ACE AVIATION

Quarter 2 2006
Management's Discussion and Analysis of Results of Operations and Financial Condition

AUGUST 10, 2006

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1. PREFACE

ACE Aviation Holdings Inc. ("ACE") is the parent holding company of various transportation and other service companies and partnerships, which are operated through the following four reporting segments: Transportation Services, Aeroplan Limited Partnership ("Aeroplan"), Jazz Air LP ("Jazz") and ACTS Limited Partnership ("ACTS"). The Transportation Services segment includes the following principal operating companies and partnerships: Air Canada, ACGHS Limited Partnership ("ACGHS"), Touram Limited Partnership ("Air Canada Vacations") and AC Cargo Limited Partnership ("Air Canada Cargo"). As at June 30, 2006, ACE holds a 75.3 percent direct ownership interest in Aeroplan and a 79.7 percent direct ownership interest in Jazz.

References to the "Corporation" in this Management's Discussion and Analysis ("MD&A") refers, as the context may require, to ACE and its subsidiaries collectively, ACE and one or more of its subsidiaries, one or more of ACE's subsidiaries, or ACE itself.

This MD&A is current as of August 10, 2006 and should be read in conjunction with ACE's unaudited interim financial statements for Quarter 2 2006 and ACE's audited annual consolidated financial statements and annual MD&A for 2005. The unaudited interim consolidated financial statements are prepared in accordance with Generally Accepted Accounting Principles ("GAAP") in Canada and are based on accounting policies consistent with those disclosed in Note 2 to the 2005 Annual Consolidated Financial Statements of ACE, with the exception of the policy on stock-based compensation. Refer to Note 1 to the Unaudited Interim Quarter 2 2006 Consolidated Financial Statements of ACE for information related to the adoption of EIC-162 Stock-based Compensation for Employees Eligible to Retire Before the Vesting Date. All amounts are stated in Canadian dollars, unless otherwise indicated. Certain percentage amounts calculated herein are based on the amounts rounded to millions. For the operating segments, the sum of quarterly financial results may not equal the year-to-date results due to rounding.

For a glossary of terms and measures used in this MD&A, refer to section 11.

For further information on ACE's public disclosure file, including ACE's Annual Information Form, consult SEDAR at www.sedar.com and EDGAR at www.sec.gov/edgar.shtml

CAUTION REGARDING FORWARD-LOOKING INFORMATION

Forward-looking statements are included in this MD&A. 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. 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, regulatory developments or proceedings, pending and future litigation and actions by third parties as well as the factors identified throughout this MD&A and, in particular, those identified in the "Risk Factors" section of ACE's 2005 MD&A dated February 9, 2006. The forward-looking statements contained in this MD&A represent ACE's expectations as of August 10, 2006, 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, except as required under applicable securities regulations.

2. OVERVIEW AND GENERAL BUSINESS SUMMARY

A detailed description of ACE's strategy and objectives is provided in ACE's 2005 MD&A and an update on the progress made in the first three months of 2006 is disclosed in ACE's Quarter 1 2006 MD&A. Further progress towards achieving the objectives and implementing the strategy has been made during the second quarter.

2.1 Air Canada Revenue model

In July 2006, Air Canada matched its passenger load factor record for the month, set in July 2005, after reporting its 27th consecutive month of record load factors in June 2006. The record load factor and improving revenue numbers are an indication that Air Canada's customers are responding well to the new revenue model. With the success seen in North America, Air Canada has now begun the pricing simplification of its international markets. Air Canada's simplified four economy class fare options are now available for travel to and from the United Kingdom, Ireland, France, Italy, the Netherlands, Scandinavia and Israel. In addition, the Corporation has rolled out consumer and agency websites in countries such as Germany, Hong Kong, Australia, Italy, Scandinavia, the Netherlands and Israel, giving customers an easy-to-use shopping display. The second major initiative in the revenue model is the development of multi-trip flight passes. The new flight passes are built to provide flexibility to large corporations, small-medium enterprise businesses as well as to the individual business or leisure traveler. Currently, Air Canada offers 13 flight passes to its customers.

To support the revenue model, the Corporation has also begun two critical projects to ensure that the customer experience is amongst the elite in the industry. The first is the improvement of the Air Canada fleet through an interior makeover program as well as the installation of an in-flight entertainment system on the CRJ705 aircraft operated by Jazz. The second is the replacement of the systems that support the Corporation's current passenger reservation and airport customer systems. This project entails replacing its legacy systems with a newly developed web-enabled system that will give the Corporation greater flexibility to evolve its commercial strategy and offer customer-focused and value-based products. The new system is expected to be implemented in late 2007.

Progress has been made on ACE's strategy of expanding the airline's relative share of the North American ASM capacity and enhancing its international operations while improving customer experience. Since the beginning of the year, Air Canada and Jazz have introduced more than a dozen new non-stop services within Canada, to the United States and international destinations, and Air Canada has added more flights and new year-round service in markets across Canada and the United States.

2.2 Fuel hedging

In order to minimize the airline's exposure to the volatility of jet fuel prices, the Corporation manages its exposure through a fuel risk management strategy. In Quarter 2, 2006, the Corporation recorded net hedging gains of $4 million in fuel expense on settled hedging instruments during the quarter. In addition, for certain derivative instruments which do not qualify for hedge accounting, the Corporation recorded a net gain of $1 million in non-operating expense.

At June 30, 2006, the Corporation had mostly collar option structures in place to hedge a portion of its anticipated jet fuel requirements over the 2006 to 2007 period. For 2006, the majority of the Corporation's hedge positions are effectively in the form of jet fuel and heating oil-based contracts. The Corporation has 33 percent of the remainder of 2006 requirements hedged at prices that can fluctuate between an average of US$81 to US$92 per barrel for the jet fuel contracts and an average of US$75 to US$86 per barrel for the heating oil-based contracts. For 2007, the majority of the hedge positions are heating and crude oil-based contracts. The Corporation has hedged 24 percent of its 2007 requirements at prices that can fluctuate between an average of US$74 to US$85 per barrel for the heating oil-based contracts and an average of US$58 to US$69 per barrel for the crude oil-based contracts.

Since June 30, 2006, the Corporation has entered into new hedging positions, using swap structures on jet fuel at US$95 per barrel, which has added a 1 percent coverage to the third quarter and a 3 percent coverage to the fourth quarter of 2006. Hence, the Corporation has currently hedged 35 percent of its jet fuel requirements for the remainder of 2006 at prices that can fluctuate between an average of US$84 to US$93 per barrel for the jet fuel contracts and an average of US$75 to US$86 per barrel for the heating oil-based contracts.

2.3 Status of wage review with unions

A majority of the employees of Air Canada and Jazz are unionized and subject to collective agreements in force until June 2009. These collective agreements provide for wage reviews that are expected to be completed by the end of 2006.

To date, Air Canada has completed negotiation, mediation and binding arbitration with one major union, the Canadian Auto Workers Union ("CAW"), which represents customer sales and services agents and crew schedulers. The arbitrator awarded wage increases of 1 percent effective June 2006, 1.75 percent effective June 2007 and 1.75 percent effective June 2008. Negotiations with all other major labour groups except the Canadian Union of Public Employees ("CUPE"), which represents Air Canada's flight attendants, have moved to mediation and, potentially, binding arbitration in August and September 2006.

Jazz has also completed negotiation, mediation and arbitration with the CAW, which represents its technical services, crew scheduling and customer service agents. The arbitrator awarded wage increases of 1 percent effective July 2006, 1.75 percent effective July 2007 and 1.75 percent effective July 2008. Negotiations with Teamsters Canada, which represents Jazz flight attendants, are expected to begin in early August. No dates have been set for negotiations with Jazz flight dispatchers although they are also expected to be completed by the end of 2006.

2.4 Non-unionized labour reductions

A workforce reduction plan was announced in February 2006 whereby non-unionized employee levels are in the process of being reduced by 20 percent. This program is expected to be substantially completed by the end of 2006. As at August 10, 2006, approximately 58 percent of the planned reductions had been completed.

2.5 Fleet

In Quarter 2 2006, Air Canada took delivery of four Embraer 190 aircraft and drew loans to finance the acquisition of these aircraft totaling $98 million (US$88 million). Three Embraer 190 aircraft were delivered in Quarter 4 2005 and four aircraft were delivered in Quarter 1 2006. The remaining 34 of a total of 45 Embraer 190 aircraft deliveries are planned to be completed by January 2008. In Quarter 1 2006, Air Canada took delivery of the last of 15 Embraer 175 aircraft on order. Air Canada had an operating fleet of 195 aircraft at June 30, 2006, after the transfer of 25 CRJ100 aircraft to Jazz, compared to 198 aircraft at June 30, 2005, a net decrease of 3 aircraft.

