# ACE AVIATION

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


**February 14, 2007**

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# 1. Preface

ACE Aviation Holdings Inc. ("ACE"), incorporated on June 29, 2004, is an investment holding company of various aviation interests including Air Canada Services, Aeroplan Limited Partnership ("Aeroplan"), Jazz Air LP ("Jazz"), ACTS LP ("ACTS") and other investments.

ACE is listed on the Toronto Stock Exchange where its Class A variable voting shares and Class B voting shares are traded under the symbols ACE.A and ACE.B, respectively.

Management's Discussion and Analysis ("MD&A") of the financial condition and results of operations should be read in conjunction with ACE's audited consolidated financial statements and notes thereto. Reference to "Corporation" in this MD&A 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. Except where the context otherwise requires, all monetary amounts are stated in millions of Canadian dollars.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a detailed description of the risks affecting the business of ACE and its subsidiaries, see "Risk Factors" in this MD&A.

The MD&A is the responsibility of the management of ACE and, unless otherwise noted, is current as of February 14, 2007. The ACE Audit, Finance & Risk Committee reviewed this MD&A and the audited consolidated financial statements and ACE's Board of Directors approved these documents prior to their release. For further information on ACE's public disclosure file, including ACE's Annual Information Form, please consult ACE's website at www.aceaviation.com, SEDAR at www.sedar.com or EDGAR at www.sec.gov/edgar.shtml.

# 2. 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. 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 factors, 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 operation costs and employee counts, employee relations, labour negotiations or disputes, pension issues, currency exchange and interest rates, changes in laws, adverse regulatory developments or proceedings, pending litigation and actions by third parties as well as the factors identified throughout this MD&A and, in particular, those discussed in section 14 "Risk Factors" to this MD&A. The forward-looking statements contained in this discussion represent ACE's expectations as of February 14, 2007, 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.

## 3. Glossary of Terms

**EBITDAR** — EBITDAR is earnings before interest taxes, depreciation, amortization and obsolescence and aircraft rent and is a non-GAAP financial measure;
**EBITDA** — EBITDA is earnings before interest taxes, depreciation, amortization and obsolescence and is a non-GAAP financial measure;
**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;
**Jazz CPA** — The amended and restated capacity purchase agreement, effective January 1, 2006, between Air Canada and Jazz;
**Initial Jazz CPA** — The capacity purchase agreement between Air Canada and Jazz Air Limited Partnership which was in effect from October 1, 2004 until December 31, 2005;
**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;
**Yield** — Average passenger revenue per RPM.

## 4. Industry Segments

ACE's aviation interests are operated through four reportable segments. The following is a descriptive listing of these segments and the operating companies therein at December 31, 2006.

| Segment | Operating Companies | Ownership |
|---|---|---|
| Air Canada Services | Air Canada (TSX: AC.A, AC.B), Canada's largest domestic and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada - US transborder market and in the international market to and from Canada.<br><br>AC Cargo Limited Partnership ("Air Canada Cargo"), together Air Canada and Air Canada Cargo is Canada's largest provider of air cargo services.<br><br>ACGHS Limited Partnership ("Air Canada Ground Handling"), a passenger and ground handling service provider.<br><br>Touram Limited Partnership ("Air Canada Vacations"), a major Canadian tour operator offering leisure vacation packages. Air Canada Services has a 51 percent ownership in Air Canada Vacations, while ACE holds 87.25 percent of Air Canada Vacations at the diluted consolidated level. | 75.0% |
| Aeroplan | Aeroplan, Canada's premier loyalty marketing program. Aeroplan provides its commercial partners with loyalty marketing services designed to stimulate demand for such partners' products and services. Subsequent to the special distribution of units of Aeroplan Income Fund (TSX: AER.UN) on January 10, 2007, ACE retained a 50.3 percent interest in Aeroplan. (See section 18) | 75.3% |
| Jazz | Jazz (TSX: JAZ.UN), the largest regional airline and second largest airline in Canada, after Air Canada, based on fleet size and number of routes operated. Jazz operates both domestic and US transborder services for Air Canada under a capacity purchase agreement. | 79.7% |
| ACTS | ACTS , a full-service aircraft maintenance, repair and overhaul organization that competes on a global basis. On December 4, 2006, ACTS entered into an agreement to acquire 80 percent of Aeromantenimiento, S.A. Refer to section 6 "Significant Events in 2006" for additional information. | 100% |

## 5. Accounting Policies and Estimates

ACE prepares its consolidated financial statements in accordance with Canadian Generally Accepted Accounting Principles ("GAAP").

Significant accounting policies and methods used in preparation of ACE's audited consolidated financial statements are described in Note 2 to ACE's audited consolidated financial statements.

The preparation of ACE's consolidated financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent liabilities and reported amounts of revenues and expenses for the period of the consolidated financial statements. ACE and its operating companies evaluate these estimates and assumptions on a regular basis, based on historical experience and other relevant factors. Actual amounts could differ materially from those estimates and assumptions. Refer to section 13 of this MD&A for a discussion of ACE's Critical Accounting Estimates.

## 6. Significant Events in 2006

A number of significant events occurred during the year which affected ACE's consolidated results for 2006 and their comparability to results for 2005. These events are discussed below.

ACE completed an initial public offering of the Jazz Air Income Fund ("the Fund") on February 2, 2006. The Fund sold 23.5 million units at a price of $10.00 per unit for net proceeds of $218 million, after offering costs of $17 million. Following the closing of the initial public offering, the Fund issued an additional 1.5 million units from the exercise of an over-allotment option for net proceeds of approximately $14 million bringing the aggregate net proceeds of the offering to approximately $232 million. Following the completion of this offering, ACE's ownership interest in Jazz was 79.7 percent. In addition, a $150 million secured syndicated credit facility was established by Jazz of which approximately $115 million ($113 million, net of fees of $2 million) was drawn by Jazz on closing of the offering.

