders' Equity as presented on the Consolidated Statement of Financial Position of ACE under

Canadian GAAP does not reflect this implied value for the reasons explained in the following paragraphs.

Due to certain characteristics of the \$250 million Convertible Preferred Shares issued pursuant to the Investment Agreement, Canadian GAAP requires that the instrument be presented as a compound instrument, and as such, \$127 million is presented as a financial liability and not in Shareholders' Equity.

Under fresh start reporting, Canadian GAAP does not permit goodwill to be recorded even if the fair value of net assets is less than the fair value of the enterprise as a whole. This presentation differs from US GAAP for fresh start reporting. Refer to Note 25 to the 2004 Annual Consolidated Financial Statements – Schedule of Differences between Generally Accepted Accounting Principals in Canada and the United States.

The combination of the above factors and the existing Shareholders' Deficit as reported prior to the adoption of fresh start reporting contribute to the reporting of a Shareholders' Equity of \$186 million as at September 30, 2004, which does not reflect the implied value of the various classes of shares by ACE.

The following cash flow discussion uses 2004 Non-GAAP information which is the combination of financial results for the nine months ended September 30, 2004 of the Predecessor Company and financial results for the period ended December 31, 2004 of the Successor Company. As a result of the application of fresh start reporting, application of new accounting policies, the effectiveness of certain lease contracts on emergence of CCAA and the debt and equity transactions that occurred on September 30, 2004, the Successor financial statements are not comparable to those prepared for Air Canada prior to the emergence. The presentation of the financial information of Air Canada for periods prior to October 1, 2004 and the combination of the financial information of Air Canada and ACE for the year ended December 31, 2004 should not be viewed as a continuum because the financial statements of Air Canada for periods prior to October 1, 2004 and the financial statements of ACE for the period ended December 31, 2004 are those of different reporting entities and are prepared using different bases of accounting and different accounting policies and, therefore, are not comparable.

## Cash Flow Analysis

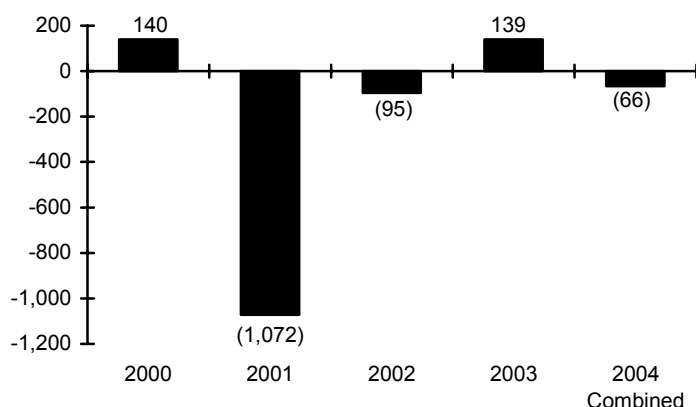
### Ace Aviation Holdings Inc. Consolidated Statement of Cash Flow

(in millions of Canadian dollars)	Successor Company ACE	Predecessor Company Air Canada		
	Period Ended Dec 31, 2004	9 Months ended Sept 30, 2004	Combined 2004	12 Months ended Dec 31, 2003
<b>Cash flows from (used for)</b>				
<b>Operating</b>				
Income (loss) for the period	15	(895)	(880)	(1,867)
<u>Adjustments to reconcile to net cash provided by operations</u>				
Reorganization and restructuring items	-	786	786	986
Depreciation, amortization and obsolescence	85	312	397	366
Loss on sale of and provisions on assets	-	75	75	168
Foreign exchange	(98)	(106)	(204)	(137)
Future income taxes	11	(5)	6	(19)
Employee future benefit funding less than expense	(52)	98	46	204
Decrease (increase) in accounts receivable	269	(191)	78	183
Decrease (increase) in spare parts, materials & supplies	(30)	-	(30)	55
Increase (decrease) in accounts payable & accrued liabilities	(256)	34	(222)	50
Increase (decrease) in advance ticket sales, net of restricted cash	(103)	196	93	(71)
Aircraft lease payments (in excess of) less than rent exp.	(14)	(31)	(45)	363
Other	61	87	148	(142)
Cash flows from (used for) operating activities before under noted items	(112)	360	248	139
Settlement of lease obligations	(290)	-	(290)	-
Rebate on lease settlement	33	-	33	-
Payment of restructuring obligation	(45)	-	(45)	-
Fees conditional on emergence	(12)	-	(12)	-
	(426)	360	(66)	139
<b>Financing</b>				
GE DIP financing	(300)	300	-	-
Drawdown of Exit Financing	527	-	527	-
Aircraft related borrowings	-	233	233	-
Credit facility borrowings	-	80	80	315
Reduction of long-term debt and capital lease obligations	(67)	(358)	(425)	(240)
Preferred shares issued to Cerberus for cash	238	-	238	-
Shares issued for cash under Rights Offering	852	-	852	-
Issue of share capital	1	-	1	-
DIP financing fees	-	-	-	(62)
Other	-	(2)	(2)	9
	1,251	253	1,504	22
<b>Investing</b>				
Additions to property and equipment	(129)	(328)	(457)	(96)
Proceeds from sales of assets	-	2	2	45
Investments and advances	-	-	-	2
Cash collateralization of lines of credit	(21)	-	(21)	-
	(150)	(326)	(476)	(49)
<b>Increase (decrease) in cash and cash equivalents</b>	675	287	962	112
<b>Cash and cash equivalents, beginning of period</b>	-	670	670	558
<b>Cash and cash equivalents transferred to the Successor Company</b>	957	(957)	-	-
<b>Cash and cash equivalents, end of period</b>	1,632	-	1,632	670

## Combined Cash Flows from (used for) Operations

The cash flow discussion below is on the 2004 Combined cash flow for the period ended December 31, 2004 of ACE and the nine months ended September 30, 2004 of Air Canada.

### Cash Flows from (used for) Operations \$M



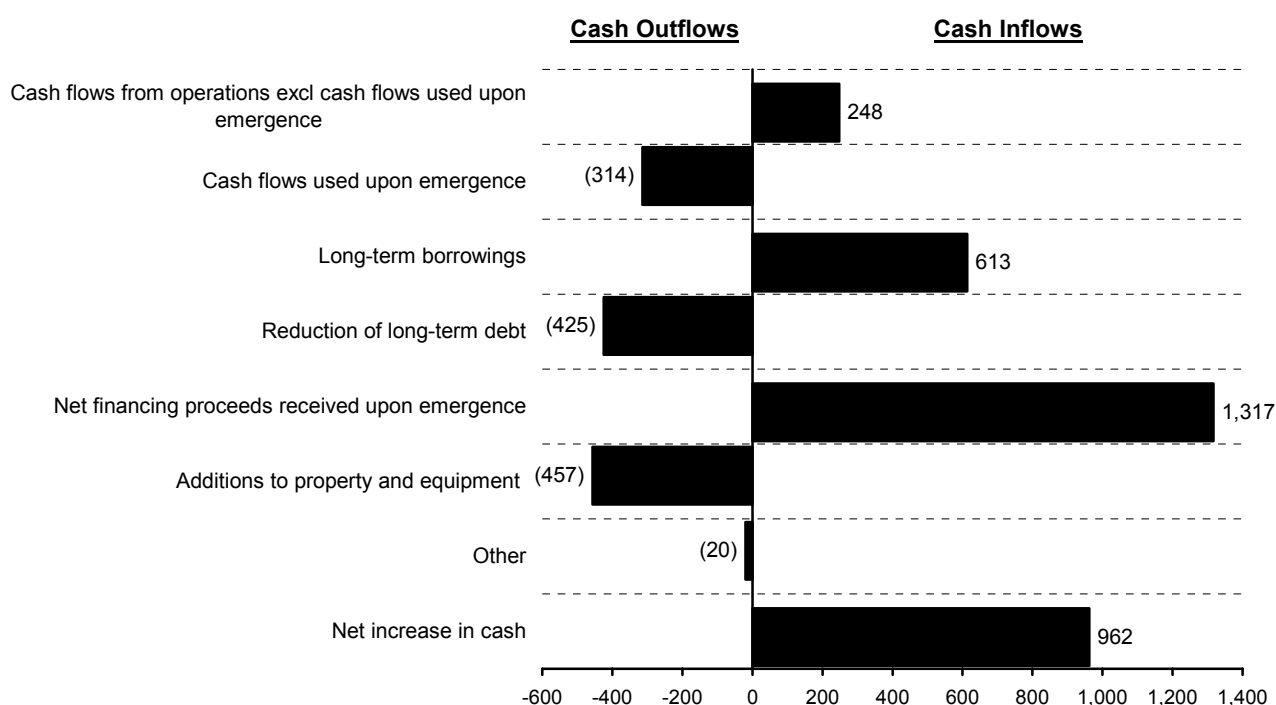
2004 Combined cash flows used for operations amounted to \$66 million compared to cash flows from operations of \$139 million in 2003. 2004 Combined cash flows used for operations included \$314 million of net payments made on implementation of the Plan, relating mainly to the settlement of restructuring obligations.

Before these payments, 2004 Combined cash from operations amounted to \$248 million, an improvement of \$109 million over 2003. Improved operating results in 2004 were partially offset by the cash flow benefit in 2003 resulting from the moratorium on aircraft lease payments and stay of proceedings under the CCAA. Components of the cash flow change are further described below:

- Combined aggregate aircraft lease payments (in excess of) less than rent expense were a use of funds of \$45 million in 2004 versus a source of \$363 million in 2003, a deterioration of \$408 million in relation to 2003. In 2003, subsequent to the CCAA filing, due to the moratorium on aircraft lease payments allowed under the Court order, net scheduled cash payments of \$520 million were not made. Aircraft lease payments (in excess of) less than rent expense represent the difference between actual cash lease payments, either at the inception or during the term of a lease, and amounts recorded for aircraft rent expense which are expensed on a straight line basis over the term of the lease.

- Combined accounts payable was a use of funds of \$222 million in 2004. This compared to a source of funds of \$50 million in 2003, a deterioration of \$272 million. 2003 was favourably impacted by the stay on certain pre-petition obligations as allowed under the Court order, partially offset by accelerated payment terms and prepayments for certain goods and services after the filing.
- The change in Combined accounts receivable, advance ticket sales and spare parts, materials and supplies was a source of funds of \$141 million versus a source of funds of \$167 million, a deterioration of \$26 million from the prior year, largely due to higher fuel inventories, including the impact of higher fuel costs in fuel inventories.
- Combined other cash from operations was \$148 million versus a use of funds of \$142 million in 2003 reflecting the repatriation of various deposits made while under CCAA.