As disclosed in ACE's Quarter 1 2006 MD&A, on April 3, 2006, Air Canada announced that it had signed a 10-year lease for one new Boeing 777 from International Lease Finance Corporation ("ILFC"). Air Canada will take delivery of this aircraft in 2007.

The interior makeover program began in April 2006. The Corporation is currently refitting its third Airbus A320 and its first Boeing 767-300 aircraft. The interior upgrades for the Airbus A319, A321 and A330 aircraft are expected to begin in early 2007. This makeover program is expected to be completed by December 2007. In addition, the new Embraer and Boeing 777 aircraft are being delivered with the new seats and entertainment systems already installed.

In Quarter 2 2006, the remaining five CRJ100 aircraft of a total of 25 aircraft were transferred from Air Canada to Jazz. Jazz had an operating fleet of 134 aircraft at June 30, 2006 compared to 97 aircraft at June 30, 2005, an increase of 37 aircraft.

2.6 Sale of US Airways shares

In Quarter 3 2005 the Corporation made an investment of US$75 million in US Airways Group, Inc. ("US Airways") for 5 million shares.

On April 10, 2006, the Corporation disposed of 1.75 million shares of its holdings in US Airways to PAR Investment Partners LP. The proceeds from the sale transaction amounted to $78 million (US$68 million). ACE has recorded a pre-tax gain of $46 million ($38 million after tax) in Quarter 2 2006 as a result of this transaction.

Over the period from June 7, 2006 to July 6, 2006, the Corporation disposed of 2.75 million shares of its holdings in US Airways through a series of transactions on the open stock market at an average price of over US$50 per share. Prior to June 30, 2006, 1.5 million shares were sold at an average price of over US$47 per share for net proceeds of $80 million (US$72 million). The Corporation has recorded a pre-tax gain of $54 million ($45 million after tax) in Quarter 2 2006 as a result of these transactions.

In July the Corporation sold an additional 1.25 million shares at an average price of over US$53 per share for net proceeds of $74 million (US$66 million). The Corporation has recorded a pre-tax gain of $52 million ($43 million after tax) in Quarter 3 2006 as a result of these transactions.

The aggregate net proceeds to date from the sale of 4.5 million shares of US Airways amount to $232 million (US$206 million).

As of August 10, 2006, ACE continues to hold 0.5 million shares in US Airways with a market value of US$20 million.

2.7 Contingencies

US Department of Justice Cargo pricing investigation

The European Commission, the United States Department of Justice (the "US DoJ") and the Competition Bureau in Canada, among other competition authorities, are investigating alleged anti-competitive cargo pricing activities, including certain fuel surcharges levied by a number of airlines and other cargo operators. The US DoJ has recently sought information from Air Canada as part of its investigation. Air Canada is cooperating fully with this investigation.

In addition, Air Canada is named as a defendant in a number of class action lawsuits that have been filed before the United States District Court and in Canada in connection with these allegations. It is not possible to predict, with any degree of certainty, the outcome of these actions. Air Canada intends to defend these lawsuits vigorously.

It is Air Canada's policy to conduct its business in full compliance with all applicable laws, including competition laws.

WestJet litigation

In the 2005 Annual Consolidated Financial Statements of ACE, the Corporation disclosed a potential contingency related to claims and counterclaims between Air Canada and WestJet Airlines Limited ("WestJet"). During Quarter 2 2006, and as further discussed in a joint press release dated May 29, 2006, a resolution was reached by which WestJet agreed to pay Air Canada's investigation and litigation costs of $5.5 million and accepted Air Canada's request that WestJet make a donation in the amount of $10 million in the name of Air Canada and WestJet to children's charities across the country. The $5.5 million has been recorded as a recovery of Other operating expenses during Quarter 2 2006. Air Canada has withdrawn its claims in light of this settlement. All legal proceedings between the parties have been terminated.

3. QUARTER AND YEAR-TO-DATE RESULTS

3.1 Comparison of consolidated quarter and year-to-date results

The following table compares the consolidated results of operations of ACE for Quarter 2 2006 and the six months ended June 30, 2006 to the corresponding periods in 2005.

($ millions, except per share amounts)	Quarter 2		Change		YTD		Change	
	2006	2005	$	%	2006	2005	$	%
Operating revenues								
Passenger	$2,288	$2,100	$188	9	$4,309	$3,839	$470	12
Cargo	152	147	5	3	303	282	21	7
Other	242	211	31	15	554	514	40	8
	2,682	**2,458**	**224**	**9**	**5,166**	**4,635**	**531**	**11**
Operating expenses								
Salaries, wages and benefits	636	622	14	2	1,278	1,235	43	3
Aircraft fuel	631	530	101	19	1,200	945	255	27
Aircraft rent	113	98	15	15	226	188	38	20
Airport and navigation fees	245	230	15	7	475	443	32	7
Aircraft maintenance, materials and supplies	118	89	29	33	247	183	64	35
Communications and information technology	69	78	(9)	(12)	147	155	(8)	(5)
Food, beverages and supplies	82	81	1	1	162	159	3	2
Depreciation, amortization and obsolescence	140	119	21	18	274	239	35	15
Commissions	59	73	(14)	(19)	127	138	(11)	(8)
Special labour charges	-	-	-		33	-	33	n/a
Other	408	360	48	13	878	782	96	12
	2,501	**2,280**	**221**	**10**	**5,047**	**4,467**	**580**	**13**
Operating income	**181**	**178**	**3**		**119**	**168**	**(49)**	
Non-operating income (expense)								
Interest income	29	15	14		51	27	24	
Interest expense	(91)	(77)	(14)		(179)	(152)	(27)	
Interest capitalized	13	3	10		22	6	16	
Gain on sale of US Airways shares	100	-	100		100	-	100	
Gain on sale of assets	1	-	1		4	-	4	
Aeroplan dilution gain	-	190	(190)		-	190	(190)	
Jazz dilution gain	-	-	-		220	-	220	
Other	-	(27)	27		3	(30)	33	
	52	**104**	**(52)**		**221**	**41**	**180**	
Income before the following items:	**233**	**282**	**(49)**		**340**	**209**	**131**	
Non-controlling interest	(19)	(4)	(15)		(34)	(7)	(27)	
Foreign exchange gain (loss)	107	(53)	160		120	(68)	188	
Provision for income taxes	(85)	(56)	(29)		(72)	(42)	(30)	
Income for the period	**$236**	**$169**	**$67**		**$354**	**$92**	**$262**	
Earnings per share								
- Basic	**$2.32**	**$1.68**	**$0.64**		**$3.47**	**$0.97**	**$2.50**	
- Diluted	**$2.05**	**$1.50**	**$0.55**		**$3.16**	**$0.93**	**$2.23**	
EBITDAR[(1)]	**434**	**395**	**39**		**619**	**595**	**24**	
EBITDAR[(1)] excluding special labour charges	**434**	**395**	**39**		**652**	**595**	**57**	

(1) Refer to "Non-GAAP Financial Measures" on page 21 of this MD&A for a reconciliation of EBITDAR.

ACE reported operating income of $181 million in Quarter 2 2006, an increase of $3 million from the operating income of $178 million recorded in Quarter 2 2005. For the first half of 2006, ACE recorded operating income of $119 million, a decrease of $49 million (a decrease of $16 million, excluding special labour charges) from the same period in 2005.

On a consolidated basis, EBITDAR for Quarter 2 2006 and for the first half of 2006 improved $39 million and $24 million, respectively, over the same periods in 2005, reflecting improvements in all segments with the exception of ACTS. In the quarter, EBITDAR for Transportation Services, Aeroplan and Jazz were up $22 million, $8 million and $29 million, respectively, while EBITDA for ACTS decreased $20 million.

Included in net income in Quarter 2 2006 was a pre-tax gain of $100 million ($83 million after tax) relating to the sale of 3.25 million shares of ACE's holdings in US Airways. Included in net income in Quarter 2 2005 were a pre-tax dilution gain of $190 million ($162 million after tax) relating to the initial public offering of Aeroplan Income Fund and pre-tax charges of $29 million ($19 million after tax) related to the extinguishment of a credit facility with GE. Net income for Quarter 2 2006 amounted to $236 million or $2.05 per diluted share compared to $169 million or $1.50 per diluted share in Quarter 2 2005. On a year-to-date basis, net income increased $262 million or $2.23 per diluted share over the same period in 2005. Gains from revaluation of foreign currency monetary items amounted to $107 million in Quarter 2 2006, attributable to a stronger Canadian dollar at June 30, 2006 compared to March 31, 2006. This compared to a foreign exchange loss on foreign currency monetary items of $53 million in Quarter 2 2005. On a year-to-date basis, gains from revaluation of foreign currency monetary items amounted to $120 million, attributable to a stronger Canadian dollar at June 30, 2006 compared to December 31, 2005. This compared to a loss of $68 million in the first half of 2005.