In March 2006, ACE completed a special distribution of units of the Aeroplan Income Fund to its shareholders. The record date for the purpose of the special distribution was March 3, 2006. Based on the closing price of the units of Aeroplan Income Fund on March 3, 2006, the value of the units distributed to ACE's shareholders amounted to $251 million. Following the completion of the distribution and the transfer of units in connection with the Initial Long Term Incentive Plan of Aeroplan, ACE's ownership interest in Aeroplan was 75.3 percent.

In Quarter 2 and Quarter 3 2006, ACE disposed of 4.5 million shares of its holdings in US Airways for net proceeds of $232 million and recorded a gain of $152 million.

At a special meeting of shareholders held on October 5, 2006, the shareholders of ACE approved a statutory plan of arrangement pursuant to the Canada Business Corporations Act. On October 6, 2006, the Quebec Superior Court issued a final order approving the statutory plan of arrangement which became effective October 10, 2006. The arrangement grants authority to the board of directors of ACE to make from time to time one or more special distributions to ACE shareholders in an aggregate amount of up to $2 billion by way of reduction of the stated capital of the Class A variable voting shares, Class B voting shares and the preferred shares of ACE.

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On November 24, 2006, ACE and Air Canada completed an initial public offering and secondary offering of an aggregate 25 million Air Canada shares at $21 per share for net proceeds of $491 million, after offering costs of $34 million. Through the initial public offering, Air Canada sold an aggregate of 9,523,810 Class A variable voting shares and Class B voting shares for net proceeds of $187 million, after offering costs of $13 million. In the secondary offering, ACE sold an aggregate of 15,476,190 Class A variable voting shares and Class B voting shares for net proceeds of $304 million, after offering costs of $21 million. As at December 31, 2006, an aggregate of 100 million Class A variable voting shares and Class B voting shares in the capital of Air Canada were issued and outstanding. ACE retains control of Air Canada through a 75 percent ownership interest.

On December 4, 2006 ACTS and Grupo TACA Holdings Limited ("Grupo TACA") of El Salvador entered into an agreement for ACTS to acquire 80 percent of Grupo TACA's aircraft maintenance division, Aeromantenimiento, S.A ("Aeroman"). Total consideration includes cash and a right to acquire an equity stake in ACTS. The cash component of US$45 million consists of cash of US$43 million on closing and a milestone payment of up to US$2 million, funded by ACTS through ACE's available cash resources. The size of the equity stake in ACTS will be confirmed at the time of the monetization of ACTS and is expected to represent less than 7 percent of the total equity of ACTS. Prior to ACTS' monetization, Grupo TACA can put its right to acquire equity back to ACE at a discounted value from US$40 million and accreting up to a cap of US$51 million over 12 months or the date of monetization, if earlier. On February 13, 2007, ACTS completed the acquisition of Aeroman.

The monetization of ACTS, which commenced in late 2006, is expected to be completed by mid-2007.

On December 28, 2006, ACE announced the terms of a distribution of 50,000,000 units of Aeroplan Income Fund to ACE shareholders under the statutory plan of arrangement approved by ACE's shareholders at the special meeting held on October 5, 2006. ACE shareholders, on January 10, 2007, the record date for the distribution, received a non-cash distribution of approximately 0.442 units of Aeroplan Income Fund per Class A variable voting share, Class B voting share and preferred share (on an as converted basis) of ACE. Based on a closing price of $17.97 per unit of Aeroplan Income Fund on the Toronto Stock Exchange on January 10, 2007, the distribution is valued at approximately $899 million or $7.95 per ACE share.

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## 7. Fourth Quarter Results of Operations

The following table reflects the results of the Corporation, the results of its reportable segments and certain non-GAAP measures for the three months ended December 31, 2006 and for the three months ended December 31, 2005.