**Combined 2004 Changes in Cash Position**  
\$M



In 2004, Air Canada obtained financing of approximately \$233 million for the purchase of two Airbus A340-500 aircraft. The purchase was 100 per cent financed through a conditional sales agreement.

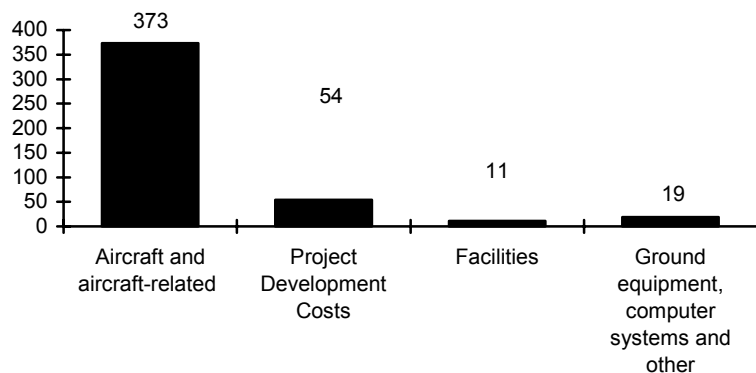
Prior to implementation of the Plan on September 30, 2004, other long-term borrowings amounted to \$380 million, \$300 million of which related to the GE Canada Finance Holding Company debtor-in-possession (DIP) secured financing which was fully repaid through the consummation of the exit financing transactions effective upon emergence from creditor protection and \$80 million related to a secured non-revolving term credit facility with Amex Bank of Canada Inc.

In 2004, Combined reduction of long-term debt and capital lease obligations amounted to \$425 million which included repayments of \$251 million related to capital lease obligations and repayments of \$105 million made on the non-revolving term borrowing credit facility with the CIBC. In 2003, repayments of long-term debt and capital lease obligations amounted to \$240 million of which \$159 million related to the repayment of the non-revolving term borrowing credit facility with CIBC.

### **Combined Cash Flows used for Investing Activities**

In 2004, Combined additions to property and equipment amounted to \$457 million. Included in this amount were \$235 million for the purchase of two Airbus A340-500 aircraft, \$105 million for progress payments on the Embraer and Bombardier aircraft and \$19 million for the purchase of four Boeing B767 aircraft previously under operating leases. Other aircraft-related spending amounted to \$27 million and included inventory and spare engines. These expenditures were partly offset by a Federal government refund recorded in the third quarter of 2004 totaling approximately \$13 million relating to costs incurred for upgrading cockpit security. Other Combined expenditures amounted to \$84 million of which \$54 million related to system development projects.

### **2004 Combined Capital Expenditures \$M**



## **QUARTERLY RESULTS - 2004 AND 2003**

The following discussion covers quarterly financial results for Air Canada as Predecessor Company, for the seven quarters ended September 30, 2004 and ACE for the quarter ended December 31, 2004 as Successor Company. As a result of the application of fresh start reporting and the effectiveness of certain lease contracts on emergence from CCAA, fourth quarter 2004 results of the Successor Company are not comparable to prior quarterly results of the Predecessor Company. The results for the periods ending September 30, 2004 of the Predecessor Company do not include any adjustments to reflect the impact of the emergence, fresh start reporting and other transactions.

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 high number of leisure travelers and their preference for travel during the spring and summer months. The Corporation has substantial fixed costs that do not meaningfully fluctuate with passenger demand in the short-term. Seasonably low passenger demand results in significantly lower operating cash flow and margins in the first and fourth quarters for each calendar year compared to the second and third quarters.

The table below describes quarterly financial results of Air Canada for each quarter of 2003 and the first three quarters of 2004 and the financial results of ACE for the fourth quarter of 2004 as well as major operating statistics:



### Quarterly Financial Data – Condensed Consolidated

<b>\$ millions (except per share figures)</b>	<b>Predecessor Company Air Canada</b>			<b>Successor Company ACE</b>	<b>Predecessor Company Air Canada</b>			
	<b>2004</b>				<b>2003</b>			
	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Q4</b>
Passenger revenues	1,661	1,844	2,123	1,681	1,745	1,597	1,901	1,615
Cargo revenues	126	137	142	151	144	122	122	131
Other revenues	334	240	231	230	323	235	207	231
Operating revenues	2,121	2,221	2,496	2,062	2,212	1,954	2,230	1,977
Operating expenses	2,266	2,199	2,253	2,065	2,566	2,225	2,212	2,054
Operating income (loss) before reorganization and restructuring items	(145)	22	243	(3)	(354)	(271)	18	(77)
Reorganization and restructuring items	(132)	(426)	(313)	-	-	(216)	(274)	(560)
Non-operating income (expense)	(43)	(72)	(133)	(67)	(61)	(68)	(21)	(132)
Income (loss) before foreign exchange on non- compromised long-term monetary items and income taxes	(320)	(476)	(203)	(70)	(415)	(555)	(277)	(769)
FX gain (loss) on non- compromised long-term monetary items	17	(34)	123	98	132	(5)	17	(7)
Income (loss) before income taxes	(303)	(510)	(80)	28	(283)	(560)	(260)	(776)
Recovery of (provision for) income taxes	(1)	-	(1)	(13)	13	(6)	(3)	8
Net income (loss)	(304)	(510)	(81)	15	(270)	(566)	(263)	(768)
Earnings (loss) (1) Per share - basic	(2.53)	(4.24)	(0.67)	0.17	(2.25)	(4.70)	(2.18)	(6.39)
- diluted	(2.53)	(4.24)	(0.67)	0.17	(2.25)	(4.70)	(2.18)	(6.39)
Revenue passenger miles (millions)	10,057	10,836	12,853	9,681	9,586	9,073	11,617	9,289
Available seat miles (millions)	13,797	13,931	15,993	12,815	13,310	12,579	15,156	13,115
Passenger load factor (%)	72.9	77.8	80.4	75.5	72.0	72.1	76.6	70.8
Operating expense per available seat mile (CASM) (cents)	16.4	15.8	14.1	16.1	19.3	17.7	14.6	15.7
Operating expense per available seat mile excl. fuel expense (cents)	14.0	13.1	11.2	12.7	16.7	15.4	12.5	13.5

(1) Pursuant to the Plan as further described in Note 2 to the 2004 Annual Consolidated Financial Statements, all issued and outstanding options of Air Canada and warrants were cancelled without payment or consideration. In addition, a new share capital was established under ACE, as further described in Notes 19 and 20 to the 2004 Annual Consolidated Financial Statements.

## Quarterly Analysis of Results

Quarterly operating revenues for 2004 showed positive year-over-year increases for the last three quarters of the year. The year 2003 was significantly impacted by a number of external events and factors, notably the SARS crisis, the war in Iraq and increased competition.

The table below describes, by major market, the percentage change from the prior year in passenger revenues for the eight most recent quarters.

### Passenger Revenue % Change Year-over-Year by Quarter

	Predecessor Company Air Canada				Successor Company ACE			
	Quarter 1 2003	Quarter 2 2003	Quarter 3 2003	Quarter 4 2003	Quarter 1 2004	Quarter 2 2004	Quarter 3 2004	Quarter 4 2004
Canada	(12)	(26)	(17)	(13)	(9)	8	3	0
US	(5)	(27)	(24)	(19)	(13)	5	(1)	(17)
Atlantic	(1)	(11)	(4)	(5)	(5)	6	6	4
Pacific	(3)	(63)	(52)	(13)	15	162	113	35
Other	21	(8)	3	18	24	38	25	22
System (excl. Aeroplan)	(6)	(26)	(19)	(12)	(5)	15	12	1
System (incl. Aeroplan)	(6)	(26)	(19)	(12)	(5)	15	12	4

First quarter 2004 consolidated passenger revenues declined \$84 million or 5 per cent from the same period in 2003. This represented the smallest quarter-over-quarter reduction since the fourth quarter of 2003 as compared to 2002. Pacific and other international routes recorded strong revenue growth, while North American routes continued to show declines, but at a lower rate than in previous quarters. Increased competition in both Canada and the U.S. contributed to a 9 per cent decline in overall system yield per RPM.

The second quarter showed significant improvement due to recovery in most markets but notably the Pacific market which accounted for one half of the total year-over-year improvement. Passenger revenues in the second quarter increased \$247 million or 15 per cent from the second quarter of 2003. During the 2004 quarter, system passenger traffic increased 19 per cent on an 11 per cent increase in ASM capacity producing a 5.7 percentage point improvement in load factor. RASM increased 4 per cent reflecting the rise in passenger load factor. In the second quarter of 2003, passenger revenues were negatively impacted due to lower domestic and international demand resulting from the SARS crisis and a second outbreak in May 2003.

The third quarter passenger revenue increase of \$222 million or 12 per cent from the prior year represented a progressive recovery in all markets with the exception of the US transborder market. International markets continued their rebound from a SARS impacted 2003. A stronger domestic market showed improving yield per RPM and traffic performance as well. In the 2003 quarter, passenger revenues were negatively impacted by lower domestic and international demand resulting from the SARS crisis and increased capacity by low-cost carriers. System passenger traffic for the third quarter 2004 increased 11 per cent on a 6 per cent increase in ASM capacity producing a 3.8 percentage point improvement in load factor. With the improvement in load factor, RASM rose 6 per cent over the third quarter of 2003.

Beginning in October 2004, Aeroplan passenger revenues are recorded in passenger revenue. Previously, Aeroplan redemption revenues were included in other revenue. As a result of the inclusion of Aeroplan passenger revenues in passenger revenues starting in October 2004, passenger revenues, RASM and yield per RPM are not directly comparable to the previous years. The following discussion will provide the reader with variances that include Aeroplan passenger revenues. However, for comparative purposes, passenger revenues, RASM and yield per RPM will also provide the reader with variances excluding these revenues.