ACE supplements reported GAAP results with an analysis of results adjusted for items which are not reflective of the underlying financial performance of the Corporation from ongoing operations. The Corporation adjusts for these items because they affect the comparability of its financial results and could potentially distort the analysis of trends in business performance. The analysis of results adjusted for major non-recurring items is considered a non-GAAP financial measure as it does not have a standardized meaning and is therefore unlikely to be comparable to similar measures presented by other companies. The following table adjusts ACE's results for the major non-recurring items presented above and compares the adjusted non-GAAP results for Quarter 2 2006 to the corresponding period in 2005. Excluding these major non-recurring items, the adjusted net income for Quarter 2 2006 was $153 million compared to an adjusted net income for Quarter 2 2005 of $26 million.

($ millions)	Actual GAAP results for Quarter 2 2006	US Airways shares disposition	Adjusted non-GAAP results for Quarter 2 2006
Operating revenues	$2,682		$2,682
Operating expenses	2,501		2,501
Operating income	181		181
Non-operating income (expense)	52	(100)	(48)
Non-controlling interest	(19)		(19)
Foreign exchange gain	107		107
Provision for income taxes	(85)	17	(68)
Income for the period	$236	($83)	$153

($ millions)	Actual GAAP results for Quarter 2 2005	Aeroplan dilution gain	GE Credit facility extinguishment	Adjusted non-GAAP results for Quarter 2 2005
Operating revenues	$2,458			$2,458
Operating expenses	2,280			2,280
Operating income	178			178
Non-operating income (expense)	104	(190)	29	(57)
Non-controlling interest	(4)			(4)
Foreign exchange loss	(53)			(53)
Provision for income taxes	(56)	28	(10)	(38)
Income for the period	$169	($162)	$19	$26

Consolidated operating revenues rose $224 million or 9 percent over Quarter 2 2005 and $531 million or 11 percent over the first six months of 2005, mainly due to an increase in passenger revenues reflecting system yield and traffic improvements due to a strong market demand. The system yield improvement of 3 percent in Quarter 2 2006 and 6 percent in the first half of 2006 was principally due to fuel-related fare increases and increased fuel surcharges to cover higher fuel costs. The yield improvement was also due to a more rapid growth in business premium traffic. The negative impact of a strong Canadian dollar on foreign currency denominated revenues partly offset these improvements. For Quarter 2 2006 and the first half of 2006, traffic grew 5 percent and 6 percent, respectively, on a capacity increase of 3 percent over Quarter 2 2005 and 4 percent over the first six months of 2005. This resulted in a passenger load factor improvement of 1.9 percentage points in the quarter and 1.3 percentage points on a year-to-date basis. RASM grew 6 percent over Quarter 2 2005 and 8 percent over the first half of 2005 due to both the growth in system yield and the improvement in passenger load factor.

Cargo revenues for Quarter 2 2006 and the first half of 2006 increased $5 million or 3 percent and $21 million or 7 percent, respectively. This increase was due to growth in cargo traffic of 8 percent over Quarter 2 2005 and 13 percent over the first six months of 2005, partly offset by lower yield of 4 percent in Quarter 2 2006 and 5 percent in the first six months of 2006. Despite higher fuel surcharges, yields declined due mainly to the adverse impact of a stronger Canadian dollar on foreign currency denominated revenues and the relative growth in long-haul freight traffic, which has a lower yield per revenue ton mile.

Other revenues increased $31 million or 15 percent in Quarter 2 2006 and $40 million or 8 percent in the first half of 2006, in large part due to higher Aeroplan redemption and third party maintenance revenues. The increase in revenues on a year-to-date basis from these two sources was partially offset by reduced revenues from Air Canada Vacations in Quarter 1 2006 due to lower passenger volumes as a result of the disruptions to the Mexican leisure market following the 2005 hurricane season and to difficulties integrating a new IT system.

Unit cost, as measured by operating expense per ASM, increased 6 percent from Quarter 2 2005 and 8 percent from the first half of 2005. Excluding fuel expense and special labour charges of $33 million recorded in Quarter 1 2006, unit cost was up 4 percent in both the quarter and on a year-to-date basis over the corresponding periods in 2005. The increase in unit cost, excluding fuel expense, was in part due to increased ownership costs which were mainly affected by the net addition of 34 aircraft, such as the Embraer 175/190 and the Bombardier CRJ705 aircraft, with higher unit costs but with lower trip costs. Higher aircraft maintenance, materials and supplies largely due to the timing of the maintenance cycle relating to certain Air Canada engines, as well as growth in non-ASM producing businesses were also factors in the unit cost increase over 2005. The following table compares ACE's operating expenses per ASM for Quarter 2 2006 and the first six months of 2006 to ACE's operating expenses per ASM for the corresponding periods in 2005.

($ cents per ASM)	**Quarter 2**		**Change**		**YTD**		**Change**	
	2006	**2005**	**$**	**%**	**2006**	**2005**	**$**	**%**
Salary and wages	3.33	3.35	(0.02)	(1)	3.38	3.40	(0.02)	(1)
Benefits	0.93	0.94	(0.01)	(1)	1.00	1.00	0.00	0
Ownership (DAR) [(1)]	1.70	1.50	0.20	13	1.71	1.52	0.19	13
Airport and navigation fees	1.64	1.59	0.05	3	1.62	1.58	0.04	3
Aircraft maintenance, materials and supplies	0.79	0.62	0.17	27	0.85	0.65	0.20	31
Food, beverages and supplies	0.55	0.56	(0.01)	(2)	0.55	0.57	(0.02)	(4)
Commissions	0.40	0.50	(0.10)	(20)	0.43	0.49	(0.06)	(12)
Other	3.19	3.03	0.16	5	3.51	3.34	0.17	5
Operating expense, excluding special labour charges and fuel expense [(2)]	**12.53**	**12.09**	**0.44**	**4**	**13.05**	**12.55**	**0.50**	**4**
Special labour charges	-	-	-		0.11	-	0.11	n/a
Aircraft fuel	4.23	3.65	0.58	16	4.11	3.37	0.74	22
Total operating expense	**16.76**	**15.74**	**1.02**	**6**	**17.27**	**15.92**	**1.35**	**8**

(1) DAR refers to the combination of Aircraft rent and Depreciation, amortization and obsolescence.
(2) Refer to "Non-GAAP Financial Measures" on page 21 of this MD&A for additional information.

Salaries and wages expense totaled $497 million in Quarter 2 2006, an increase of $11 million or 2 percent from the same period in 2005 largely due to the impact of higher employee levels. On a year-to-date basis, salaries and wages expense increased $32 million or 3 percent over 2005. Average full-time equivalent ("FTE") employees increased by 684 FTE employees or 2 percent on a capacity increase of 3 percent in Quarter 2 2006 and 1,013 FTE employees or 3 percent on a capacity increase of 4 percent in the first half of 2006. The average FTE growth was mainly reflected in Jazz and ACTS. Employee productivity, as measured by ASM per FTE employee, grew 1 percent over both Quarter 2 2005 and the first half of 2005.

Employee benefits expense increased $3 million or 2 percent in Quarter 2 2006 and $11 million or 4 percent in the first half of 2006. For the first six months of 2006, there were two key reasons for this increase. The first related to pension expense which reflected a lower discount rate applied to pension obligations. The second was a growth in health benefits for active employees. These increases were partly offset by a decline in post-retirement and post-employment benefit expenses.

Fuel expense was up $101 million or 19 percent in Quarter 2 2006 bringing the year-to-date increase over 2005 to $255 million or 27 percent, driven by continuing high fuel prices. In Quarter 2 2006, the average base fuel price increase of $134 million and the volume-related increase of $29 million were partially offset by the favourable impact of a stronger Canadian dollar versus the US dollar of $58 million and a fuel hedging gain of $4 million. In the first half of 2006, the average base fuel price increase of $283 million, the volume-related increase of $56 million and a fuel hedging loss of $1 were partially offset by a reduction of $85 million due to the favourable impact of a stronger Canadian dollar.

Ownership costs, comprised of aircraft rent and depreciation, amortization and obsolescence expenses, increased $36 million in Quarter 2 2006 and $73 million in the first half of 2006, largely due to the net addition of 34 aircraft to the operating fleet, including the year-over-year effect of increasing to three the MD-11 freighter aircraft by the end of Quarter 2 2005. These aircraft additions (net of aircraft returns) accounted for approximately $27 million of the increase over Quarter 2 2005 and $56 million of the increase over the first half of 2005. A change in assumptions relating to the residual values of certain aircraft was also a factor in depreciation and accounted for approximately $10 million of the increase in Quarter 2 2006 and $20 million in the first six months of 2006. The increases in the quarter and on a year-to-date basis were partly offset by the impact of a stronger Canadian dollar on aircraft rent which amounted to approximately $6 million in Quarter 2 2006 and $10 million in the first six months of 2006.