| | Three months ended December 31, 2006 | | | | | | Three months ended December 31, 2005 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Air Canada Services | Aeroplan | Jazz | ACTS | CIE | ACE Total | Air Canada Services | Aeroplan | Jazz | ACTS | CIE | ACE Total |
| **Operating revenue** | | | | | | | | | | | | |
| Passenger revenue | $ 2,071 | $ - | $ - | $ - | $ 25 | $ 2,096 | $ 1,949 | $ - | $ 1 | $ - | $ 19 | $ 1,969 |
| Cargo revenue | 165 | - | - | - | - | 165 | 176 | - | - | - | - | 176 |
| Other revenue | 138 | 205 | 2 | 64 | (126) | 283 | 111 | 149 | 5 | 39 | (87) | 217 |
| External revenue | 2,374 | 205 | 2 | 64 | (101) | 2,544 | 2,236 | 149 | 6 | 39 | (68) | 2,362 |
| Inter-segment revenue | 41 | 3 | 350 | 164 | (558) | - | 35 | 5 | 298 | 153 | (491) | - |
| | **2,415** | **208** | **352** | **228** | **(659)** | **2,544** | **2,271** | **154** | **304** | **192** | **(559)** | **2,362** |
| **Operating expenses** | | | | | | | | | | | | |
| Salary, wages, and benefits | 443 | 21 | 82 | 85 | 3 | 634 | 463 | 19 | 75 | 85 | 5 | 647 |
| Aircraft fuel | 583 | - | 69 | - | (68) | 584 | 577 | - | 62 | 1 | (62) | 578 |
| Aircraft rent | 75 | - | 34 | - | (2) | 107 | 90 | - | 28 | - | (1) | 117 |
| Airport user fees | 232 | - | 46 | - | (45) | 233 | 222 | - | 37 | - | (37) | 222 |
| Aircraft maintenance, materials, and supplies | 205 | - | 27 | 56 | (164) | 124 | 180 | - | 18 | 56 | (150) | 104 |
| Depreciation, amortization, and obsolescence | 135 | 3 | 5 | 8 | 6 | 157 | 106 | 3 | 4 | 8 | 4 | 125 |
| Food, beverages and supplies | 76 | - | 4 | - | - | 80 | 78 | - | 3 | - | - | 81 |
| Commissions | 49 | - | - | - | (1) | 48 | 47 | - | - | - | - | 47 |
| Capacity purchase fees paid to Jazz | 224 | - | - | - | (224) | - | 194 | - | - | - | (194) | - |
| Special charge for labour restructuring | (8) | - | - | - | - | (8) | - | - | - | - | - | - |
| Other operating expenses | 406 | 147 | 52 | 67 | (160) | 512 | 405 | 102 | 43 | 50 | (125) | 475 |
| | **2,420** | **171** | **319** | **216** | **(655)** | **2,471** | **2,362** | **124** | **270** | **200** | **(560)** | **2,396** |
| **Operating income (loss)** | **(5)** | **37** | **33** | **12** | **(4)** | **73** | **(91)** | **30** | **34** | **(8)** | **1** | **(34)** |
| **Non-operating income (expense)** | | | | | | | | | | | | |
| Interest income | 24 | 6 | 2 | 1 | 3 | 36 | 14 | 4 | - | - | 1 | 19 |
| Interest expense | (88) | (4) | (2) | (6) | (5) | (105) | (74) | (2) | (3) | (4) | (4) | (87) |
| Interest capitalized | 22 | - | - | - | - | 22 | 6 | - | - | - | - | 6 |
| Dilution gain - Air Canada | - | - | - | - | 25 | 25 | - | - | - | - | - | - |
| Gain (loss) on sale of and provisions on assets | (10) | - | - | - | 6 | (4) | (30) | - | 1 | - | (1) | (30) |
| Other non-operating income (expense) | - | - | (1) | - | - | (1) | (2) | (3) | - | - | 9 | 4 |
| | **(52)** | **2** | **(1)** | **(5)** | **29** | **(27)** | **(86)** | **(1)** | **(2)** | **(4)** | **5** | **(88)** |
| **Income (loss) before non-controlling** | **(57)** | **39** | **32** | **7** | **25** | **46** | **(177)** | **29** | **32** | **(12)** | **6** | **(122)** |
| Non-controlling interest | (3) | - | - | - | (16) | (19) | (2) | - | - | - | (6) | (8) |
| Foreign exchange gain (loss) | (107) | - | - | 1 | 1 | (105) | (11) | - | - | - | - | (11) |
| Recovery of (provision for) income taxes | 23 | - | - | - | 6 | 29 | 55 | - | - | - | (16) | 39 |
| **Income (loss) for the period** | **$ (144)** | **$ 39** | **$ 32** | **$ 8** | **$ 16** | **$ (49)** | **$ (135)** | **$ 29** | **$ 32** | **$ (12)** | **$ (16)** | **$ (102)** |
| **EBITDAR[(1)]** | **205** | **40** | **72** | **20** | - | **337** | **105** | **33** | **66** | - | **4** | **208** |
| **EBITDAR[(1)] excluding special charges** | **197** | **40** | **72** | **20** | - | **329** | **105** | **33** | **66** | - | **4** | **208** |

*(1) Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).*

ACE reported operating income of $73 million in Quarter 4 2006, an improvement of $107 million from the operating loss of $34 million recorded in Quarter 4 2005. Excluding special charges, operating income increased $99 million over 2005.

On a consolidated basis, for Quarter 4 2006, EBITDAR increased $129 million over Quarter 4 2005. Excluding special charges, EBITDAR improved $121 million over Quarter 4, 2005. EBITDAR increased in all reportable segments. For Quarter 4, 2006, the Air Canada Services, Aeroplan, Jazz and ACTS segments achieved EBITDAR improvements over Quarter 4, 2005 of $100 million, $7 million, $6 million and $20 million, respectively.

Non-operating expense amounted to $27 million in Quarter 4 2006 compared to non-operating expense of $88 million in Quarter 4 2005. For Quarter 4 2006, net interest expense decreased $15 million from the same period in 2005. An increase in interest expense, largely driven by the financing of additional aircraft, was more than offset by interest capitalized relating to the acquisition of Boeing aircraft and growth in interest income due to higher cash balances and higher average interest rates.

Losses from the revaluation of foreign currency monetary items amounted to $105 million in Quarter 4 2006, attributable to a weaker Canadian dollar at December 31, 2006 compared to September 30, 2006. This compared to foreign exchange losses on foreign currency monetary items of $11 million in Quarter 4 2005.

The net loss in Quarter 4 2006 amounted to $49 million or $0.48 per diluted share compared to a net loss of $102 million or $1.01 per diluted share in Quarter 4 2005.

### 7.1. Air Canada Services

Air Canada Services recorded an operating loss of $5 million in Quarter 4 2006, an improvement of $86 million from Quarter 4 2005. EBITDAR increased $100 million over Quarter 4 2005.

System passenger revenues in Quarter 4 2006 increased $122 million or 6 percent over Quarter 4 2005, reflecting system traffic and yield improvements due to stronger market demand. The system yield improvement of 1 percent in Quarter 4 2006 over the same period in 2005 was principally due to fuel-related fare increases and increased fuel surcharges to offset higher fuel costs and, to a lesser extent, a higher average business class fare. The yield increase was partly offset by the negative effect of a stronger Canadian dollar on international, US transborder and domestic revenues. In Quarter 4 2006, traffic grew 5 percent on a capacity increase of 4 percent over Quarter 4 2005, resulting in a passenger load factor increase of 1.1 percentage points. RASM increased 2 percent compared to Quarter 4 2005 due to both the improvement in system passenger load factor and the growth in yield.

Cargo revenues for Quarter 4 2006 decreased $11 million or 6 percent from Quarter 4 2005. System traffic declined 4 percent and cargo yield per revenue ton mile was down 2 percent. Freighter operations were reduced from three to two chartered MD-11 aircraft effective November 2006 as compared to three MD-11 aircraft operated in Quarter 4 2005.

In Quarter 4 2006, other revenues increased $33 million or 23 percent over Quarter 4 2005 and included higher revenues from Air Canada Vacations, increased flight cancellation/change fees and buy-on-board revenues as well as other miscellaneous revenues.