Fourth quarter 2004 passenger revenues increased \$66 million or 4 per cent which included Aeroplan passenger revenues of \$41 million in the quarter. For the 2004 quarter, system passenger traffic increased 4 per cent on a decrease of 2 per cent in ASM flying capacity producing a 4.7 percentage point improvement in load factor. Excluding Aeroplan passenger revenues, yield per RPM decreased 3 per cent. The yield per RPM decrease was due to increased low-cost competition, a weak transborder market and a greater proportion of longer haul flying which has a lower yield per RPM. With the major improvement in load factor, system RASM, excluding Aeroplan passenger revenues, rose 4 per cent over the fourth quarter of 2003.

First quarter 2004 operating expenses declined \$300 million or 12 per cent on a 4 per cent increase to ASM capacity. Unit cost was 15 per cent below the 2003 level. Salaries and wage expense was reduced \$118 million or 19 per cent as a result of a reduction of an average of over 6,300 FTE employees as well as salary reductions for unionized and non-unionized employee groups. Expense reductions were also recorded in most areas including aircraft rent, aircraft maintenance, material and supplies and communications and information technology and other operating expenses.

For the second quarter, operating expenses were reduced by \$26 million or 1 per cent on an 11 per cent increase to ASM capacity. With a significant increase to fuel prices, fuel rose \$82 million or 28 per cent. Unit cost was 11 per cent below the 2003 level (excluding fuel expense, down 15 per cent). Expense reductions were recorded in essentially all controllable areas. Salary and wages expense per ASM declined 22 per cent from the second quarter of 2003.

In the third quarter of 2004, consolidated operating expenses increased \$41 million or 2 per cent despite an increase in fuel expense of \$138 million on an ASM increase of 6 per cent. Unit cost was down 3 per cent from the third quarter of 2003 (excluding fuel expense, down 10 per cent).

In the fourth quarter of 2004, operating expenses increased \$11 million or 1 per cent, despite an increase of \$142 million or 49 per cent in fuel expense, on an ASM capacity reduction of 2 per cent. Unit cost increased 3 per cent (excluding fuel expense, down by 5 per cent). As the cost reduction initiatives undertaken under the restructuring process largely came into effect beginning in the third quarter of 2003, the quarter-over-quarter reduction in unit cost for the fourth quarter was smaller than in the previous quarters.

## **SEGMENT INFORMATION**

As a result of the corporate restructuring, the Corporation's businesses are operated through four reporting segments: transportation services, loyalty program, technical services, and regional operations. In the Predecessor Company, Technical Services was a cost center within Air Canada and discrete financial information is not available. As described in Note 1 to the 2004 Annual Consolidated Financial Statements, a capacity purchase agreement between Air Canada and Jazz came into effect on September 30, 2004. The Jazz segment information in the Successor Company is not comparable as a result of this new agreement.

Aeroplan was operated as a division of the Predecessor Company until January 1, 2002. An asset purchase agreement was executed between Air Canada and Aeroplan having an effective date of January 1, 2002. Based upon the terms contained in the asset purchase agreement, Air Canada maintained the liability with respect to Aeroplan Miles issued prior to January 1, 2002. Aeroplan assumes all risks and rewards for the management of Aeroplan Miles issued on or after January 1, 2002. As at September 30, 2004, Air Canada had a remaining liability of approximately 25 per cent of the total Aeroplan Miles outstanding. As a result of this transitional period, Loyalty Program results are not directly comparable to prior periods.

The accounting policies for each of these segments are as those described in Note 4 to the 2004 Annual Consolidated Financial Statements. Segment financial information has been prepared consistent with how financial information is produced internally for the purposes of making operating decisions. Segments negotiate transactions with each other as if they were unrelated parties. A reconciliation of the total amounts reported by each segment to the applicable amounts in the consolidated financial statements follows:

**Successor Company**  
**Period ended December 31, 2004**

(\$ Millions)	Transportation Services (1)	Loyalty Program (2)	Technical Services	Regional Operations (3)	Inter-Segment Elimination	ACE Consolidated Total
Passenger revenue	1,680	-	-	1	-	1,681
Cargo revenue	151	-	-	-	-	151
Other revenue	40	126	62	2	-	230
External revenue	1,871	126	62	3	-	2,062
Inter-segment revenue	54	6	122	185	(367)	-
Total revenue	<u>1,925</u>	<u>132</u>	<u>184</u>	<u>188</u>	<u>(367)</u>	<u>2,062</u>
Operating expenses, before the following:	1,925	105	155	162	(367)	1,980
Amortization of capital assets	72	2	7	4	-	85
Significant non-cash and special items	-	-	-	-	-	-
Total operating expenses	<u>1,997</u>	<u>107</u>	<u>162</u>	<u>166</u>	<u>(367)</u>	<u>2,065</u>
Operating income (loss)	(72)	25	22	22	-	(3)
Net interest expense	(39)	-	(4)	(4)	-	(47)
Foreign exchange on long-term monetary items	98	-	-	-	-	98
Income tax expense	(13)	-	-	-	-	(13)
Other non-operating items	(19)	-	-	(1)	-	(20)
	<u>27</u>	<u>-</u>	<u>(4)</u>	<u>(5)</u>	<u>-</u>	<u>18</u>
Segment Results	<u>(45)</u>	<u>25</u>	<u>18</u>	<u>17</u>	<u>-</u>	<u>15</u>

- (1) Includes revenues and costs for Air Canada Mainline operations, Jazz transportation revenues and fees to Air Canada Mainline for Jazz operations under the CPA as well as Air Canada Cargo, Destina, AC Online, Air Canada Ground Handling Services, Air Canada Vacations and ACE. Foreign exchange on long-term monetary items is included by management in the Transportation Services segment. Interest expense in the Transportation Services segment represent interest on third party debt. Interest expense included in other segments represent interest on intercompany and third party debt. Management reflects all income taxes within the Transportation Services segment including any income taxes that may be applicable to amounts earned in the other segments because the activities of the other segments are carried out as limited partnerships and the income is taxable in one of the entities included in Transportation Services.
- (2) Other revenue of \$126 million includes revenue recognized on redemption of points accumulated through both air and third party contracts. Inter-segment revenue of \$6 million represents the management fee charged to Air Canada by Aeroplan relating to the redemption of points accumulated prior to January 1, 2002. The value of points earned through air, charged by Aeroplan to Air Canada, is recorded in Aeroplan's accounts as deferred revenues.
- (3) Includes Jazz operations under the CPA effective September 30, 2004.

This segment reporting is applied on a prospective basis and, accordingly, segment reporting pertaining to periods prior to September 30, 2004 is not directly comparable.

## **OFF-BALANCE SHEET ARRANGEMENTS**

An off-balance sheet arrangement is any transaction, agreement or other contractual arrangement with an entity not reported on a consolidated basis under which a company has (1) any obligation under certain guarantee contracts; (2) a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for the assets; (3) any obligation under certain derivative instruments; or (4) any obligation arising under a material variable interest held in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the company, or that engages in leasing, hedging or research and development arrangements with the company.

### **Guarantees**

As described in Note 24 to the 2004 Annual Consolidated Financial Statements of ACE for the year ended December 31, 2004, under certain aircraft lease agreements accounted for as operating leases, ACE may be required to provide residual value support not exceeding \$382 million. Any potential payment under the guarantee would be payable on lease expiry, and the amount of the loss is dependent on the net proceeds received on the sale of the aircraft, or the fair value of the aircraft in the event that the Corporation exercises its purchase option, where applicable. The current carrying value of amounts recorded under residual value guarantees is \$133 million.

With respect to 35 GECC owned aircraft leases and 10 GECC managed aircraft leases, the difference between the amended rents and amounts due under the original lease contracts will be forgiven at the expiry date of the leases if no material defaults have occurred. If a material default occurs, this difference plus interest will become due and payable and all future rent will be based on the original contracted rates.

ACE participates in fuel facilities arrangement, along with other airlines that contract for fuel services at various airports in Canada. The Fuel Facilities Corporations operate on a cost recovery basis. The purpose of the Fuel Facilities Corporations is to own and finance the system that distributes the fuel to the contracting airlines, including leasing the land rights under the land lease. The aggregate debt of the Fuel Facilities Corporations in Canada as at December 31, 2004 is approximately \$135 million which is Successor Company's maximum exposure to loss without taking into consideration any cost sharing that would occur amongst

the other contracting airlines. The Successor Company views this loss potential as remote. Each contracting airline shares pro rata, based on system usage, in the guarantee of this debt.

### **Retained or Contingent Interest in Assets Transferred**

ACE has no material arrangements involving the transfer of assets to an unconsolidated entity where those assets serve as credit, liquidity or market risk support to that entity.

### **Derivative Instruments**

ACE's risk management policies and use of derivative financial instruments are described in Note 23 to the 2004 Annual Consolidated Financial Statements of ACE for the year ended December 31, 2004. The Corporation has entered into currency swap agreements for five Canadair Regional Jet operating leases until lease termination in 2007. These currency swaps, with unrelated creditworthy third parties, were put in place on the inception of these leases and have a fair value at December 31, 2004 of \$12 million in favour of the third parties (2003 \$7 million in favour of unrelated creditworthy third parties), taking into account foreign exchange rates in effect at that time.

Air Canada had entered into currency swaps with an unrelated creditworthy third party for three Airbus A330 operating leases until 2010. These currency swaps were terminated during the quarter ended September 30, 2004. The fair value of these currency swaps at December 31, 2003 was \$19 million in favour of the Corporation.

### **Variable Interest Entities**

Accounting Guideline 15 – Consolidation of Variable Interest Entities (AcG 15) is effective for periods beginning on or after November 1, 2004. As a result, ACE will be adopting this standard effective January 1, 2005. AcG 15 relates to the application of consolidation principles to certain entities that are subject to control on a basis other than ownership of voting interests. The purpose of AcG 15 is to provide guidance for determining when an enterprise includes the assets, liabilities and results of activities of such an entity (a "variable interest entity") in its consolidated financial statements.

Air Canada has entered into aircraft and engine lease transactions with several special purpose entities (SPEs), referred to as variable interest entities under AcG 15. On adoption of AcG 15, the Corporation anticipates consolidating leasing entities covering 51 aircraft and 22



engines accounted for as operating leases under Canadian GAAP as at December 31, 2004. In addition, the Corporation participates in fuel facilities arrangement, along with other airlines that contract for fuel services at various airports. The Fuel Facilities Corporations operate on a cost recovery basis. Under AcG 15, the Corporation anticipates consolidating those Fuel Facilities Corporations where the Corporation uses more than 50 per cent of the services of the Fuel Facilities Corporations.