Airport and navigation fees increased $15 million or 7 percent in Quarter 2 2006 and $32 million or 7 percent in the first half of 2006, mainly due to an increase in aircraft departures and increased rates for landing and general terminal fees primarily at Toronto's Pearson International Airport. Aircraft departures for Quarter 2 2006 and for the first half of 2006 were up 4 and 5 percent, respectively. At Pearson, landing fees increased 7 percent per metric tonne and general terminal charges rose 9 percent per seat for domestic and international arrivals.

Aircraft maintenance, materials and supplies increased $29 million in Quarter 2 2006 and $64 million in the first half of 2006 in large part due to an increase in Airbus A320 aircraft maintenance costs. These aircraft are presently beginning a work cycle which requires replacement of engine life limited parts as well as major inspections. In the quarter, the maintenance costs relating to the Airbus A320 aircraft fleet accounted for approximately $20 million of the overall increase. In addition, increased volume largely related to Air Canada component and engine maintenance on other aircraft types contributed to the growth in material expense, accounting for approximately $6 million of the increase in the quarter. Higher than expected maintenance expenses related to satisfying the return to lessor and minimum return conditions on three Airbus A319 short-term aircraft leases which terminated in Quarter 2 2006 was also a factor, accounting for $3 million of the increase. On a year-to-date basis, the Airbus A320 maintenance costs accounted for $31 million of the increase over the first half of 2005. Maintenance expenses related to satisfying minimum return conditions on certain shorter-term aircraft leases and provisions for future return to lessor expenses accounted for $8 million of the increase. In Quarter 1 2006, ACTS outsourced heavy maintenance activities to outside MRO companies for seven Air Canada Boeing 767 aircraft, accounting for $9 million of the increase over 2005. The remaining increase was largely due to higher engine and component activity as compared to the first half of 2005.

Commission expense decreased $14 million or 19 percent in Quarter 2 2006 and $11 million or 8 percent in the first six months of 2006 on combined passenger and cargo revenue growth in Quarter 2 2006 and in the first half of 2006 of 9 and 12 percent, respectively. The decrease in commission expenses was largely due to the impact of a change in the base commission structure which more than offset the volume-related increase. In Quarter 1 2005, the Corporation recorded a favorable adjustment of $11 million relating to changes in estimates on commission expense on corporate contracts.

Other expenses were up $48 million or 13 percent in Quarter 2 2006 and $96 million or 12 percent in the first half of 2006 over the corresponding periods in 2005. In Quarter 2 2006, capacity and revenue related expenses accounted for approximately $12 million or 24 percent of the increase. Increases were also recorded in non-ASM expense categories. Third party maintenance materials increased $17 million, Aeroplan non-air redemption expenses rose by $3 million and Aeroplan consulting and advisory fees increased $3 million attributable mainly to public company costs. In addition, the promotion related to multi-trip flight passes increased advertising and promotion expense by $4 million in the quarter. Unusual items in the quarter included uniform expenses of $5 million, a recovery of investigation and litigation costs of $5.5 million relating to the settlement reached with WestJet, and a recovery of $4 million relating to an insurance settlement for a damaged engine.

Non-operating income amounted to $52 million in Quarter 2 2006 compared to a non-operating income of $104 million in Quarter 2 2005. On a year-to-date basis, non-operating income totaled $221 million compared to $41 million in the same period in 2005. Net interest expense amounted to $49 million in Quarter 2 2006, a decrease of $10 million from the 2005 quarter. Interest expense increased $14 million due to the addition of Embraer aircraft to the Air Canada fleet and the Aeroplan credit facilities, which were entered into on June 29, 2005. These increases were more than offset by an increase in interest income.

As previously discussed in section 2.6, in Quarter 2 2006, ACE recorded a gain on the sale of US Airways shares of $100 million ($83 million after tax). In the 2005 quarter, ACE recorded a dilution gain of $190 million ($162 million after tax) as a result of the dilution of its interest in Aeroplan and charges of $29 million ($19 million after tax) related to the extinguishment of a credit facility with GE.

Gains from revaluation of foreign currency monetary items amounted to $107 million in Quarter 2 2006, attributable to a stronger Canadian dollar at June 30, 2006 compared to March 31, 2006.

The provision for income taxes in Quarter 2 2006 of $85 million is net of a tax reduction of $17 million relating to recent changes in federal tax rates.

3.2 Comparison of segment quarter and year-to-date results

The following tables compare segment results for Quarter 2 2006 and the six months ended June 30, 2006 to the corresponding periods in 2005. Refer to Note 9 of the Unaudited Interim Quarter 2 2006 Consolidated Financial Statements of ACE for additional information.

VARIANCE	Quarter 2 2006 versus Quarter 2 2005					
($ millions)	Transportation Services	Aeroplan	Jazz	ACTS	Inter-Segment Elimination	ACE Consolidated
Passenger revenue	188	-	-	-	-	188
Cargo revenue	5	-	-	-	-	5
Other revenue	(2)	26	(1)	8	-	31
External revenue	191	26	(1)	8	-	224
Inter-segment revenue	(21)	-	110	29	(118)	-
Total revenue	**170**	**26**	**109**	**37**	**(118)**	**224**
Salaries, wages and benefits	(13)	3	12	12	-	14
Fuel	101	-	34	-	(34)	101
Ownership (DAR)	15	2	20	(1)	-	36
Other operating expenses	60	15	34	45	(84)	70
Total operating expenses	**163**	**20**	**100**	**56**	**(118)**	**221**
Operating income (loss)	**7**	**6**	**9**	**(19)**	**-**	**3**
Total non-operating [(1)]	61	1	3	(1)	-	64
Segment results	**68**	**7**	**12**	**(20)**		**67**
Operating margin pp change	**0.0**	**1.0**	**(1.1)**	**(10.2)**	**-**	**(0.5)**
EBITDAR / EBITDA[(2)]	**22**	**8**	**29**	**(20)**	**-**	**39**

VARIANCE	Six months ended June 30, 2006 versus Six months ended June 30, 2005					
($ millions)	Transportation Services	Aeroplan	Jazz	ACTS	Inter-Segment Elimination	ACE Consolidated
Passenger revenue	470	-	-	-	-	470
Cargo revenue	21	-	-	-	-	21
Other revenue	(27)	53	(1)	15	-	40
External revenue	464	53	(1)	15	-	531
Inter-segment revenue	(17)	-	216	47	(246)	-
Total revenue	**447**	**53**	**215**	**62**	**(246)**	**531**
Salaries, wages and benefits	(12)	4	27	24	-	43
Special labour charges	28	-	-	5	-	33
Fuel	255	-	67	-	(67)	255
Ownership (DAR)	34	5	36	(1)	(1)	73
Other operating expenses	167	25	70	92	(178)	176
Total operating expenses	**472**	**34**	**200**	**120**	**(246)**	**580**
Operating income (loss)	**(25)**	**19**	**15**	**(58)**	**-**	**(49)**
Total non-operating [(1)]	308	1	4	(2)	-	311
Segment results	**283**	**20**	**19**	**(60)**	**-**	**262**
Operating margin pp change	**(0.6)**	**2.8**	**(1.9)**	**(15.2)**	**-**	**(1.3)**
EBITDAR / EBITDA[(2)]	**9**	**24**	**51**	**(59)**	**(1)**	**24**
EBITDAR / EBITDA[(2)] excluding special labour charges	**37**	**24**	**51**	**(54)**	**(1)**	**57**

(1) Total non-operating refers to the combination of non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income taxes.

(2) Refer to "Non-GAAP Financial Measures" on page 21 of this MD&A for a reconciliation of EBITDAR. For Aeroplan and ACTS, EBITDA is used and is comparable to EBITDAR as these two segments do not incur aircraft rent expense.

3.3 Transportation Services

The Transportation Services segment reported operating income of $113 million in Quarter 2 2006, an increase of $7 million from the operating income of $106 million recorded in Quarter 2 2005, despite a fuel expense increase of $101 million or 19 percent. For the first six months of 2006, the Transportation Services segment reported an operating loss of $5 million, a decrease of $25 million from the operating income of $20 million recorded in 2005. Fuel expense increased $255 million or 27 percent in the first six months of 2006.