Operating expenses in Quarter 4 2006 rose $58 million or 2 percent over Quarter 4 2005. Unit cost, as measured by operating expense per ASM, decreased 1 percent over Quarter 4 2005.

Operating expense increases included salaries and wages, aircraft fuel, airport and navigation fees, aircraft maintenance, materials and supplies, ownership costs, comprised of aircraft rent and depreciation, amortization and obsolescence, and capacity purchase fees paid to Jazz. Capacity purchase fees paid to Jazz increased $30 million or 15 percent, driven by a growth of 12 aircraft in Jazz's operating fleet covered by the Jazz CPA, and an increase in ASM capacity of 26 percent for flights operated by Jazz. Aircraft maintenance, materials and supplies increased $25 million or 14 percent in Quarter 4 2006 largely due to increased airframe maintenance activity for Boeing 767 aircraft and, to a lesser extent, Airbus A320 aircraft, due to cycle timing. Other increases included increased engine maintenance activity for Airbus A320 and A340 aircraft and expenses related to satisfying minimum return conditions on short-term leases and future return to lessor expenses. Ownership costs increased $14 million in Quarter 4 2006 and included a change in assumptions relating to the residual value of certain aircraft and the addition of 16 Embraer aircraft to Air Canada's operating fleet. The impact of aircraft returns and lease terminations, the transfer of 10 CRJ-100 aircraft to Jazz, which shifts the ownership cost to the capacity purchase expense category, the reduction of one MD-11 freighter aircraft and the impact of a stronger Canadian dollar on aircraft rent partly offset the increase in ownership costs.

Non-operating expense amounted to $52 million in Quarter 4 2006 compared to non-operating expense of $86 million for Quarter 4 2005. The increase in interest expense of $14 million, largely driven by the financing of additional aircraft, was more than offset by a higher amount of capitalized interest relating to the acquisition of Boeing 777 and 787 aircraft and growth in interest income due to higher cash balances and higher average interest rates

Losses from the revaluation of foreign currency monetary items amounted to $107 million in Quarter 4 2006, attributable to a weaker Canadian dollar at December 31, 2006 compared to September 30, 2006. This compared to losses of $11 million in Quarter 4 2005.

A segment loss of $144 million was recorded in Quarter 4 2006 compared to a segment loss of $135 million in Quarter 4 2005.

## 7.2. Aeroplan

Aeroplan recorded operating income of $37 million in Quarter 4 2006, an increase of $7 million over Quarter 4 2005. EBITDA improved $7 million over Quarter 4 2005. The improvement in operating income and EBITDA was mainly driven by a 37 percent growth in miles redeemed and higher redemption activity.

Operating revenues in Quarter 4 2006 were up $54 million or 35 percent, primarily attributable to higher redemption activity and to higher average revenue recognized per Aeroplan mile and an increase of $3 million in breakage revenues. These increases were partly offset by lower revenue generated from the tier management, contact centre management and marketing fees from Air Canada for Quarter 4 2006.

Total operating expenses rose by $47 million or 38 percent in Quarter 4 2006, largely due to an increase of $37 million in the cost of rewards, resulting from increased redemption. Other operating expenses excluding the cost of rewards, increased by $10 million over Quarter 4 2005 due to higher compensation costs, higher advertising and promotion costs as a result of promotional activities, mainly related to the launch of ClassicPlus Flight rewards during Quarter 4 2006 and higher technology costs.

In accordance with its policy to review breakage every two years, Management completed its review of the estimated breakage factor used to determine the number of miles sold which are not expected to be redeemed. While there can be no assurance that the breakage factor will remain the same in the future, based on the results of the studies, which include the impact of the program changes announced on October 16, 2006 but exclude the potential impact of the new ClassicPlus Flight rewards, the breakage factor has remained unchanged at 17 percent. The studies used data only up to December 31, 2005 and will be updated by Management in 2007.

Pursuant to an amendment of the Commercial Participation and Service Agreement (“CPSA”) entered into on October 13, 2006, Air Canada agreed to increase its obligation for the cost of air rewards related to the redemption of Aeroplan miles earned by members prior to January 1, 2002 from 103 billion to 112 billion. Refer to Note 21 to ACE’s consolidated financial statements for additional information.

On October 16, 2006, and in response to members’ demands for improved reward travel choices and greater flexibility to make travel arrangements, Aeroplan introduced ClassicPlus Flight Rewards which offer Aeroplan members unrestricted access to available seat inventory across the entire Air Canada and Air Canada Jazz networks in both Economy and Executive Class and may be booked until two hours prior to a flight’s departure should seats remain available.

Concurrently, Aeroplan also announced the implementation of certain Program changes, related to mileage expiry and mileage accumulation, which became effective January 1, 2007 and July 1, 2007. The changes have been designed to encourage members’ active participation in the program through accumulation and redemption.

### 7.3. Jazz

Jazz recorded operating income of $33 million in Quarter 4 2006, pursuant to the Jazz CPA, compared to operating income of $34 million in Quarter 4 2005, pursuant to the Initial Jazz CPA. EBITDAR for Quarter 4 2006 improved $6 million over Quarter 4 2005, mainly due to a growth in fleet size, an increase in hours of contract flying under the Jazz CPA, as well as cost control.

The Jazz CPA came into effect on January 1, 2006. The major changes from the Initial Jazz CPA 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.

Operating revenues for Quarter 4 2006 increased $48 million or 16 percent from Quarter 4 2005. The significant increase in revenues was due to a net addition of 14 aircraft operated by Jazz resulting in a 21 percent increase in block hours flown over Quarter 4 2005 as well as higher pass-though costs charged to Air Canada under the Jazz CPA.

Operating expenses increased $49 million or 18 percent compared to Quarter 4 2005 and included an increase in pass-through costs of $18 million or 17 percent in Quarter 4 2006, driven largely by a capacity increase of 26 percent over the corresponding period in 2005. Unit cost for Quarter 4 2006 decreased 8 percent over the same period in 2005, in part due to an increase in longer-haul flying which generally results in lower unit costs per ASM. Excluding fuel expense, unit cost for Quarter 4 2006 was down 5 percent over the corresponding period in 2005. The unit aircraft rental cost increase mainly reflected six CRJ-200 aircraft deliveries and the transfer of 10 CRJ-100 aircraft from Air Canada partly offset by a termination of two Dash-8 aircraft operating leases.