A summary of the anticipated impact on the consolidated balance sheet of ACE of consolidating the variable interest entities as noted as at January 1, 2005 is as follows:

<b>\$ millions</b>	<b>Aircraft and Engines</b>	<b>Fuel Facilities</b>	<b>Total</b>
Property and equipment	1,304	113	1,417
Deposits and other assets, net	57	-	57
	<u>1,361</u>	<u>113</u>	<u>1474</u>
Current portion – Long-term debt	77	-	77
Long-term debt	1,179	51	1,230
Minority interest	170	8	178
Other liabilities, net	(158)	2	(156)
	<u>1,268</u>	<u>61</u>	<u>1,329</u>
Credit to retained earnings	<u>93</u>	<u>52</u>	<u>145</u>

The existence of the Special Purpose Entity (SPE) in the lease arrangements does not, in and of itself, increase any financial risk to ACE. ACE views the off balance sheet risk in aircraft lease arrangements as being related to the duration of the lease and the existence of residual value support ACE may be required to provide.

## **ADOPTION OF ACCOUNTING POLICIES**

In accordance with Section 1625 of the CICA Handbook, Comprehensive Revaluation of Assets and Liabilities, ACE adopted fresh start reporting on September 30, 2004. As a result, all assets and liabilities of ACE have been reported at fair values, except for future income taxes which are reported in accordance with the requirements of Section 3465 of the CICA Handbook, Income Taxes.

As a result of the application of fresh start reporting, the outstanding loyalty program mileage credits ("miles") were adjusted to reflect the estimated fair value of miles to be redeemed in the future. As a consequence of this fair value adjustment and the evolving nature of the Aeroplan loyalty program, the Successor Company changed the accounting policy as of September 30, 2004 for the recognition of its obligations relating to the loyalty program. The Predecessor Company recognized the obligation related to Miles earned through transportation services based on the incremental cost of providing future transportation services. On a prospective basis from the date of fresh start reporting, Miles earned by members through transportation services provided by the Corporation and the transportation services are treated as multiple elements. Miles are recorded at fair values with the residual allocated to transportation services. Consistent with the accounting policy of the Predecessor Company, the proceeds from the sale of Miles to loyalty program partners are deferred.

Revenues from miles issued to members are recognized at the time the miles are redeemed except for breakage as noted below. Effective September 30, 2004, Miles redeemed for travel are included in passenger revenue and miles redeemed for other than travel are included in other revenue. Under the previous accounting policy in the Predecessor Company, Aeroplan redemption revenues from Miles earned by members through loyalty program partners were included in other revenue. Based on historical experience and current program policies, the Successor Company estimates the percentage of miles that may never be redeemed, defined as breakage. The amount allocated to breakage is recognized in other revenue on a straight line basis over a period of 30 months. The Corporation performs regular evaluations on the breakage estimate which may result in certain adjustments.

As a result of the restructuring, the Corporation operates its businesses through four reportable segments: transportation services, loyalty program, technical services and regional operations. Previously, the Corporation reported operating results under only one segment.

Air Canada adopted Accounting Guideline 13 – Hedging Relationships (AcG 13) beginning January 1, 2004. The new guideline outlines criteria related to the identification, designation, documentation and effectiveness of hedging relationships, for the purpose of applying hedge accounting; and the discontinuance of hedge accounting.

Effective January 1, 2004, Air Canada adopted CICA 1100 – Generally Accepted Accounting Principles and CICA 3063 – Impairment of Long-Lived Assets. CICA 1100 establishes standards for financial reporting in accordance with generally accepted accounting principles. There have been no changes in accounting policies as a result of the adoption of CICA 1100. CICA 3063 establishes standards for the recognition, measurement and disclosure of the impairment of long-lived assets. Air Canada has not recorded any impairment loss as a direct result of the transition to CICA 3063.

## **CRITICAL ACCOUNTING ESTIMATES**

Critical accounting estimates are those that are most important to the portrayal of the Corporation's financial condition and results of operations. They require management's most difficult, subjective or complex judgments, often as a result 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.

The Corporation has identified the following critical accounting policies utilized in the preparation of these financial statements:

### **Air Transportation Revenues**

Airline passenger and cargo advance sales are deferred and included in current liabilities. In addition, the current portion of loyalty program deferred revenues are reported in Advance ticket sales and loyalty program deferred revenues. Passenger, including loyalty program redemptions for air travel, and cargo revenues are recognized when the transportation is provided. The Corporation has formed alliances with other airlines encompassing loyalty program participation, code sharing and coordination of services including reservations, baggage handling and flight schedules. Revenues are allocated based upon formulas specified in the agreements and are recognized as transportation is provided. Beginning September 30, 2004, the estimated fair value of Aeroplan Miles earned through qualifying air travel is deferred in passenger revenue at the time the qualifying air travel is provided. Deferred revenues from the issue of Miles to customers, including Miles sold to loyalty program partners are recorded as passenger revenues at the time the Miles are redeemed for air travel. Redemptions for non-passenger services are included in other revenue.

The Corporation performs regular evaluations on the liability which may result in adjustments being recognized as revenue. Due to the complex pricing structures; the complex nature of interline and other commercial agreements used throughout the industry; historical experience over a period of many years; and other factors including refunds, exchanges and unused tickets, certain relatively small amounts are recognized as revenue based on estimates. Events and circumstances may result in actual results which are different from estimates, however, these differences have historically not been material. Customer behaviour, pricing policies and other factors may result in changes impacting these estimates.

## Employee Future Benefits

The significant policies related to employee future benefits, consistent with CICA #3461 - "Employee Future Benefits", are as follows:

- The cost of pensions and other post-retirement benefits earned by employees is actuarially determined using the projected benefit method prorated on service, market interest rates, and management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees and expected health care costs.
- A market-related value method is used to value plan assets for the purpose of calculating the expected return on plan assets. Under the selected method, the differences between investment returns during a given year and the expected investment returns are amortized on a straight-line basis over four years.
- Past service costs arising from plan amendments are amortized on a straight-line basis over the average remaining service period of the employees active at the date of amendment. This period does not exceed the average remaining service period of such employees up to the full eligibility date.
- Cumulative unrecognized net actuarial gains and losses in excess of 10 per cent of the greater of the projected benefit obligation or market-related value of plan assets at the beginning of the year are amortized over the remaining service period of active employees.

Management makes a number of assumptions in the calculation of both the accrued benefit obligation as well as the pension costs:

	<u>Dec 31, 2003</u>	<u>Sep 30, 2004</u>	<u>Dec 31, 2004</u>
<b>Weighted Average Assumptions used to determine accrued benefit obligation</b>			
Discount rate as at period end	6.00%	6.00%	5.75%
Rate of compensation increase	4.00%	4.00%	4.00%
<b>Weighted Average Assumptions used to determine pension costs</b>			
Discount rate as at period end	6.50%	6.00%	6.00%
Expected long term rate of return on plan assets	7.50%	7.50%	7.50%
Rate of compensation increase	4.25%	4.00%	4.00%

## 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 approximately match the timing and amount of expected benefit payments.

## Expected Return on Assets Assumption

The Corporation's expected long-term rate of return on assets assumption is selected based on the facts and circumstances that exist as of the measurement date and the specific portfolio mix of plan assets. Management, in conjunction with its actuaries, reviews anticipated future long-term performance of individual asset categories and considers the asset allocation strategy adopted by the Corporation, including the longer duration in its bond portfolio in comparison to other pension plans. These factors are used to determine the average rate of expected return on the funds invested to provide for the pension plan benefits. While the review considers recent fund performance and historical returns, the assumption is primarily a long-term, prospective rate.

## Asset Allocation

The actual and target allocations of the pension assets are as follows:

	Dec 31, 2003	Dec 31, 2004	Target Allocation
Equity	64.8%	64.8%	65.0%
Bonds and Mortgages	32.9%	33.1%	35.0%
Real Estate	0.3%	0.2%	0.0%
Short-term and Other	2.0%	1.9%	0.0%
Total	100.0%	100.0%	100.0%

## Investment Policy

For the Domestic Registered Pension Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Master Trust Fund (Fund). The Audit, Finance and Risk Committee of the Board of Directors reviews and confirms the policy annually. The investment return objective of the Fund is to achieve a total annualized rate of return that exceeds inflation by at least 3.75 per cent over the long term.

In addition to the target asset allocation, as summarized in the asset allocation section above, the following policies apply to individual asset classes:

- Equity investments can include convertible securities, and are required to be diversified among industries and economic sectors. Foreign equities can comprise 27 to 33 per cent of the total market value of the trust. Limitations are placed on the overall allocation to any individual security at both cost and market value. Derivatives are permitted to the extent they are not used for speculative purposes or to create leverage.
- Fixed income investments are oriented toward risk averse, long term, investment grade securities rated “A” or higher. With the exception of Government of Canada securities, or a province thereof, in which the plan may invest the entire fixed income allocation, fixed income investments are required to be diversified among individual securities and sectors. The target return is comprised of 50 per cent of the total return of the Scotia Capital Long Term Bond Index.

### **Best Estimate of Employer Contributions**

Based upon an agreement, subject to approval of the Office of the Superintendent of Financial Institutions (Canada) (OSFI), between Air Canada and representatives of the unionized and non-unionized employees and retirees with respect to the funding of the Canadian registered plans, the estimated 2005 contributions are as follows:

	<u>2005 Contributions</u> (\$ millions)
Current service cost for registered pension plans	128
Past service cost for registered pension plans	83
Other pension arrangements	48
Total	<u>259</u>

## Sensitivity Analysis

Sensitivity analysis on the Combined 2004 pension expense based on different actuarial assumptions with respect to discount rate and expected return on plan assets is as follows:

<u>Impact on 2004 Pension Expense</u>	<u>0.25 percentage point</u>	
	<u>Increase</u>	<u>Decrease</u>
	<u>(\$ millions)</u>	
Discount rate on obligation assumption	(6)	6
Long-term rate of return on plan assets assumption	(23)	23

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 10.75 per cent annual rate of increase in the per capita cost of covered health care benefits was assumed for 2004 (2003 10.00 per cent). The rate is assumed to decrease gradually to 5 per cent by 2013. A one percentage point increase in assumed health care trend rates would have increased the service and interest costs by \$1 million and the obligation by \$13 million. A one percentage point decrease in assumed health care trend rates would have decreased the service and interest costs by \$2 million and the obligation by \$17 million.