Passenger revenues

System passenger revenues in Quarter 2 2006 and the first half of 2006 were up $188 million or 9 percent and $470 million or 12 percent, respectively. This was achieved in an environment of strong market demand, rising capacity, increased load factors and higher yields. The growth in system passenger revenues in the quarter was due to a 3 percent improvement in yield and a 5 percent increase in traffic on a capacity growth of 3 percent. The overall yield improvements of 3 percent in Quarter 2 2006 and 6 percent in the first half of 2006 were largely as a result of fuel-related North American fare increases, higher international fuel surcharges and an improvement in business premium traffic partly offset by the adverse effect of a stronger Canadian dollar on foreign currency denominated revenues. Additionally, domestic passenger revenues reflected an improved domestic competitive position in Quarter 1 2006 compared to Quarter 1 2005 as a result of the discount carrier Jetsgo's bankruptcy in March 2005. RASM grew 6 percent over Quarter 2 2005 and 8 percent over the first half of 2005 due to both the growth in system yield and the improvement in passenger load factor of 1.9 percentage points in the quarter and the 1.3 percentage points on a year-to-date basis.

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

	Quarter 4 2004	Quarter 1 2005	Quarter 2 2005	Quarter 3 2005	Quarter 4 2005	Quarter 1 2006	Quarter 2 2006
Canada	2	5	17	24	20	16	**6**
US Transborder	(14)	(9)	4	10	23	25	**19**
Atlantic	6	9	14	13	14	16	**10**
Pacific	37	15	13	5	7	5	**2**
Other	28	22	23	21	12	11	**11**
System	**4**	**5**	**14**	**16**	**17**	**16**	**9**

The tables below describe percentage changes in passenger revenues, capacity, traffic, passenger load factor, yield and RASM for Quarter 2 2006 and the six months ended June 30, 2006 to the corresponding periods in 2005.

Quarter 2 2006 versus Quarter 2 2005	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	6	5	2	(2.2)	3	1
US Transborder	19	10	17	4.9	1	8
Atlantic	10	4	8	3.6	1	6
Pacific	2	(5)	(1)	3.4	3	7
Other	11	(2)	4	4.9	7	14
System	**9**	**3**	**5**	**1.9**	**3**	**6**

YTD 2006 versus YTD 2005	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	10	5	3	(1.0)	6	5
US Transborder	22	9	15	4.1	6	12
Atlantic	12	7	9	1.5	2	4
Pacific	3	(3)	0	2.2	3	6
Other	11	(1)	1	1.4	10	12
System	**12**	**4**	**6**	**1.3**	**6**	**8**

Domestic passenger revenues increased $53 million or 6 percent over Quarter 2 2005 due to a yield improvement of 3 percent resulting from increased fare levels to cover higher fuel costs. Traffic grew 2 percent on a capacity increase of 5 percent resulting in a decline in passenger load factor of 2.2 percentage points. Capacity increases were largely on transcontinental services and, to a lesser extent, within western Canada. Domestic RASM rose 1 percent above Quarter 2 2005 as the yield improvement more than offset the decrease in passenger load factor. For the first six months of 2006, domestic passenger revenues increased $162 million or 10 percent due to increased fare levels to cover higher fuel costs over the same period in 2005 and an improved domestic competitive position in Quarter 1 2006 compared to Quarter 1 2005 in part as a result of the discount carrier Jetsgo's bankruptcy in March 2005. Increased demand for the higher-priced Tango Plus product was also a factor in the passenger revenue growth over the first half of 2005. RASM rose 5 percent as a result of a 6 percent yield improvement partly offset by a decrease of 1.0 percentage points in passenger load factor.

US Transborder passenger revenues rose $75 million or 19 percent compared to Quarter 2 2005 and $170 million or 22 percent in the first half of 2006 due to an increase in traffic as a result of higher capacity and a very strong market demand. Yield improved 1 percent in Quarter 2 2006 reflecting fuel-related increases partly offset by the impact of a stronger Canadian dollar versus the US dollar for sales denominated in US dollars and a greater proportion of longer-haul and leisure traffic which has a lower yield per revenue passenger mile. On a year-to-date basis, yield improved 6 percent reflecting fuel-related increases partly offset by the adverse impact of a stronger Canadian dollar. In addition, the Quarter 1 2006 yield growth of 11 percent reflected an aggressive pricing environment in Quarter 1 2005 which had resulted in a very high level of price discounting. The growth in passenger traffic in both the quarter and for the first six months of 2006 was largely as a result of increased capacity on the Las Vegas route and on certain California routes such as San Francisco and Los Angeles. As a result of both the significant improvement in passenger load factor and the yield increase, RASM was up 8 percent from Quarter 2 2005 and 12 percent from the first half of 2005.

Atlantic passenger revenues in Quarter 2 2006 and in the first half of 2006 increased $42 million or 10 percent and $88 million or 12 percent, respectively, largely due to higher passenger traffic and, to a lesser extent, an increase in yield. Traffic increased 8 percent in Quarter 2 2006 and 9 percent for the first half of 2006. The traffic growth primarily reflected additional flying to Rome which was a summer service in 2005 but was converted into a year-round service late in 2005. Also, in the first six months of 2005, the Toronto-Delhi route was a non-stop flight reflected in Pacific services. Beginning in late 2005, the Toronto-Delhi route became a one-stop flight through Zurich. Consequently, in the first six months of 2006, the Toronto-Zurich portion of this route is reflected in Atlantic services while the Zurich-Delhi portion is reflected in Pacific services. On year-to-date basis, yield improved 2 percent over 2005 comprised of a Quarter 2 2006 yield improvement of 1 percent and a Quarter 1 2006 improvement of 4 percent. The yield improvement, a result of increased fuel surcharges to cover higher fuel costs, was largely offset by the adverse effect of a stronger Canadian dollar. The Quarter 2 slower quarter-over-quarter growth in yield reflected in part a larger share of foreign currency denominated revenues as compared to the first quarter and faster growth in leisure traffic. Atlantic RASM increased 6 percent in Quarter 2 2006 and 4 percent in the first half of 2006, reflecting the improvement in passenger load factor and the yield growth.

Pacific passenger revenues in Quarter 2 2006 and in the first half of 2006 were up $4 million or 2 percent and $13 million or 3 percent, respectively, largely due to an increase in yield as a result of increased fuel surcharges to cover higher fuel costs and to a higher proportion of higher-yielding business travelers. These increases were largely offset by the adverse effect of a stronger Canadian dollar on foreign currency denominated revenues. A 16 percent traffic growth was achieved in the combined China, Korea and Hong Kong markets. However, this growth was largely offset by the impact of the revenue classification of the route change discussed above. RASM increased 7 percent in Quarter 2 2006 and 6 percent in the first six months of 2006. This increase was due to both improved passenger load factor and a growth in yield.

Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) were up $14 million or 11 percent over Quarter 2 2005 and $37 million or 11 percent over the first half of 2005, due to a yield improvement mainly as a result of increased fuel surcharges to cover higher fuel costs and traffic growth. Traffic growth was primarily reflected in the South America, Cuba and the Caribbean markets and, to a lesser extent, the Mexico market, as a result of increased capacity. For Quarter 2 2006 and the first half of 2006, RASM increased 14 percent and 12 percent, respectively, due to the yield increase and the improvement in passenger load factor.

Cargo revenues

Cargo revenues for Quarter 2 2006 and the first half of 2006 increased $5 million or 3 percent and $21 million or 7 percent, respectively. This increase was due to growth in cargo traffic of 8 percent over Quarter 2 2005 and 13 percent over the first six months of 2005, partly offset by a yield deterioration of 4 percent in Quarter 2 2006 and 5 percent in the first six months of 2006. Despite higher fuel surcharges, yields declined due mainly to the adverse impact of a stronger Canadian dollar on foreign currency denominated revenues and the relative growth in long-haul freight traffic, which has a lower yield per revenue ton mile.

In 2006, three chartered MD-11 freighter aircraft were operated. In the second quarter of 2005, one MD-11 was operated initially and this was progressively increased to three MD-11 freighters by the end of June 2005. As a result of the increased capacity, cargo revenues from freighter operations increased $12 million over Quarter 2 2005 and $33 million over the first half of 2005. The revenue increase was mainly in the Pacific market with two MD-11 freighter aircraft deployed on the Toronto-Shanghai route. Freighter revenues represented almost one quarter of total cargo revenue for both the second quarter and the 2006 year-to-date results.

Other revenues

Other revenues were down $2 million in Quarter 2 2006 and $27 million in the first half of 2006. The decrease on a year-to-date basis was largely as a result of lower revenues from Air Canada Vacations in Quarter 1 2006 due to lower passenger volumes largely as a result of disruptions to the Mexican leisure market following the 2005 hurricane season. Difficulties integrating a new IT system also resulted in reduced passenger bookings.

Inter-segment revenues were down $21 million in the quarter and $17 million on a year-to-date basis mainly as a result of consolidation adjustments relating to Aeroplan passenger revenues as described in Note 15 to the 2005 Annual Consolidated Financial Statements of ACE.