Segment income of $32 million was recorded in Quarter 4, 2006, unchanged from Quarter 4 2005.

### 7.4. ACTS

ACTS recorded operating income of $12 million in Quarter 4, 2006 compared to an operating loss of $8 million in Quarter 4 2005, an improvement of $20 million, the result of revenue growth and a focus on operating efficiencies.

Operating revenues were up $36 million over Quarter 4 2005, reflecting growth of $12 million from Air Canada and $24 million from third party customers, while Jazz volumes were relatively flat. Air Canada revenue growth came from the airframe and engine divisions as a result of additional heavy checks completed in Quarter 4 2006 compared to the same period in 2005. The growth in third party revenues came from an increased volume of orders delivered by the engine and component divisions as both divisions more than doubled revenues from 2005 levels.

In Quarter 4 2006, operating expenses increased $16 million over 2005 in order to support the increased revenues, though labour and material efficiencies delivered significantly reduced cost to revenue ratios from 2005 levels.

Segment income of $8 million was recorded in Quarter 4 2006 versus a segment loss of $12 million for the same period in 2005.

### 7.5. Corporate Items and Eliminations ("CIE")

CIE includes the corporate, financing and investing activities of ACE. CIE also includes certain consolidation adjustments related to revenue recognition differences amongst the operating segments. These consolidation adjustments are related to the timing of recognition and the presentation of revenue related to Aeroplan redemptions and the timing of revenue recognition related to maintenance services provided by ACTS (completed contract for engine and component maintenance services) versus the expense recognition in Air Canada and Jazz, which is as the work is completed.

The Aeroplan consolidation adjustments recorded in CIE relate mainly to the revenue recognition timing difference from when Aeroplan records revenues, at the time a mile is redeemed for travel, to the consolidated accounting policy of revenue recognition, at the time reward transportation is provided. In addition, Aeroplan records revenue from the redemption of miles in "other" revenue, whereas in ACE's consolidated financial statements, revenue for miles redeemed for travel on Air Canada and Jazz is recorded in "passenger" revenue. This results in an elimination of certain Aeroplan "other" revenue amounts in CIE as the consolidated recognition of Aeroplan miles redeemed for travel on Air Canada and Jazz is recorded in "passenger" revenue. This also results in an adjustment to "passenger" revenue recorded in CIE. In the Aeroplan segment information, the cost to Aeroplan of purchasing rewards is recorded in "other" operating expenses.

Included in CIE's Quarter 4 2006 results is a dilution gain of $25 million as a result of ACE's initial public offering of Air Canada. In connection with the offering, ACE acquired certain investments held by Air Canada in ACTS for a consideration of $673 million.

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## 8. 2006 Results of Operations

The following table reflects the results of the Corporation, the results of its reportable segments and certain non-GAAP measures for the year ended December 31, 2006 and for the year ended December 31, 2005.