In 2003, as a result of the Predecessor Company's review of the impact of the reduction in the level of employees as part of the CCAA restructuring program on its pension liability and expense, the Corporation recorded a pension curtailment charge of \$128 million. The charge is calculated based upon the impact the reduction in the level of employees had on the expected average remaining service life of the active employees.

Upon emergence from CCAA, under fresh start reporting, all unamortized past service costs, net actuarial losses and net transition obligations were written off and the Corporation recorded the estimated net accrued benefit obligations of the plans as at the date of emergence. At that time, all assumptions used in the calculations were revalidated.

## Property and Equipment

Property and equipment is originally recorded at cost. Property under capital leases and the related obligation for future lease payments are initially recorded at an amount equal to the lesser of fair value of the property or equipment and the present value of those lease payments. Property and equipment is carried at the lesser of amortized cost and the net recoverable amount.



On the application of fresh start accounting, effective September 30, 2004, the cost of property and equipment was adjusted to fair value in the Successor Company. As at December 31, 2004, the net book value of the Corporation's property and equipment totalled \$3,696 million.

Property and equipment, including property under capital lease, are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Mainline aircraft and flight equipment are depreciated over 20 to 25 years, with 10 to 15 per cent estimated residual values. Regional aircraft and flight equipment are depreciated over 20 to 30 years, with 20 per cent estimated residual values. Aircraft reconfiguration costs are amortized over three years. Aircraft introduction costs are amortized over three years. Betterments to owned aircraft are capitalized and amortized over the remaining service life of the aircraft. Betterments to aircraft on operating leases are amortized over the term of the lease.

Buildings are depreciated over their useful lives not exceeding 50 years on a straight line basis (30 years in the Predecessor Company). An exception to this is where the useful life of the building is greater than the term of the land lease. In these circumstances, the building is depreciated over the life of the lease. Leasehold improvements are amortized over the lesser of the lease term or five years. Ground equipment is depreciated over three to 25 years (five to 25 years in the Predecessor Company). Computer equipment is depreciated over three years (five years in the Predecessor Company).

Aircraft depreciable life is determined through economic analysis, a review of existing fleet plans and comparisons to other airlines operating similar fleet types. Residual values are estimated based on Air Canada's historical experience with regards to the sale of both aircraft and spare parts, as well as future based valuations prepared by independent third parties.

The Corporation's policy is to recognize an impairment charge when an asset's carrying value exceeds its undiscounted future cash flows. In 2004, Air Canada recorded provisions of \$75 million (2003 \$168 million) related mainly to non-operating aircraft and spare parts. These provisions are based on management's best estimate of the net recoverable value of aircraft and spare parts.

Under certain aircraft lease agreements, the Corporation may be required to provide residual value support not exceeding \$382 million. Any potential payment under the guarantee

would be payable on lease expiry, and the amount of the loss is dependent on the net proceeds received on the sale of the aircraft, or the fair value of the aircraft in the event that the Corporation exercises its purchase option, where applicable. The current carrying value of amounts recorded under residual value guarantees is \$133 million.

### **Intangible Assets**

The identifiable intangible assets of the Corporation were fair valued based on valuation techniques for the purpose of financial reporting under fresh start reporting requirements as at September 30, 2004. The non-amortizable intangible assets of the Corporation are significant and require annual impairment assessments. In addition, the Company is required to assess the remaining life of amortizable assets on a regular basis.

Fair value for purposes of measuring the identifiable assets under Canadian GAAP is defined as “the amount of the consideration that would be agreed upon in an arm’s length transaction between knowledgeable, willing parties who are under no compulsion to act”. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the 2004 Annual Consolidated Financial Statements and accompanying notes. Actual results could differ from those estimates.

### **Loyalty Program**

The Corporation’s loyalty program, Aeroplan, awards mileage credits (Miles) to passengers who fly on Air Canada, Jazz, Star Alliance carriers and certain other airlines that participate in the program. Additionally, Aeroplan issues Miles to members for the purchase of goods and services from participating non-airline partners. The outstanding Miles may be redeemed for travel or other goods and services.

As a result of the application of fresh start reporting, the outstanding loyalty program Miles were adjusted to reflect the estimated fair value of Miles to be redeemed in the future. As a consequence of this fair value adjustment and the evolving nature of the Aeroplan loyalty program, the Successor Company changed the accounting policy as of September 30, 2004 for the recognition of its obligations relating to the loyalty program. The Predecessor Company recognized the obligation related to Miles earned through transportation services based on the incremental cost of providing future transportation services. On a prospective basis from the date

of fresh start reporting, Miles earned by members through transportation services provided by the Corporation and the transportation services are treated as multiple elements. Miles are recorded at fair values with the residual allocated to transportation services. Consistent with the accounting policy of the Predecessor Company, the proceeds from the sale of Miles to loyalty program partners are deferred.

Revenues from Miles issued to members are recognized at the time the Miles are redeemed except for breakage as noted below. Effective September 30, 2004, Miles redeemed for air travel on Air Canada and Jazz are included in passenger revenue. Also, effective September 30, 2004, the Corporation commenced deferring passenger revenues equivalent to the fair value of mileage credits earned through air travel on the Corporation's services based upon the cost of purchasing the mileage credits from Aeroplan. These deferred passenger revenues will be recognized in a future period when the Miles are redeemed. Miles redeemed for other than travel are included in other revenue. Under the previous accounting policy in the Predecessor Company, Aeroplan redemption revenues from Miles earned by members through loyalty program partners were included in other revenue. These revenues amounted to \$173 million for the nine months ended September 30, 2004 (\$177 million for the twelve months ended December 31, 2003). Based on historical experience and current program policies the Successor Company estimates the percentage of Miles that may never be redeemed, defined as breakage. The amount allocated to breakage is recognized on a straight line basis over a period of 30 months in other revenue. The Corporation performs regular evaluations on the breakage estimate which may result in certain adjustments.

At December 31, 2004, the Corporation's estimated outstanding number of Miles was approximately 185 billion, as compared to substantially the same number at the end of the prior year. Management has recorded a liability of \$1,599 million, including \$497 million in Advance Ticket Sales and Loyalty Program Deferred Revenues million for the estimated number of Miles expected to be redeemed. A change to the estimate of Miles expected to be redeemed could have a significant impact on the liability in the period of change and in future periods.

In 2004, 29 billion Miles (2003 29 billion) were redeemed principally for travel. These redemptions represented approximately 10 per cent of Air Canada's total revenue passenger miles in 2004 (2003 10 per cent). Inventory controls over seat allocations keeps displacement of revenue passengers to a minimum. Total Miles redeemed for travel on Air Canada in 2004,

including awards and upgrades, represented 67 per cent of the total Miles redeemed, of which 64 per cent were used for travel within the U.S. and Canada. In addition to the awards issued for travel on Air Canada, approximately 30 per cent of the total Miles redeemed in 2004 were used for travel on partner airlines and 3 per cent were used for goods and services from non-airline partners.

A change to either the redemption patterns of the Miles or the award options provided could have a significant impact on the Corporation's revenues in the year of change as well as in future years.

### **Future Income Taxes**

The Corporation utilizes the liability method of accounting for income taxes under which future income tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amount and the tax basis of assets and liabilities. Future income tax assets and liabilities are measured using substantively enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in earnings in the period that includes the enactment date. Future income tax assets are recognized to the extent that realization is considered more likely than not. The benefit of future income tax assets that exist at fresh start, and for which a valuation allowance is recorded amounts to \$2,334 million which, if recognized, will be used first to reduce to nil any remaining intangible assets (on a pro-rata basis) that were recorded upon fresh start reporting with any remaining amount as a credit to Shareholders' Equity. The benefit of future income tax assets that arise after fresh start will be recognized in the income statement.

### **Impairment of Long-Lived Assets**

Long-lived assets are tested for impairment whenever the circumstances indicate that the carrying value may not be recoverable by comparing the estimate of future expected cash flows to the carrying amount of the assets or groups of assets. If the carrying value is not recoverable from future expected cash flows, any loss is measured as the amount by which the asset's carrying value exceeds fair value. Recoverability is assessed relative to undiscounted cash flows from the direct use and disposition of the asset or group of assets.

## **SENSITIVITY OF CONSOLIDATED AIRLINE RESULTS**

Financial results of the Corporation are subject to many different internal and external factors which can have a significant impact on operating results. In order to provide a general guideline, the following table describes, on an indicative basis, the financial impact that changes in operating assumptions would generally have had on the consolidated 2004 Combined operating results. These guidelines were derived from 2004 levels of activity and make use of management estimates. The impacts are not additive, do not reflect the interdependent relationship of the elements and may vary significantly from actual results due to factors beyond the control of the Corporation.

Conversely, an opposite change in the sensitivity factor would have had the opposite effect on operating income.

<b>CONSOLIDATED</b>				<b>Estimated Operating Income Impact</b>
<b>Key Variable</b>	<b>Routes</b>	<b>2004 Measure</b>	<b>Sensitivity Factor</b>	
<b>Revenue Measures</b>				(\$ millions)
Passenger yield per RPM (cents) (incl. Aeroplan)	System Canada	16.8 21.3	1% change in yield per RPM	66 26
Traffic (RPMs) (millions)	System Canada	43,427 13,815	1% change in traffic	58 24
Passenger load factor (%)	System	76.8	1 percentage point change	76
RASM (cents) (incl. Aeroplan)	System	12.90	1% change in RASM	62
<b>Cost Measures</b>				
Labour & benefit expenses (\$ millions)		\$2,585	1% change	26
Fuel - WTI price (US\$/barrel)		US\$40.30	US\$1/barrel change (1) to WTI	28
Fuel - Jet fuel price (CDN cents/litre)		46.16	1% change (1)	16
Cost per ASM (cents)		15.54	1% change	88
<b>Currency Exchange</b>				
Canada to US (CDN\$)		\$1.31	CDN1¢ change (e.g. \$1.31 to \$1.30 CDN dollar)	8

(1) Excludes any impact of fuel surcharges.