Operating expenses

Operating expenses in Quarter 2 2006 and in the first six months of 2006 rose $163 million or 7 percent and $472 million or 11 percent, respectively. This increase in operating expenses included higher fuel expenses of $101 million or 19 percent in the quarter and $255 million or 27 percent on a year-to-date basis. As the capacity growth was essentially all at Jazz, higher CPA fees payable to Jazz and increased pass-through costs were also important factors. The increase in CPA fees and pass-through costs reflected a growth in Jazz block hours, capacity and fleet size. Other increases in operating expenses included ownership costs, airport and navigation fees and aircraft maintenance, materials and supplies. These increases were partly offset by a decrease in salaries, wages and benefits expenses, communications and information technology costs and lower expenses at Air Canada Vacations due to reduced passenger volumes mainly in the first quarter of 2006.

3.4 Aeroplan

Aeroplan recorded operating income of $31 million in Quarter 2 2006 compared to $25 million in Quarter 2 2005, an increase of $6 million. For the first half of 2006, operating income increased $19 million over the same period in 2005. EBITDA improved $8 million over Quarter 2 2005 and $24 million over the first half of 2005.

The improvement in operating income and EBITDA was mainly driven by growth in Miles redeemed issued by Aeroplan of 17 percent in the quarter and 16 percent on a year-to-date basis and a lower average cost per Mile redeemed, partially offset by an increase in other operating expenses.

Operating revenues for Quarter 2 2006 and for the first six months of 2006 were up $26 million or 17 percent and $53 million or 16 percent, respectively, primarily attributable to higher redemption activity and to a higher proportion of Aeroplan Miles redeemed. In the quarter, this growth accounted for $25 million of the increase and included $3 million in breakage revenues. On a year-to-date basis, the growth accounted for $49 million of the increase and included $5 million in breakage revenues. The increase in breakage revenues for both the quarter and the first half of 2006 was due to an increase in Miles sold in 2004 and 2005. A higher cumulative average selling price per Aeroplan Mile, due to contractual price increases, and growth in other revenues, consisting primarily of charges to members including the mileage transfer program, booking, change and cancellation fees were also factors in the increase. These increases were partly offset by lower revenue generated from tier management, contact centre management and marketing fees from Air Canada in both the quarter and on a year-to-date basis.

Operating expenses rose $20 million or 15 percent in the quarter and $34 million or 12 percent over the six-month period. An increase in the cost of rewards mainly attributable to higher redemption activity and a higher proportion of Aeroplan Miles redeemed accounted for $12 million of the increase in the quarter and $26 million in the first six months of 2006. These net increases also reflected a lower average redemption cost per Aeroplan Mile redeemed for air travel rewards, representing $3 million in Quarter 2 2006 and $6 million on a year-to-date basis. The lower costs are attributable to changes to the redemption mix of air rewards as well as an increase in non-air reward redemption activity. In Quarter 2 2006 and in the first half of 2006, depreciation and amortization increased $2 million and $5 million, respectively, mainly due to increased software amortization as projects previously under development were deployed into service. Other operating expenses, excluding depreciation and amortization, increased $6 million over Quarter 2 2005 and $3 million over the first half of 2005.

3.5 Jazz

Jazz recorded operating income of $36 million in Quarter 2 2006 compared to $27 million in Quarter 2 2005, an increase of $9 million. For the first half of 2006, operating income increased $15 million over the same period in 2005. EBITDAR for Quarter 2 2006 and the first half of 2006 improved $29 million and $51 million, respectively. The increase in operating income and EBITDAR was mainly due to the growth in fleet consistent with Jazz's plan to increase its relative share of the North American ASM capacity, an increase in hours of contract flying, as well as cost control and performance incentives earned in 2006.

A new CPA came into effect on January 1, 2006. The major changes from the initial capacity purchase agreement include: a longer term, a larger number of covered aircraft with a guaranteed minimum of 133 aircraft throughout the term, and Jazz expenses now reimbursed by Air Canada at a higher mark-up, for controllable costs, and on an at cost basis by Air Canada for other expenses. In addition, 2005 was a transition year for Jazz, reflecting an increase in the fleet, a change in the fleet mix and higher training costs, while 2006 captures the full implementation of many cost reduction initiatives which began in 2005.

Operating revenues for Quarter 2 2006 and for the first half of 2006 were up $109 million or 47 percent and $215 million or 48 percent, respectively, compared to the same periods in 2005. The significant increase in revenues was due to a net addition of 37 aircraft operated by Jazz, a 28 percent increase in block hours flown by these aircraft in Quarter 2 2006 (32 percent in the first half of 2006) and higher pass-through costs charged to Air Canada under the CPA.

Operating expenses rose $100 million or 49 percent compared to Quarter 2 2005 and $200 million or 52 percent over the first half of 2005, including an increase in pass-through costs of $55 million or 81 percent in the quarter and $109 million or 88 percent on a year-to-date basis, driven largely by a capacity increase of over 67 percent and 74 percent versus the same periods in 2005. Unit cost for both Quarter 2 2006 and the first half of 2006 decreased 11 percent compared to the same periods in 2005 in part due to an increase in average stage length. Excluding fuel expense, unit cost for the quarter and on a year-to-date basis was down 18 percent and 17 percent, respectively, over the corresponding periods in 2005. Unit cost reductions were achieved in all expense categories except fuel expense and aircraft rent. The unit aircraft rental cost increase over Quarter 2 2005 mainly reflected 8 new CRJ200 and 11 new CRJ705 aircraft deliveries and the transfer of 25 CRJ100 aircraft from Air Canada.

3.6 ACTS

For Quarter 2 2006, ACTS recorded operating income of $1 million, a decrease of $19 million from Quarter 2 2005 mainly due to losses in the airframe maintenance division. The financial results at the other divisions were only slightly lower than in 2005.

Operating revenues rose $37 million in Quarter 2 2006 reflecting growth of $29 million or 20 percent in revenues from Air Canada largely related to an increase in the replacement of expensive life limited parts due to the aging of certain engines. Another factor was an $8 million increase in third party revenues due to a higher volume of activity in the airframe maintenance division.

In Quarter 2 2006, operating expenses were up $56 million over the same period in 2005 largely due to a $42 million increase in aircraft maintenance, materials and supplies expenses largely attributable to the timing of the maintenance cycle relating to certain Air Canada engines and increased third party activity in the airframe maintenance division compared to Quarter 2 2005. To a lesser extent, an increase in components and engine maintenance activities was also a factor in this increase. The remainder of the increase in operating expenses was mainly related to higher salaries, wages and benefit expense due to a significant capacity growth at ACTS' Montreal and Vancouver airframe maintenance centres.

On a year-to-date basis, ACTS recorded an operating loss of $18 million in 2006 compared to operating income of $40 million in 2005. This deterioration in operating results was mostly due to losses at the airframe maintenance division primarily attributable to greater than expected operational challenges relating to significant production capacity growth at ACTS' Montreal and Vancouver maintenance centres. Operating revenues increased $62 million but were completely offset by an increase of $120 million in operating expenses. The year-to-date results included non-recurring special labour charges of $5 million and other unfavorable adjustments of $6 million which were recorded in the first quarter of 2006.

4. FINANCIAL AND CAPITAL MANAGEMENT

4.1 Financial position

Condensed Statement of Financial Position *($ millions)*	June 30, 2006	December 31, 2005
ASSETS		
Cash, cash equivalents and short-term investments	2,822	2,181
Other current assets	1,200	1,173
Current assets	4,022	3,354
Property and equipment	5,753	5,494
Intangible assets	2,267	2,462
Other assets	432	537
	12,474	**11,847**
LIABILITIES		
Current liabilities	3,404	3,011
Long term debt and capital leases obligations	3,584	3,543
Pension and other benefit liabilities	2,062	2,154
Other liabilities	1,954	1,971
	11,004	10,679
SHAREHOLDERS' EQUITY	1,470	1,168
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	**12,474**	**11,847**

Current assets have increased $668 million since December 31, 2005, largely due to the increase in cash and short-term investments of $641 million. Property and equipment increased $259 million mainly due to additions to capital assets of $479 million, as described in section 4.7, offset by depreciation. Intangible assets decreased $195 million mainly due to amortization expenses of $46 million and a reduction of $165 million relating to the accounting for future income taxes.

Current liabilities increased $393 million, mainly reflecting the seasonal increase in advance ticket sales heading into the third quarter. Long-term debt and capital lease obligations increased by a net $41 million and included the impact of the financing activities as described in section 4.6 as well as the favourable impact of a stronger Canadian dollar on US dollar denominated debt and capital leases.