| | 2006 | | | | | | 2005 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Air Canada Services | Aeroplan | Jazz | ACTS | CIE | ACE Total | Air Canada Services | Aeroplan | Jazz | ACTS | CIE | ACE Total |
| **Operating revenue** | | | | | | | | | | | | |
| Passenger revenue | $ 8,887 | $ - | $ - | $ - | $ 82 | $ 8,969 | $ 8,197 | $ - | $ 2 | $ - | $ 70 | $ 8,269 |
| Cargo revenue | 625 | - | - | - | - | 625 | 620 | - | - | - | - | 620 |
| Other revenue | 558 | 759 | 7 | 228 | (489) | 1,063 | 537 | 627 | 8 | 187 | (418) | 941 |
| External revenue | 10,070 | 759 | 7 | 228 | (407) | 10,657 | 9,354 | 627 | 10 | 187 | (348) | 9,830 |
| Inter-segment revenue | 169 | 10 | 1,374 | 627 | (2,180) | - | 155 | 13 | 1,013 | 567 | (1,748) | - |
| | 10,239 | 769 | 1,381 | 855 | (2,587) | 10,657 | 9,509 | 640 | 1,023 | 754 | (2,096) | 9,830 |
| Special charge for Aeroplan miles | (102) | - | - | - | - | (102) | - | - | - | - | - | - |
| | **10,137** | **769** | **1,381** | **855** | **(2,587)** | **10,555** | **9,509** | **640** | **1,023** | **754** | **(2,096)** | **9,830** |
| **Operating expenses** | | | | | | | | | | | | |
| Salary, wages, and benefits | 1,816 | 79 | 311 | 331 | 16 | 2,553 | 1,857 | 71 | 265 | 308 | 16 | 2,517 |
| Aircraft fuel | 2,544 | - | 285 | 1 | (284) | 2,546 | 2,197 | - | 177 | 1 | (177) | 2,198 |
| Aircraft rent | 314 | - | 134 | - | (7) | 441 | 341 | - | 80 | - | (4) | 417 |
| Airport user fees | 982 | - | 178 | - | (177) | 983 | 924 | - | 124 | - | (124) | 924 |
| Aircraft maintenance, materials, and supplies | 768 | - | 98 | 234 | (629) | 471 | 693 | - | 68 | 174 | (568) | 367 |
| Depreciation, amortization, and obsolescence | 493 | 14 | 21 | 31 | 17 | 576 | 404 | 8 | 18 | 32 | 20 | 482 |
| Food, beverages and supplies | 322 | - | 15 | - | (2) | 335 | 326 | - | 8 | - | - | 334 |
| Commissions | 237 | - | - | - | (1) | 236 | 253 | - | - | - | - | 253 |
| Capacity purchase fees paid to Jazz | 871 | - | - | - | (871) | - | 693 | - | - | - | (693) | - |
| Special charge for labour restructuring | 20 | - | - | 5 | - | 25 | - | - | - | - | - | - |
| Other operating expenses | 1,656 | 536 | 195 | 255 | (648) | 1,994 | 1,630 | 459 | 154 | 192 | (552) | 1,883 |
| | **10,023** | **629** | **1,237** | **857** | **(2,586)** | **10,160** | **9,318** | **538** | **894** | **707** | **(2,082)** | **9,375** |
| **Operating income (loss)** | **114** | **140** | **144** | **(2)** | **(1)** | **395** | **191** | **102** | **129** | **47** | **(14)** | **455** |
| **Non-operating income (expense)** | | | | | | | | | | | | |
| Interest income | 82 | 20 | 6 | 1 | 11 | 120 | 48 | 6 | 1 | - | 11 | 66 |
| Interest expense | (313) | (15) | (8) | (18) | (24) | (378) | (270) | (5) | (16) | (14) | (10) | (315) |
| Interest capitalized | 62 | - | (1) | - | - | 61 | 14 | - | - | - | - | 14 |
| Gain on sale of US Airways shares | - | - | - | - | 152 | 152 | - | - | - | - | - | - |
| Dilution gain - Air Canada | - | - | - | - | 25 | 25 | - | - | - | - | - | - |
| Dilution gain - Jazz | - | - | - | - | 220 | 220 | - | - | - | - | - | - |
| Dilution gain - Aeroplan | - | - | - | - | - | - | - | - | - | - | 190 | 190 |
| Gain (loss) on sale of and provisions on assets | (6) | - | - | - | 2 | (4) | (31) | - | 4 | - | (1) | (28) |
| Other non-operating income (expense) | (16) | (1) | (1) | 1 | 3 | (14) | 15 | (3) | - | - | (24) | (12) |
| | **(191)** | **4** | **(4)** | **(16)** | **389** | **182** | **(224)** | **(2)** | **(11)** | **(14)** | **166** | **(85)** |
| **Income (loss) before the following items:** | **(77)** | **144** | **140** | **(18)** | **388** | **577** | **(33)** | **100** | **118** | **33** | **152** | **370** |
| Non-controlling interest | (12) | - | - | - | (60) | (72) | (13) | - | - | - | (11) | (24) |
| Foreign exchange gain (loss) | 12 | - | - | - | - | 12 | 47 | - | - | - | (1) | 46 |
| Recovery of (provision for) income taxes | 3 | - | - | - | (112) | (109) | (21) | - | - | - | (110) | (131) |
| **Income (loss) for the period** | **$ (74)** | **$ 144** | **$ 140** | **$ (18)** | **$ 216** | **$ 408** | **$ (20)** | **$ 100** | **$ 118** | **$ 33** | **$ 30** | **$ 261** |
| **EBITDAR[1]** | **921** | **154** | **299** | **29** | **9** | **1,412** | **936** | **110** | **227** | **79** | **2** | **1,354** |
| **EBITDAR[1] excluding special charges** | **1,043** | **154** | **299** | **34** | **9** | **1,539** | **936** | **110** | **227** | **79** | **2** | **1,354** |

*(1) Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).*

ACE recorded operating income of $395 million in 2006, a decrease of $60 million from 2005. Excluding special charges of $127 million, operating income increased $67 million over 2005.

Included in 2006 was a special charge of $102 million recorded in operating revenues in connection with Air Canada's obligations for the redemption of pre-2002 Aeroplan miles and a special charge for labour restructuring of $25 million recorded in operating expenses in connection with a non-unionized workforce reduction plan.

On a consolidated basis for 2006, EBITDAR increased $58 million over 2005. Excluding special charges, EBITDAR improved $185 million over 2005, reflecting improvements in all reportable segments with the exception of ACTS. In 2006, Air Canada Services, Aeroplan and Jazz segments achieved EBITDAR, (excluding special charges) improvements over 2005 of $107 million, $44 million and $72 million, respectively. Excluding the special charge for labour restructuring of $5 million recorded in Quarter 1 2006, EBITDA for the ACTS segment decreased $45 million over 2005.

Non-operating income amounted to $182 million compared to non-operating expense of $85 million in 2005. Net interest expense decreased $38 million over 2005. The increase in interest expense, largely driven by the financing of additional aircraft, was more than offset by interest capitalized mainly relating to the acquisition of Boeing aircraft and growth in interest income due to higher cash balances and higher average interest rates. Included in 2006 results was a gain of $152 million relating to the sale of shares of US Airways, a dilution gain of $220 million as a result of ACE's initial public offering of Jazz Income Fund and a dilution gain of $25 million as a result of ACE's initial public offering of Air Canada.

Gains from the revaluation of foreign currency monetary items amounted to $12 million in 2006, attributable to a stronger Canadian dollar at December 31, 2006 compared to December 31, 2005. This compared to foreign exchange gains on foreign currency monetary items of $46 million in 2005.

Net income for 2006 amounted to $408 million or $3.80 per diluted share compared to $261 million or $2.48 per diluted share in 2005.

## 8.1. Air Canada Services

For 2006, Air Canada Services recorded operating income of $114 million, a decrease of $77 million from the operating income of $191 million recorded in 2005. Excluding the special charges of $122 million for Aeroplan miles and labour restructuring, operating income increased $45 million over 2005. EBITDAR decreased $15 million from 2005. Excluding the special charge for Aeroplan miles and the special charge for labour restructuring, EBITDAR improved $107 million over 2005.

System passenger revenues for 2006 increased $690 million or 8 percent, reflecting yield and traffic improvements due to stronger market demand. The system yield improvement of 3 percent in 2006 was principally due to fuel-related fare increases and increased fuel surcharges to offset higher fuel costs. A higher average business class fare was also a factor in the yield increase. The impact of the fuel-related fare increases, increased fuel surcharges and a higher business class fare was partially offset by the negative effect of a stronger Canadian dollar on international, US transborder and domestic revenues, which accounted for approximately $200 million in 2006. The August 10, 2006 terrorist threat in the United Kingdom and resultant additional security measures also had an adverse impact in 2006. For 2006, traffic grew 5 percent on a capacity increase of 4 percent over 2005 resulting in a passenger load factor improvement of 0.7 percentage points over 2005. RASM increased 4 percent compared to 2005 due primarily to the growth in system yield and partly to the improvement in passenger load factor.