## **RISK FACTORS**

### **Risks Relating to the Corporation**

#### **Recent Operating Losses**

In the recent past, Air Canada, ACE's predecessor corporation and now its wholly-owned subsidiary, has, like other legacy carriers, sustained significant operating losses and the Corporation may sustain significant losses in the future. Air Canada and certain of its subsidiaries recently emerged from protection under the CCAA and implemented the Plan. For the years ended December 31, 2003 and 2002, Air Canada incurred operating losses before reorganization and restructuring items and non-recurring labour expenses of \$684 million and \$192 million, respectively. For the nine months period ended September 30, 2004, Air Canada realized operating income before reorganization and restructuring items of \$120 million and for the period ended December 31, 2004, ACE incurred an operating loss before reorganization and restructuring items of \$3 million. Despite the Corporation's recent emergence from creditor protection under the CCAA, the resulting cost reductions and recent results, ACE may not be able to effectively achieve planned cost reductions or restore positive net profitability.

#### **Leverage and Liquidity**

ACE has, and will continue to have, a significant amount of indebtedness, including fixed obligations under aircraft leases. ACE and its subsidiaries will be able to incur additional debt, including secured debt, in the future. The amount of indebtedness that ACE and its subsidiaries incur could have important consequences. For example, it could (i) limit ACE's ability to obtain additional financing for working capital, capital expenditures, acquisitions and general corporate purposes, (ii) require ACE to dedicate a substantial portion of its cash flow from operations to payments on its indebtedness, thereby reducing the funds available for other purposes, (iii) make ACE more vulnerable to economic downturns, (iv) limit its ability to withstand competitive pressures and reduce its flexibility in responding to changing business and economic conditions and, (v) limit ACE's flexibility in planning for, or reacting to, changes in its businesses and the industries in which it operates.

#### **Limitations Due to Restrictive Covenants**

The financing arrangements entered into by the Corporation contain restrictive covenants which affect and, in some cases, significantly limit or prohibit, among other things, the Corporation's ability to incur indebtedness, make prepayments of certain indebtedness,

create liens, sell assets, make capital expenditures and engage in acquisitions, mergers, amalgamations and consolidations. In addition, the financing arrangements require the Corporation to maintain certain financial ratios. Any future borrowings are also likely to be subject to covenants which limit the Corporation's operating and financial flexibility, which may materially and adversely affect the Corporation's profitability. If the Corporation fails to comply with the various covenants of its indebtedness, it will be in default under the terms thereof, which would permit holders of such indebtedness to accelerate the maturity of such indebtedness and could cause defaults under other indebtedness or agreements. In such circumstances, the lenders under the financing arrangements could foreclose upon all or substantially all of the assets of the Corporation which secure the obligations of the Corporation.

The ability of the Corporation to make scheduled payments under its indebtedness will depend on, among other things, its future operating performance and its ability to refinance its indebtedness when necessary. Each of these factors is to a large extent subject to economic, financial, competitive, regulatory, operational and other factors, many of which are beyond the Corporation's control. There can be no assurance that the Corporation will be able to generate sufficient cash from its operations to pay its debts and lease obligations.

### **Need for Additional Capital**

The Corporation is facing a number of challenges in its current business operations, including high fuel prices and increased competition from transborder and low-cost domestic carriers. There can be no assurance that the Corporation will continue to be able to obtain on a timely basis sufficient funds on terms acceptable to the Corporation to provide adequate liquidity and to finance the operating and capital expenditures necessary to implement its new business strategy if cash flow from operations and cash on hand are insufficient.

Failure to generate additional funds, whether from operations or additional debt or equity financings, may require the Corporation to delay or abandon some or all of its anticipated expenditures or to modify its new business strategy, which could have a material adverse effect on the Corporation's business, results from operations and financial condition. Furthermore, the ability of competitors to raise money more easily and on less onerous terms could create a competitive disadvantage for the Corporation.

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

### **Fresh Start Reporting**

ACE's financial statements reflect the adoption of fresh start reporting, which contains valuations based on estimates and assumptions that may vary from actual results and values realized. ACE adopted fresh start reporting on September 30, 2004. As a result, all of ACE's consolidated assets and liabilities have been reported at fair values except for future income taxes which are reported in accordance with the requirements of Section 3465 of the CICA Handbook, Income Taxes. The adoption of fresh start reporting resulted in Shareholders' Equity of \$186 million as at September 30, 2004, versus a Shareholders' Deficit of \$5,050 million at Air Canada prior to the adoption of fresh start reporting. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the 2004 Annual Consolidated Financial Statements and accompanying notes. Actual results could differ from those estimates.

As a result of the adoption of fresh start reporting, ACE's financial statements beginning with the financial statements for the period from June 29, 2004 to December 31, 2004 are not comparable to Air Canada's earlier financial statements.

### **Dependence Upon Subsidiaries**

ACE is a holding company with no material sources of income or assets of its own other than the interest that it has in its subsidiaries. ACE is entirely dependent on the operations and assets of its subsidiaries. Any possible declaration of dividends by ACE to its shareholders will be dependent on the ability of its subsidiaries to declare dividends or make other payments or advances to ACE. The ability of ACE's subsidiaries to make distributions or other payments or advances will be subject to applicable laws and regulations and contractual restrictions that may be contained in the instruments governing any indebtedness of those entities. In addition, any right of ACE to receive assets of its subsidiaries upon their liquidation or reorganization will be structurally subordinated to the prior claims of creditors of such subsidiaries.



## **Regional Jets**

A key component of the Corporation's new business plan is the restructuring of its aircraft fleet, including the elimination of older, less efficient aircraft and the introduction of new regional jet aircraft. The Corporation plans to focus on high frequency on key domestic and transborder routes, while maintaining frequency on other domestic and transborder routes through the increased use of large regional jet aircraft with lower trip costs in order to better match capacity with demand. These aircraft are expected to enable Air Canada to compete more effectively with low-cost carriers. A delay or failure in the completion of the Corporation's fleet restructuring, including a delay in delivery of the regional jets, could adversely affect the implementation of the new business plan, which may, in turn, have an adverse effect on the Corporation's business, results from operations and financial condition.

## **Key Personnel**

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

## **Employee Relations**

Most of the Corporation's employees are unionized and new or modified collective agreements have recently been concluded with their bargaining agents. The collective agreements permit bargaining on wages in 2006 but no strikes or lock-outs may lawfully occur until after the agreements expire in 2009. There can be no assurance that there will not be a labour conflict that could lead to an interruption or stoppage in service at key airports. Any labour conflicts could have a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, labour problems at Air Canada's Star Alliance partners, including Lufthansa and United Airlines, could result in lower demand for connecting traffic with Air Canada and, ultimately, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

## **Interruptions or Disruptions in Service**

The Corporation's business is significantly dependent upon its ability to operate without interruption at a number of key airports, including Toronto's Lester B. Pearson Airport. An interruption or stoppage in service at a key airport could have a material adverse impact on the Corporation's business, results from operations and financial condition.

## **Dependence on Technology**

The Corporation relies in part on technology, including computer and telecommunications equipment and software to increase revenues, reduce costs, and operate its business. Proper implementation and operation of technology initiatives is fundamental to the Corporation's ability to operate a profitable business. The Corporation continuously invests in new technology initiatives to remain competitive, and its continued ability to invest sufficient amounts to enhance technology will affect the Corporation's ability to operate successfully. An inability to invest in technological initiatives would have a material adverse effect on the Corporation's business, results from operations and financial condition.

The technology systems of the Corporation may be vulnerable to a variety of sources of interruption due to events beyond the Corporation's control, including natural disasters, terrorist attacks, telecommunications failures, computer viruses, hackers and other security issues. While the Corporation has in place, and continues to invest in, technology security initiatives and disaster recovery plans, these measures may not be adequate or implemented properly. Any failure in technology employed by the Corporation, including by reason of power, telecommunication or Internet interruptions, could materially and adversely affect the Corporation's operations and could have a material adverse effect on the Corporation's 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 (*i.e.*, essentially assuming indefinite plan continuation) and a solvency basis (*i.e.*, essentially assuming immediate plan termination). Although there would not ordinarily have been a requirement to file formal actuarial valuations on the majority of Air Canada's registered pension plans in 2003, the deterioration in their solvency position in 2002 triggered, in March 2003, a direction by the Office of the Superintendent of Financial Institutions (Canada) (OSFI) to file such valuations by April 30, 2003. OSFI further directed that Air Canada remit to eight of the registered pension

plans additional contributions beyond those recommended by the actuary in the last-filed valuations. On April 1, 2003, Air Canada filed for creditor protection under the CCAA and, accordingly, it did not comply with such regulatory demand.

The solvency liability is influenced primarily by long-term interest rates and by the investment return on plan assets. 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. In the current low interest rate environment, the calculation results in a higher present value of the pension obligations, leading to a larger unfunded solvency position.

In May 2004, Air Canada and OSFI agreed on a protocol pursuant to which the solvency funding requirements for the Corporation's registered pension plans provided for in the then existing regulations, were amended retroactive to January 1, 2004. These requirements include lower solvency deficit amortization payments in 2004 and 2005. Even with the relaxed funding requirements, the Corporation will have to make substantial annual cash contributions, and the level of those contributions will increase in the event of poor pension fund investment performance and/or further declines in long-term Government of Canada bond rates.

### **Federal Court of Appeal Judgment**

The Federal Court of Appeal released a judgment on March 18, 2004 allowing the appeal of the Canadian Human Rights Commission and the Canadian Union of Public Employees (CUPE) from the Trial Division's and Canadian Human Rights Tribunal's (CHRT) decisions regarding the preliminary issue as to whether Air Canada pilots, flight attendants and technical operations personnel are in the same "establishment" for the purposes of pay equity. CUPE filed complaints in 1991 and 1992 against Air Canada and Canadian Airlines International Ltd. alleging wage discrimination against the predominantly female flight attendants, as compared to two predominantly male employee groups – pilots and technical operations personnel. The CHRT and the Trial Division of the Federal Court found that the three employee groups were not in the same establishment for the purposes of pay equity and that therefore the complaints could not proceed. The Federal Court of Appeal overturned this ruling and found that the three employee groups are in the same establishment and that the complaints should proceed on the merits. The Supreme Court of Canada granted Air Canada leave to appeal the Federal Court of Appeal decision. The appeal is expected to be heard in December 2005. During the restructuring under the CCAA, it was agreed that any resolution of

the complaint would have no retroactive financial impact prior to September 30, 2004. Should these complaints succeed, the cost going forward could be very significant and the Corporation's business, results from operations and financial condition could be materially adversely affected.

### **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 the Star Alliance or otherwise be unable to meet its obligations thereunder, the Corporation's business, results from operations and financial condition could be materially adversely affected.