4.2 Liquidity and working capital

The Corporation maintains considerable liquidity in cash and short-term investments along with access to additional funds under various credit facilities. At June 30, 2006, the Corporation had cash, cash equivalents and short-term investments of $2,822 million and positive working capital of $618 million. Compared to December 31, 2005, cash, cash equivalents and short term investments have increased $641 million and working capital has increased $275 million.

At June 30, 2006, Air Canada, Aeroplan and Jazz had unused credit facilities of $250 million, $175 million and $35 million, respectively.

4.3 Share information

At June 30, 2006 and at December 31, 2005, the issued and outstanding common shares of ACE, along with common shares potentially issuable, pursuant to convertible preferred shares, convertible notes and stock options were as follows:

		Number of shares (000)	
	Authorized	At June 30, 2006	At December 31, 2005
Issued and outstanding common shares			
Class A variable voting shares	Unlimited	79,600	76,735
Class B voting shares	Unlimited	22,360	25,059
Shares held in escrow		-	28
Total issued and outstanding common shares		**101,960**	**101,822**

	Number of shares (000)	
	At June 30, 2006	At December 31, 2005
Common shares potentially issuable		
Convertible preferred shares	10,483	10,228
Convertible notes	7,354	6,875
Stock options	3,869	3,187
Total common shares potentially issuable	**21,706**	**20,290**

	Number of shares (000)	
	At June 30, 2006	At December 31, 2005
Total outstanding and potentially issuable common shares	**123,666**	**122,112**

In connection with the special distribution of units of Aeroplan Income Fund to the shareholders of ACE in March 2006, the conversion rate of the 4.25 percent Convertible Senior Notes due 2035 ("Convertible Notes") has been adjusted from 20.8333 to 22.2838 Class A variable voting shares (if the holder is not a Canadian) or Class B voting shares (if the holder is Canadian) per $1,000 principal amount of Convertible Notes. This adjustment was effective on March 22, 2006 and has been determined in accordance with the terms of indenture governing the Convertible Notes. Similarly, the Corporation's stock option plan provided for amendments to the option exercise price and the number of common shares to which participants are entitled to exercise in order to maintain the participants' economic rights in respect of their options in connection with a distribution. Effective March 22, 2006, the adjustment was applied to all unexercised ACE stock options as of March 1, 2006, whether vested or not. As at the adjustment date, the weighted average exercise price and number of options outstanding had been amended from $25.54 and 3,131,946 options to $23.87 and 3,350,193 options. These amendments are reflected in the number of common shares potentially issuable at June 30, 2006. Refer to Note 8 to the Unaudited Interim Quarter 2 2006 Consolidated Financial Statements of ACE for additional information on this transaction. In Quarter 2 2006, an additional 535,000 options were granted.

4.4 Pension funding obligations

The table below provides projections for the Corporation's pension funding obligations for the remainder of 2006 and for the full years 2006 to 2010:

($ millions)	Remainder of 2006	Full year 2006	2007	2008	2009	2010
Past service domestic registered plans	141	226	250	244	247	248
Current service domestic registered plans	83	153	161	167	172	177
Other pension arrangements	29	52	56	61	65	69
Projected pension funding obligations	**253**	**431**	**467**	**472**	**484**	**494**

These pension funding requirements are in respect of the Corporation's pension arrangements. For domestic registered pension plans, the funding requirements are based on the minimum past service contributions disclosed in the January 1, 2006 actuarial valuations plus a projection of the current service contributions.

As at January 1, 2006 the solvency deficit in the registered domestic plans was $1,655 million compared to $1,416 million at January 1, 2005, mainly due to a decline in long-term interest rates partially offset by improved returns on assets. The solvency ratio of 86 percent at January 1, 2006 was comparable to the ratio of 87 percent at January 1, 2005, reflecting an increase in both pension assets and obligations.

Changes in the economic conditions, mainly the return on fund assets and changes in interest rates, will impact projected required contributions. The required contributions and solvency deficit disclosed above assume no future gains and losses on plan assets and liabilities over the projection period and do not reflect the economic experience of 2006 to date. The increase in long-term interest rates since the beginning of the year, if maintained, would be expected to decrease the required contributions and solvency deficit and would be reflected in the January 1, 2007 actuarial valuations.

4.5 Cash flows from operations

Cash flows from operations in Quarter 2 2006 and in the first half of 2006 decreased $129 million and $86 million, respectively, primarily as a result of increased pension plan funding of $43 million during Quarter 2 2006 ($52 million during the first half of 2006) and a source of funds in Quarter 2 2005 relating to the return of a pension prepayment of $61 million. In addition, the impact on cash flows from the EBITDAR improvement during Quarter 2 2006 over Quarter 2 2005 of $39 million was largely offset by a source of cash in accounts receivable in Quarter 2 2005 reflecting the collection of a commodity tax receivable.

4.6 Cash flows from financing activities

Aircraft borrowings amounted to $98 million (US$88 million) in Quarter 2 2006 and $222 million (US$195 million) in the first half of 2006 and related mainly to the delivery of four Embraer aircraft in the quarter and nine Embraer on a year-to-date basis. Scheduled and other debt and capital lease payments in the quarter and in the first six months of 2006 amounted to $61 million and $149 million, respectively.

In Quarter 1 2006, ACE completed an initial public offering of Jazz Air Income Fund for aggregate net proceeds of $232 million of which $218 million is included in financing activities and $14 million is included in investment activities. In connection with the offering, Jazz arranged for senior secured syndicated credit facility in the amount of $150 million. Jazz received proceeds of $115 million ($113 million, net of fees of $2 million), representing the drawing under this new credit facility.

4.7 Cash flows used for investing activities

Additions to capital assets totaled $199 million in Quarter 2 2006 and $479 million in the first half of 2006. In the second quarter, these additions included $121 million related to the purchase of four Embraer aircraft ($269 million related to nine aircraft on a year-to-date basis) and $34 million ($57 million for the first six months of 2006) related to the interior makeover program announced in late 2005 and to the installation of an in-flight entertainment system on Jazz CRJ705 aircraft. In addition, pre-delivery payments made on Boeing aircraft amounted to $44 million in Quarter 1 2006. Other additions to capital assets in the quarter and for the first six months of 2006 included inventory and spare engines, systems developments costs as well as ground equipment and facilities. In Quarter 2 2006, as detailed in section 2.6, the Corporation sold 3.25 million shares of its investment in US Airways for proceeds of $158 million.

5. QUARTERLY FINANCIAL DATA

The table below describes quarterly financial results and major operating statistics of the Predecessor Company, Air Canada, for the third quarter of 2004 and the financial results of ACE for the subsequent periods.

($ millions, except per share amounts)	Air Canada [(1)] Q3 2004	ACE Q4 2004	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006
Operating revenues	**$2,496**	**$2,062**	**$2,177**	**$2,458**	**$2,833**	**$2,362**	**$2,484**	**$2,682**
Operating expenses [(2)]	(2,253)	(2,065)	(2,187)	(2,280)	(2,512)	(2,396)	(2,546)	(2,501)
Operating income (loss) before reorganization and restructuring items	**243**	**(3)**	**(10)**	**178**	**321**	**(34)**	**(62)**	**181**
Reorganization and restructuring items	(313)	-	-	-	-	-	-	-
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax [(3)]	(11)	18	(67)	(9)	(50)	(68)	180	55
Net income (loss)	**$(81)**	**$15**	**$(77)**	**$169**	**$271**	**$(102)**	**$118**	**236**
Earnings (loss) [(4)]								
Per share – basic	**$(0.67)**	**$0.17**	**$(0.87)**	**$1.68**	**$2.67**	**$(1.01)**	**$1.15**	**$2.32**
Per share – diluted	**$(0.67)**	**$0.17**	**$(0.87)**	**$1.50**	**$2.33**	**$(1.01)**	**$1.12**	**$2.05**
Revenue passenger miles (millions)	12,853	9,681	10,586	11,613	13,981	10,584	11,240	12,248
Available seat miles (millions)	15,993	12,815	13,566	14,487	16,961	13,808	14,287	14,926
Passenger load factor (%)	80.4	75.5	78.0	80.2	82.4	76.7	78.7	82.1
Operating expense per available seat mile (CASM) (cents)	14.1	16.1	16.1	15.7	14.8	17.4	17.8	16.8
CASM, excluding fuel expense (cents) [(5)]	11.2	12.7	13.1	12.1	10.8	13.2	13.8	12.5
CASM, excluding fuel expense and special labour charges (cents) [(5)]	-	-	-	-	-	-	13.6	12.5

(1) On September 30, 2004, Air Canada and certain subsidiaries emerged from creditor protection under the provisions of the Companies' Creditors Arrangement Act (Canada) ("CCAA"). In accordance with Section 1625 of the Canadian Institute of Chartered Accountants ("CICA") Handbook, ACE adopted fresh start reporting on September 30, 2004. Prior period financial information has not been restated to reflect the impact of fair value adjustments and, accordingly, certain amounts in the Predecessor Company's results are not directly comparable to those of ACE.
(2) Includes special labour charges of $33 million in Quarter 1 2006.
(3) In Quarter 2 2005, ACE recorded a dilution gain of $190 million and a tax provision of $28 million relating to the dilution of ACE's interest in Aeroplan. In Quarter 1 2006, ACE recorded a dilution gain of $220 million and a tax provision of $10 million relating to the dilution of ACE's interest in Jazz. In Quarter 2 2006, ACE recorded a gain of $100 million and a provision for income taxes of $17 million relating to the sale of 3.25 million shares of ACE's holdings in US Airways.
(4) All issued and outstanding options of Air Canada and warrants were cancelled without payment or consideration on September 30, 2004 and a new ACE share capital structure was established.
(5) Refer to "Non-GAAP Financial Measures" on page 21 of this MD&A for additional information.