Cargo revenues increased $5 million or 1 percent due to a growth in cargo traffic of 4 percent partly offset by a 3 percent decline in yield per revenue ton mile. Freighter revenues increased $28 million over 2005 mostly in the Pacific market during the first six months of 2006 where an additional MD-11 freighter capacity was deployed. Effective November 2006, Air Canada reduced the number of chartered MD-11 freighter aircraft from three to two.

Other revenues increased $35 million or 5 percent over 2005. Increases included flight cancellation and change fees, buy-on-board revenues as well as other miscellaneous revenues.

Operating expenses increased $705 million or 8 percent largely reflecting a 4 percent growth in capacity in addition to a $347 million or 16 percent increase in fuel expense. For 2006, unit cost increased 4 percent over 2005. Excluding fuel expense and the special charge for labour restructuring, unit cost increased 1 percent over 2005.

Operating expenses increases included salaries and wages, aircraft fuel, ownership costs, comprised of aircraft rent, depreciation, amortization and obsolescence expenses, airport and navigation fees, aircraft maintenance, materials and supplies and capacity fees paid to Jazz. Capacity fees paid to Jazz, pursuant to the Jazz CPA, amounted to $871 million compared to $693 million in 2005, pursuant to the Initial Jazz CPA. The increases in 2006 were mainly driven by a 27 percent increase in block hours over 2005. ASM capacity for flights operated by Jazz increased 51 percent over 2005. Aircraft maintenance, materials and supplies increased $75 million in 2006 primarily due to growth in Airbus A320 aircraft maintenance costs and, to a lesser extent, in Boeing 767 aircraft maintenance costs. Other engine maintenance increases were due to an increase in maintenance activity for Airbus A340 aircraft and overall engine price increases. An addition to maintenance reserves required to satisfy minimum return conditions on short-term leases and future return to lessor expenses were also factors in the increase over 2005. Ownership costs increased $62 million in 2006 and included a change in assumptions relating to the residual value of certain aircraft, the addition of 16 Embraer aircraft to Air Canada's operating fleet and increased MD-11 freighter aircraft flying in the first half of 2006 partly offset by the transfer of 10 CRJ-100 aircraft to Jazz, the impact of a stronger Canadian dollar on aircraft rent and the impact of aircraft returns and terminations. Airport and navigation fees increased $58 million in 2006, mainly due to a 6 percent increase in aircraft departures and increased rates for landing and general terminal fees primarily at Toronto's Pearson International Airport.

Operating expense decreases included employee benefits, commissions and food, beverage and supplies expenses. Employee benefits expense decreased $35 million or 8 percent over 2005 largely due to a decline in post-employment benefits partly offset by higher pension expense which reflected a lower discount rate applied to pension obligations and to a favourable adjustment of $8 million related to an updated evaluation of workers' compensation liability recorded in Quarter 4 2006. Commission expense decreased $16 million or 6 percent in 2006 on combined passenger and cargo revenue growth of 8 percent, largely due to the impact of a change in the base commission structure together with other commercial initiatives to reduce commission expense which more than offset the volume-related increase.

Non-operating expense amounted to $191 million for 2006 compared to non-operating expense of $224 million for 2005. In 2006, net interest expense decreased $39 million from 2005. The increase in interest expense, largely driven by the financing of additional aircraft, was more than offset by capitalized interest relating to the acquisition of the Boeing 777 and 787 aircraft and growth in interest income due to higher cash balances and higher average interest rates.

In 2006, gains from the revaluation of foreign currency monetary items amounted to $12 million, attributable to a stronger Canadian dollar at December 31, 2006 compared to December 31, 2005. This compared to foreign exchange gains of $47 million recorded in 2005.

A segment loss of $74 million was recorded in 2006 compared to a segment loss of $20 million in 2005.

### 8.2. Aeroplan

Aeroplan recorded operating income of $140 million in 2006 compared to $102 million in 2005, an increase of $38 million. EBITDA improved $44 million over 2005. The increase in operating income and EBITDA was mainly driven by an 11 percent growth in miles redeemed and higher reward redemption activity with improved margin.

Operating revenues in 2006 increased $129 million or 20 percent, mainly attributable to higher redemption activity and to higher average revenue recognized per Aeroplan mile. In 2006, this growth accounted for a $126 million increase including a $12 million increase in breakage revenues, attributable to an increase in miles sold. 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 the tier management, contact centre management and marketing fees from Air Canada.

Operating expenses rose by $91 million or 17 percent in 2006. The increase was due to a net rise in the cost of rewards of $68 million, attributable to higher redemption activity and a higher number of Aeroplan miles redeemed, representing $85 million, partly offset by a $17 million decrease related to a lower average redemption cost per Aeroplan mile redeemed mostly related to air travel rewards. 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. During 2006, depreciation and amortization increased $6 million, mainly due to increased software amortization as projects previously under development were deployed into service. Other operating expenses, excluding depreciation and amortization, increased $17 million over 2005 due to higher compensation costs, including stock-based compensation and separation costs; higher consulting, advisory and other expenses, including public company costs and securities laws compliance; increased information technology maintenance costs as development projects are deployed into service; and higher advertising and promotion costs as a result of promotional activities, mainly related to the launch of ClassicPlus Flight rewards.

## 8.3. Jazz

In 2006, operating income amounted to $144 million, pursuant to the Jazz CPA, compared to operating income of $129 million in 2005, pursuant to the Initial Jazz CPA. EBITDAR in 2006 improved $72 million over 2005. The increase in operating income and EBITDAR in 2006 was mainly due to a growth in fleet size consistent with Jazz's plan to increase its relative share of the North American ASM capacity, an increase in hours of contract flying under the Jazz CPA, as well as cost control.