### **Foreign Exchange**

The Corporation's financial results are sensitive to the changing value of the Canadian dollar. In particular, the Corporation has a significant annual net outflow of US dollars and is affected by fluctuations in the Canada/US dollar exchange rate. The Corporation estimates that during 2004, a \$0.01 increase in the Canada/US dollar exchange rate (i.e. from \$1.30 to \$1.31 per US dollar) would have had an estimated \$8 million unfavourable impact on operating income. Conversely, an opposite change in the exchange rate would have had the opposite effect on operating income. The Corporation incurs significant expenses in US dollars for such items as fuel, aircraft rental 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 US dollar would increase the costs of the Corporation relative to its US competitors and could have a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, the Corporation may be unable to appropriately hedge the risks associated with fluctuations in exchange rates.

### **Risks Relating to the Industry**

#### **Competition**

Air Canada and Jazz, two of the Corporation's principal operating subsidiaries, operate within a highly competitive industry. Over the past few years, Canadian low-cost airlines have completed a significant expansion in many of Air Canada's and Jazz's key domestic markets.

Several Canadian carriers have also entered or announced their intent to enter the transborder market. Specifically, Canjet has flights to New York and Florida during the winter and WestJet provides regular scheduled service to Florida, California, New York and Arizona. If these carriers are successful in their expansion in the domestic and transborder markets, or if other carriers enter Air Canada's and Jazz's markets, the Corporation's business, financial condition and results from operations could be materially adversely affected.

US carriers currently operate routes in Air Canada's and Jazz's transborder market. If additional US carriers were to enter Air Canada's and Jazz's transborder market, or if US carriers were to introduce additional transborder services, this could have a material adverse effect on the Corporation's business, results from operations and financial condition.

The Corporation also encounters substantial price competition. The expansion of low-cost carriers in recent years has resulted in a substantial increase in discounted and promotional fares initiated by competitors. The decision to match competitors' fares to maintain passenger traffic results in reduced yields which, in turn, could have a material adverse effect on the Corporation's business, results from operations and financial condition. Furthermore, the Corporation's ability to reduce Air Canada's and Jazz's fares in order to effectively compete with other carriers may be limited by government policies to encourage competition. Such government policies could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Internet travel websites have driven significant distribution cost savings for airlines, but have also enabled consumers to more efficiently find lower fare alternatives by providing them with access to more pricing information. The increased price consciousness of both business and leisure travelers, as well as the growth in new distribution channels, have further motivated airlines to price aggressively to gain fare and market share advantages. These factors will increase over time as Internet ticket sales increase, which will reduce yields and, in turn, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

### **Airline Reorganizations**

Since September 11, 2001, several US air carriers have sought to reorganize under Chapter 11 of the United States Bankruptcy Code. Successful completion of such reorganizations could present the Corporation with competitors having reduced levels of

indebtedness and significantly lower operating costs derived from labour, supply and financing contracts that were renegotiated under the protections of the Bankruptcy Code. In addition, air carriers involved in reorganizations historically have undertaken substantial fare discounting in order to maintain cash flows and to enhance continued customer loyalty. Such fare discounting could result in lower yields for the Corporation which, in turn, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

### **Economic and Geopolitical Conditions**

Airline operating results are sensitive to economic and geopolitical conditions, which have a significant impact on the demand for air transportation. Airline fares and passenger demand have fluctuated significantly in the past and may fluctuate significantly in the future. The Corporation is not able to predict with certainty market conditions and the fares Air Canada and Jazz will be able to charge. Customer expectations are changing rapidly and the demand for lower fares may limit revenue opportunities. An unsustained recovery in economic growth in North America, as well as geopolitical instability in various areas of the world would have the effect of reducing demand for air travel in Canada and, together with the other factors discussed herein, could materially adversely impact the Corporation's profitability. Any prolonged or significant weakness of the economy could have a material adverse effect on the Corporation's business, results from operations and financial condition, especially given the Corporation's substantial fixed cost structure.

### **Airline Industry Characterized By Low Gross Profit Margins and High Fixed Costs**

The airline industry as a whole and scheduled service in particular are characterized by low gross profit margins and high fixed costs. The costs of operating each 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 could, in the aggregate, have a significant effect on the Corporation's operating and financial results. This condition has been exacerbated by aggressive pricing by low-cost carriers, which has had the effect of driving down airline fares in general. Accordingly, a minor shortfall from expected revenue levels could have a material adverse effect on the Corporation's business, results from operations and financial condition.

## **Fuel Costs**

Fuel costs represent a major expense to companies operating within the airline industry. Fuel prices fluctuate widely depending on international market conditions, geopolitical events and the Canada/US dollar exchange rate. The Corporation cannot accurately predict fuel prices. During 2003 and 2004, fuel prices remained at historically high levels. Should fuel prices continue at such high levels, fuel costs could have a material adverse impact on the Corporation's profitability. Due to the competitive nature of the airline industry, the Corporation may not be able to pass on any increases in fuel prices to its customers by increasing its fares. Furthermore, the impact of lower aircraft fuel prices could be offset by increased price competition, and a resulting decrease in revenues, for all air carriers. Any prolonged increase in crude oil or fuel prices as a result of war, terrorist attacks, fuel shortage, geopolitical events or otherwise, could have a material adverse effect on the Corporation's business, results from operations and financial condition. Based on 2004 volumes, the Corporation estimates that a US\$1 per barrel movement in the average price of West Texas Intermediate crude oil would have resulted in an approximate \$28 million change in 2004 fuel expense for Air Canada (excluding any impact of fuel surcharges), assuming flying capacity remained unchanged and that refining spreads between West Texas Intermediate crude oil and jet fuel as well as foreign exchange rates remained constant. The Corporation currently has no hedges for its anticipated 2005 fuel consumption.

## **Terrorist Attacks**

The September 11, 2001 terrorist attacks and subsequent terrorist attacks, notably in the Middle East, Southeast Asia and Europe have caused uncertainty in the minds of the traveling public. The occurrence of a major terrorist attack (whether domestic or international and whether involving the Corporation or another carrier) could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on Air Canada's and Jazz's flights. It could also lead to a substantial increase in insurance and airport security costs. Any resulting reduction in passenger revenues and/or increases in insurance and security costs could have a material adverse impact on the Corporation's business, results from operations and financial condition.

## **Severe Acute Respiratory Syndrome (SARS) or Other Epidemic Diseases**

As a result of the international outbreaks of SARS in 2003, the World Health Organization (the "WHO") issued on April 23, 2003 a travel advisory, which was subsequently

lifted on April 30, 2003, against non-essential travel to Toronto, Canada. The WHO travel advisory relating to Toronto, the location of Air Canada's primary hub, and the international SARS outbreak had a significant adverse effect on passenger demand for air travel destinations served by Air Canada and Jazz, and on the number of passengers traveling on Air Canada's and Jazz's flights and resulted in a major negative impact on traffic on the entire network. A further outbreak of SARS or of another epidemic disease (whether domestic or international) or a further WHO travel advisory (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 and on the number of passengers traveling on Air Canada's and Jazz's flights. Any resulting reduction in traffic on Air Canada's and Jazz's network could have a material adverse effect on the Corporation's 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 high number of leisure travelers and their preference for travel during the spring and summer months. The Corporation has substantial fixed costs that do not meaningfully fluctuate with passenger demand in the short-term. Seasonably low passenger demand results in significantly lower operating cash flow and margins in the first and fourth quarters for each calendar year compared to the second and third quarters.

As described elsewhere, demand for air travel is also affected by factors such as economic conditions, war or the threat of war, 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 a 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 security, safety, licensing, competition, noise levels and the environment. Additional laws and regulations may be proposed from time to time which could impose additional requirements or restrictions on airline operations. The implementation of additional limitations by governments, the Competition Bureau and/or the Competition Tribunal or other governmental entities may have a material adverse effect on the Corporation's business, results



from operations and financial condition. The Corporation cannot give any assurances that new regulations or revisions to the existing regulations will not be adopted. The adoption of such new regulations or revisions could be materially adverse to the Corporation's business, results from operations and financial condition.

The availability of international routes to domestic 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 the Corporation's international operations.

In July 2000, the Government of Canada amended the CTA, the Competition Act and the *Air Canada Public Participation Act (Canada)* to address the competitive airline environment in Canada and ensure protection for consumers. This legislation increased the powers of the Canadian Transportation Agency with respect to pricing on non-competitive domestic routes, and domestic terms and conditions of carriage. In addition, this legislation included airline-specific provisions concerning "abuse of dominance" under the Competition Act, including the establishment of administrative monetary penalties for a breach of the "abuse of dominance" provision by a dominant domestic air carrier.

In February 2001, the Competition Bureau released for consultation draft guidelines outlining the approach it proposed to take in enforcing the airline-specific "abuse of dominance" provisions of the Competition Act. The guidelines described, among other things, how the Competition Bureau would calculate whether a carrier was operating or increasing capacity at fares that do not cover the avoidable costs of providing the services, and uses of commissions, incentives, loyalty programs or corporate discounts that would be regarded as anti-competitive. The implementation of any of these limitations could have a material adverse effect on the Corporation's business, results from operations and financial condition. The guidelines were never finalized in light of the letter issued in 2004 by the Commissioner of Competition described below outlining her approach to enforcement of the airline "abuse of dominance" provisions on a going forward basis.

In March 2001, the Commissioner of Competition brought an application under the "abuse of dominance" provisions of the Competition Act, seeking an order prohibiting Air Canada from charging fares on flights on certain routes in Eastern Canada if such fares would not cover the avoidable costs of such flights. By agreement of Air Canada and the Commissioner of Competition, the application was divided into two phases. Phase I involved a

review of all of Air Canada's costs for the period from April 2000 to March 2001 and a determination of which of those cost items would be considered avoidable costs. The Competition Tribunal released its reasons and findings regarding Phase I on July 22, 2003, and adopted a broadly crafted avoidable cost test. The decision of the Competition Tribunal does not constitute a determination that Air Canada breached the Competition Act by abusing its dominant position, which is an issue that would have been determined in Phase II of the application. As described below, Phase II of the application will not proceed because the proceeding was terminated by the Commissioner of Competition with the agreement of Air Canada, for the reasons described below.