Seasonality

The Corporation 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. Air Canada and Jazz have substantial fixed costs that do not meaningfully fluctuate with passenger demand in the short-term.

6. CONTROLS AND PROCEDURES

Disclosure controls and procedures within the Corporation have been designed to provide reasonable assurance that all relevant information is identified to its Disclosure Policy Committee to ensure appropriate and timely decisions are made regarding public disclosure.

ACE's 2005 annual report contains a statement that the Chairman, President and Chief Executive Officer ("CEO") and the Executive Vice President and Chief Financial Officer ("CFO") have concluded that the Corporation's disclosure controls and procedures are effective based upon an evaluation of these controls and procedures conducted at December 31, 2005.

ACE filed certifications, signed by the CEO and CFO, with the Canadian Securities Administrators and the SEC in the United States upon filing of ACE's 2005 Annual Report. In those filings, ACE's CEO and CFO certify, as required in Canada by Multilateral Instrument 52-109 and in the United States by the Sarbanes-Oxley Act, the appropriateness of the financial disclosures and the effectiveness of ACE's disclosure controls and procedures. ACE's CEO and CFO also certify the appropriateness of the financial disclosures in its interim filings with Securities Regulators and the design of the disclosure controls and procedures.

As in prior quarters, ACE's Audit, Finance and Risk Committee reviewed this MD&A and the unaudited interim consolidated financial statements and ACE's Board of Directors approved these documents prior to their release.

7. MATERIAL CHANGES

There have been no material changes to debt and lease obligations other than those disclosed in section 4 of this MD&A. Similarly, there have been no material changes to capital expenditures, off-balance sheet arrangements, critical accounting estimates and accounting policies, with the exception of the policy on stock-based compensation disclosed in Note 1 to the Unaudited Interim Quarter 2 2006 Consolidated Financial Statements, from those disclosed in ACE's 2005 MD&A dated February 9, 2006.

ACE's projected pension funding obligations have been updated as disclosed in section 4.4 of this MD&A.

8. RISK FACTORS

For a detailed description of the possible risk factors associated with ACE and/or its subsidiaries, refer to the section entitled "Risk Factors" in ACE's 2005 Annual MD&A dated February 9, 2006. There have been no material changes to the risk factors disclosed at that time.

9. SUBSEQUENT EVENT – STRATEGIC INITIATIVES

On August 11, 2006, the Board of Directors of ACE announced the following strategic initiatives, market conditions permitting, to create further value for ACE shareholders:

- Launching of an initial public offering (IPO) of a minority stake in Air Canada in late 2006;
- Commencing a process in late 2006 to monetize ACTS; and
- Pursuing opportunities that realize the value of its investment in Aeroplan and Jazz.

In connection with these plans, ACE intends, subject to shareholder and Court approval under the Canada Business Corporations Act, to enter into a plan of arrangement. The plan would provide the Board of ACE with the authority to reduce the capital of the Corporation up to an aggregate amount of approximately $2 billion over time, but without any maximum time limit. A special meeting of shareholders will be convened in October 2006 to review the proposed plan of arrangement.

10. NON-GAAP FINANCIAL MEASURES

EBITDAR/EBITDA

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 depreciation, obsolescence and amortization, as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. For segments without aircraft rent, such as Aeroplan and ACTS, EBITDA (earnings before interest, taxes, depreciation, amortization and obsolescence) is used. EBITDAR and EBITDA are not recognized measures for financial statement presentation under GAAP and do not have a standardized meaning and are therefore not likely to be comparable to similar measures presented by other public companies. EBITDAR and EBITDA are reconciled to operating income (loss) as follows:

($ millions)	Quarter 2		$	YTD		$
	2006	2005	Change	2006	2005	Change
ACE Consolidated						
GAAP operating income	181	178	3	119	168	(49)
Add back:						
Aircraft rent	113	98	15	226	188	38
Depreciation, amortization and obsolescence	140	119	21	274	239	35
EBITDAR	**434**	**395**	**39**	**619**	**595**	**24**
Add back:						
Special labour charges	-	-	-	33	-	33
EBITDAR excluding special labour charges	**434**	**395**	**39**	**652**	**595**	**57**
Transportation Services						
GAAP operating income (loss)	113	106	7	(5)	20	(25)
Add back:						
Aircraft rent	82	84	(2)	165	161	4
Depreciation, amortization and obsolescence	122	105	17	240	210	30
EBITDAR	**317**	**295**	**22**	**400**	**391**	**9**
Add back:						
Special labour charges	-	-	-	28	-	28
EBITDAR excluding special labour charges	**317**	**295**	**22**	**428**	**391**	**37**
Aeroplan						
GAAP operating income	31	25	6	70	51	19
Add back:						
Depreciation, amortization and obsolescence	4	2	2	8	3	5
EBITDA	**35**	**27**	**8**	**78**	**54**	**24**
Jazz						
GAAP operating income	36	27	9	72	57	15
Add back:						
Aircraft rent	33	15	18	65	30	35
Depreciation, amortization and obsolescence	7	5	2	11	10	1
EBITDAR	**76**	**47**	**29**	**148**	**97**	**51**
ACTS						
GAAP operating income (loss)	1	20	(19)	(18)	40	(58)
Add back:						
Depreciation, amortization and obsolescence	7	8	(1)	15	16	(1)
EBITDA	**8**	**28**	**(20)**	**(3)**	**56**	**(59)**
Add back:						
Special labour charges	-	-	-	5	-	5
EBITDA excluding special labour charges	**8**	**28**	**(20)**	**2**	**56**	**(54)**

Operating expense, excluding fuel expense and special labour charges

The Corporation uses operating expense excluding fuel expense and special labour charges to assess the operating performance of its ongoing business without the effects of fuel expense and special labour charges. These items are excluded from the Corporation's results as they could potentially distort the analysis of trends in business performance. Fuel expense has increased significantly year-over-year and excluding this expense from GAAP results allows the Corporation to compare its operating performance on a consistent basis. Special labour charges are not reflective of the underlying financial performance of the Corporation from ongoing operations as they are expected to be non-recurring in nature.

The following measures are not recognized measures for financial statement presentation under GAAP and do not have a standardized meaning and are therefore not likely to be comparable to similar measures presented by other public companies. Operating expense, excluding fuel expense and operating expense, excluding fuel expense and special labour charges are reconciled to operating expense as follows:

($ millions)	Quarter 2		$	YTD		$
	2006	**2005**	**Change**	**2006**	**2005**	**Change**
ACE Consolidated						
GAAP operating expense	2,501	2,280	221	5,047	4,467	580
Remove:						
Aircraft fuel	(631)	(530)	(101)	(1,200)	(945)	(255)
Operating expense, excluding fuel expense	**1,870**	**1,750**	**120**	**3,847**	**3,522**	**325**
Remove:						
Special labour charges	-	-	-	(33)	-	(33)
Operating expense, excluding fuel expense and special labour charges	**1,870**	**1,750**	**120**	**3,814**	**3,522**	**292**

11. GLOSSARY

Available Seat Miles or ASMs — A measure of passenger capacity calculated by multiplying the total number of seats available for passengers by the miles flown;

CPA — CPA is the amended and restated capacity purchase agreement, effective January 1, 2006, between Air Canada and Jazz;

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 Available Seat Mile or RASM — Average passenger revenue per ASM;

Revenue Passenger Miles or RPMs — A measure of passenger traffic calculated by multiplying the total number of revenue passengers carried by the miles they are carried;

Subsidiary or subsidiaries — refers to, in relation to ACE, any entity, including a corporation or a limited partnership, which is controlled, directly or indirectly, by ACE;

Yield — Average passenger revenue per RPM.