In September 2004, following extensive discussions with Air Canada, the Commissioner of Competition issued a letter describing the enforcement approach to be taken by the Competition Bureau to any new complaint made against a dominant domestic carrier in light of the changes in the airline industry that have occurred since 2000. Furthermore, certain undertakings given by Air Canada to the Commissioner of Competition in 1999 as a condition of its acquisition of Canadian Airlines and which inhibited, in some respects, Air Canada's ability to compete have now been rescinded. In addition, on November 2, 2004, the Minister of Industry tabled amendments to the Competition Act in Bill C-19 which, if enacted, will remove the airline-specific "abuse of dominance" provisions from the Competition Act. The legislative process for Bill C-19 is ongoing.

In light of these developments, and as part of the agreement to terminate the application to the Competition Tribunal, Air Canada determined that it would not appeal the Competition Tribunal's decision in Phase I of the application. The Competition Bureau has expressed its view that the principles established by the Competition Tribunal in Phase I of the application regarding the application of the avoidable cost test would be relevant for any future cases which may arise in similar circumstances. If the Commissioner of Competition commences inquiries or brings similar applications with respect to significant competitive domestic routes and such applications are successful, it could have a material adverse effect on the Corporation's business, results from operations and financial condition.

The Corporation is subject to domestic and foreign laws regarding privacy of passenger and employee data that are not consistent in all countries in which the Corporation operates. In addition to the heightened level of concern regarding privacy of passenger data in Canada, certain US and European government agencies are initiating inquiries into airline privacy

practices. Compliance with these regulatory regimes is expected to result in additional operating costs and could have a material adverse effect on the Corporation's business, results from operations and financial condition.

### **Increased Insurance Costs**

The terrorist attacks of September 11, 2001, and the resulting staggering losses to the insurance industry, led to a significant increase in Air Canada's insurance premiums and could lead to future increases in insurance premiums. These increases have and could continue to negatively impact the financial results of the Corporation. In addition, the resulting general instability in the insurance industry could adversely affect some of the Corporation's existing insurance carriers or the Corporation's ability to obtain future insurance coverage. To the extent that the Corporation's existing insurance carriers are unable or unwilling to provide it with insurance coverage, the Corporation's insurance costs could increase further and could result in the Corporation being in breach of contractual arrangements requiring that specific insurance be maintained, which could have a material adverse effect on the Corporation's 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 the Corporation and certain other carriers in Canada. In the event that the Government of Canada does not continue to provide such indemnity, the Corporation and other industry participants would have to turn to the commercial insurance market to seek such coverage. Such coverage would cost the Corporation in excess of \$20 million per year. Alternative solutions, such as that envisioned by the International Civil Aviation Organization (ICAO), have not developed as planned, due to actions taken by other countries and the recent availability of commercial insurance. ICAO's plan is to set up a non-profit single purpose insurance company which would cover third party war liability in excess of US\$50 million. Initial support would be provided by various governments, with their respective contributions based on their ICAO contribution percentages. Airlines would pay a premium on a per passenger segment basis. The US federal government has set up its own facility to provide war risk coverage to US carriers, thus removing itself as a key component of the ICAO plan.

Furthermore, the London aviation insurance market has announced its intention to introduce a new standard war and terrorism exclusion clause to apply to aircraft hull, spares, passenger and third party liability policies, that will exclude claims caused by the hostile use of a dirty bomb, electromagnetic pulse device, or bio-chemical materials.

### **Casualty Losses**

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

### **Airport User Fees and Air Navigation Fees**

With the privatization of airports over the last several years in Canada, new airport authorities have imposed significant increases in airport user fees. If airport authorities continue to increase their fees at the rate at which they have increased them in the recent past, the Corporation's business, results from operations and financial condition could be materially adversely affected.

Similarly, if air navigation fees continue to increase at the rate at which they have increased in the recent past, the Corporation's business, results from operations and financial condition could be materially adversely affected.

## **OUTLOOK**

Since April 2003, the Corporation has made significant progress on delivering its restructuring plan. Over this time, the Corporation has implemented a new business model, restructured its operations, improved employee and asset productivity, reduced labour, ownership and other costs and established a new corporate and capital structure with reduced financial leverage. This has resulted in significantly improved financial results and competitive position.

The Corporation is committed in 2005 is to continue to deliver the key components of its business plan including continued cost and productivity improvements, technological innovation and, for the new business units, to establish and grow their operations.

In 2005, the Corporation expects its airline businesses to increase ASM flying capacity by approximately 4 per cent, with North American operations growing by approximately 2 per cent and international operations growing by approximately 7 per cent. The major focus of the planned 2005 international growth will be on Pacific, South American and Atlantic routes. In the North American market, the Corporation is undertaking a major expansion at Jazz to increase its relative share of North American ASM capacity and airport operations in order to benefit from lower operating costs. The above ASM capacity projections do not take into account any potential changes as a result of Jetsgo ceasing its operations.

2004 has seen a continued major expansion of low cost carrier operations in Canada and more recently on many transborder routes. In the US, the airline industry has experienced fierce competition as low cost carriers expand and legacy carriers, many of which are experiencing financial difficulties, endeavour to restructure their operations. While the future of Jetsgo's operations is uncertain, the expansion of low cost carriers in Canada and the US is expected to continue in 2005. As a result, passenger fares and yields per RPM are expected to remain under pressure in 2005. Over the past 11 months, the Corporation has achieved record load factors with the implementation of its new business model. With competitively priced passenger fares, operating higher load factors enables greater revenue generation per flight operation and the Corporation is targeting to maintain high load factors in 2005.

With the delivery of new Bombardier and Embraer regional jets, by mid-2005 the Corporation will start to increase the operation of the 75 to 100 seat aircraft segment. This will offer the ability to increase aircraft frequencies and operate profitably on specific routes with relatively fewer passengers per flight as compared to larger aircraft operated by either Air Canada or its low cost carrier competition. The deliveries of these aircraft are scheduled starting in May 2005 and are continuing to early 2008. With these new aircraft in service, the Corporation will progressively reduce the average seats available per North American flight departure as a means to enhance its ability to compete with low cost carriers operating larger aircraft on specific routes.

The Corporation is currently evaluating its widebody fleet options. A cornerstone of the Corporation's strategy going forward will be the growth of its international operations. In order to support the expansion of these operations, the Corporation is planning to take delivery of additional widebody aircraft in 2005, including one leased Airbus A340-300 aircraft and three leased Boeing 767-300 aircraft. Two currently owned Boeing 767-200 aircraft have been reintroduced into active service in early 2005.

In addition, the Corporation is studying new aircraft alternatives from both Boeing (the 787 and 777 series aircraft) and Airbus (the A330, A340 and A350 series aircraft). The acquisition of further used aircraft to provide the units needed for growth is not viewed as a likely outcome, due to the current and anticipated medium-term lack of availability of the appropriate aircraft. Part of any order will be made in order to replace the Corporation's current fleet of Boeing 767 aircraft with the Boeing 787 aircraft, or the Airbus A350 aircraft, which aircraft will become available during the 2008-2010 period.

The airline industry is subject to various factors and costs over which it has little or no control (more fully described in the Risk Factors section). These include fuel and crude oil prices and quasi-government or airport authority fees for airport and navigation charges amongst others. With crude oil prices trading in the record US \$50 range and refining spreads continuing at extremely high levels, fuel expense remains a major risk in 2005. The Corporation has been able to mitigate a portion of previous fuel price increases through higher passenger and cargo charges. However, the pricing of crude oil and aircraft fuel is subject to market forces and it is not certain whether the Corporation will be able to mitigate, in any meaningful way, continuing record fuel prices in a highly competitive market environment. 2004 has seen continuing major increases in airport fees especially at its main hub in Toronto. Further double

digit increases were implemented in 2005 and these costs will increase accordingly during the year.

The Aeroplan business is projecting continued growth in 2005 through expanded redemption opportunities on the Air Canada network and growth in retail and other customer sales. The Air Canada Technical Services business is also planning expanded third party maintenance revenues but will have to contend with a stronger Canadian dollar which impacts its largely US dollar based revenues. ACTS intends to leverage its unused capacity by developing its third party customer base, including US carriers that have recently increased their outsourcing of maintenance repair and overhaul work.

ACE's subsidiaries are at varying stages of their corporate development and maximizing value at these entities is a priority in the efforts of ACE's senior management. ACE's value enhancement strategy in respect of its stand-alone subsidiaries includes considering stand-alone financings, sales or distributions of equity interests and involving outside investors for these and other purposes. ACE is examining a range of alternatives to maximize the value of its investment in Aeroplan for the benefit of all its shareholders.

With the successful implementation of its restructuring plan, the Corporation has achieved a significant improvement in its competitive position and financial prospects for the future. More work remains to be done to deliver the continuing elements of the plan and further enhance the Corporation's competitive position. While there are uncertainties with respect to fuel prices, user fees and the highly competitive market in which the Corporation operates, we remain fully committed to delivering our 2005 business plan and producing continued improvements in our financial results and competitive position in the future.

## **SUBSEQUENT EVENTS**

### **Revolving Credit Facility**

On February 7, 2005, ACE and Air Canada entered into a commitment letter with BMO Nesbitt Burns Inc. and its Canadian chartered bank parent in respect of the establishment of a senior secured syndicated revolving credit facility in favour of Air Canada, as borrower, in an aggregate amount of up to \$300 million or the US dollar equivalent, subject to satisfaction of certain conditions. The revolving credit facility will have a two-year term which can be extended at Air Canada's option for additional one-year periods on each anniversary of closing, subject to prior approval by a majority of the lenders. A swingline facility of up to \$20 million will also be provided for cash management and working capital purposes. The amount available to be drawn by Air Canada under the revolving credit facility will be limited to the lesser of \$300 million and the amount of a borrowing base determined with reference to certain eligible accounts receivable of Air Canada and certain eligible owned and leased real property of Air Canada. The credit facility will be secured by a first priority security interest and hypothec over the present and after-acquired property of Air Canada, subject to certain exclusions and permitted encumbrances. The revolving credit facility and the security provided are expected to provide Air Canada with flexibility to dispose of, finance and otherwise deal with its assets and property other than accounts receivable and leased real property of Air Canada.

### **CRJ 200 Aircraft**

On March 8, 2005, the Board of Directors approved the addition of eight Bombardier CRJ 200 aircraft to Jazz's fleet in 2005 under operating leases.

### **MD-11 Cargo Freight Aircraft**

On March 17, 2005, the Corporation announced the signing of a two-year lease agreement for an additional MD-11 Cargo freighter aircraft. As well, the Corporation announced an extension of an existing leased MD-11 Cargo freighter for a further two years effective March 1, 2005.