The Jazz CPA came into effect on January 1, 2006. The major changes from the Initial Jazz CPA 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.

Operating revenues in 2006 increased $358 million or 35 percent over 2005. The significant increase in revenues was due to a net addition of 14 aircraft operated by Jazz resulting in a 27 percent increase in block hours flown over 2005 as well as higher pass-though costs charged to Air Canada under the Jazz CPA.

Operating expenses increased $343 million or 38 percent over 2005 and included an increase in pass-through costs of $177 million or 55 percent, driven largely by a capacity increase of 51 percent. Unit cost in 2006 decreased 12 percent compared to 2005, in part due to an increase in longer-haul flying which generally results in lower unit costs per ASM. Excluding fuel expense, unit cost for 2006 was down 10 percent. Unit cost reductions were achieved in all expense categories with the exception of fuel expense and aircraft rent. The unit aircraft rental cost increase mainly reflected six CRJ-200 aircraft deliveries and the transfer of 10 CRJ-100 aircraft from Air Canada partly offset by a termination of two Dash 8 aircraft operating leases.

Segment income of $140 million was recorded in 2006 compared to segment income of $118 million in 2005.

## 8.4. ACTS

ACTS recorded operating revenues of $855 million in 2006, an increase of $101 million over 2005, enabled by production capacity expansion. The revenue growth over 2005 was delivered in all three divisions, airframe, engine and component, and across all customer portfolios. Revenues from Air Canada, Jazz and third party increased $36 million, $24 million and $41 million, respectively.

Operating expenses in 2006 increased $150 million over 2005. In addition to variable expenses associated with increased volume, non-recurring charges of $11 million were recorded in Quarter 1 2006. The non-recurring items included a special charge for labour restructuring of $5 million and net unfavorable adjustments of $6 million relating to 2005. Increased salary and wage expense to support growth, material cost increases as a result of higher levels of engine life limited part replacements, additional outsourced aircraft events, and spending to support strategic initiatives to fuel future business growth were also factors in the year-over-year increase.

An operating loss of $2 million was recorded in 2006 compared to operating income of $47 million in 2005, a decrease of $49 million. The focus through the second half of 2006 on product competencies, operational efficiencies, and customer and supplier contract re-negotiations enabled ACTS to record significantly improved results in Quarter 3 and Quarter 4.

A segment loss of $18 million was recorded in 2006 compared to segment income of $33 million in 2005.

### 8.5. Corporate Items and Eliminations ("CIE")

Included in CIE's 2006 results is a gain of $152 million relating to the sale of shares of US Airways. Also included in 2006 results was a dilution gain of $220 million as a result of ACE's initial public offering of Jazz Income Fund and a dilution gain of $25 million as a result of ACE's initial public offering of Air Canada. Included in 2005 results was a dilution gain of $190 million as a result of ACE's initial public offering of Aeroplan Income Fund and charges of $29 million related to the extinguishment of a credit facility with General Electric.

# 9. Consolidated Financial Position

## 9.1. Consolidated Assets

Consolidated assets increased to $13.4 billion at December 31, 2006 from $11.8 billion at December 31, 2005. Assets in the Air Canada Services segment represented in excess of 80 percent of consolidated assets.

Significant growth in consolidated assets in 2006 was realized in cash and short-term investments, up $997 million mainly due to the Air Canada and Jazz initial public offerings and the sale of most of ACE's interest in US Airways. Consolidated cash and short-term investments at December 31, 2006 amounted $3.2 billion. Growth in property and equipment amounted to $495 million mainly as a result of aircraft acquisitions during 2006.

Intangible assets were affected as a result of a reversal of a tax valuation allowance. The Corporation has determined that it is more likely than not that certain future income tax assets of $575 million, of which an amount of $504 million was offset by a valuation allowance, will be realized through a combination of future reversals of temporary differences and taxable income. The plan of arrangement which was approved on October 5, 2006 provides part of the basis for Management's assessment of realization due to the use of future income tax assets involved in the distribution of Aeroplan units. Refer to Note 24 of ACE's consolidated financial statements for additional information.

With the reversal of the valuation allowance, a reduction to intangible assets (on a pro-rata basis) of $504 million was recorded based on the current carrying value of future income tax assets that existed at fresh start, $16 million was recorded as a recovery of income tax in ACE's consolidated statement of operations for those future income tax assets arising after fresh start, $12 million was recorded as a recovery of income tax for the current year, and $43 million has been recorded as a deferred tax recovery related to the increase in the effective tax rate applicable to certain of the Corporation's future income tax assets. This deferred recovery is recorded in "accounts payable and accrued liabilities" and will reverse to income as the underlying future income tax assets are realized. The Corporation has determined that it is more likely than not that future income tax assets of $1,511 million are not recoverable and continue to be 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.

## 9.2. Consolidated Debt and Lease Obligations

### Debt

Consolidated long-term debt and capital leases, including the current portion, at December 31, 2006 amounted to $4.1 billion, up $318 million from December 31, 2005. The table below summarizes consolidated long-term debt and capital leases by entity/segment. The increase in long-term debt was primarily due to the financing of Embraer aircraft by Air Canada and a drawdown of $115 million by Jazz under its new credit facility.

| ($ millions) | 2006 | 2005 |
|---|---|---|
| ACE convertible senior notes | 263 | 247 |
| Air Canada Services: | | |
| Direct debt | 1,052 | 696 |
| Consolidated under AcG-15 (1) (2) | 1,110 | 1,178 |
| Capital lease obligations | 1,281 | 1,365 |
| Aeroplan | 300 | 300 |
| Jazz | 115 | 14 |
| Other | 5 | 8 |
| **Consolidated total** | **4,126** | **3,808** |

*(1) Accounting Guideline of the CICA Handbook, Consolidation of Variable Interest Entities ("AcG-15").*

*(2) Includes end of lease debt principal payments due on aircraft and engine leasing entities consolidated under AcG-15 before taking into account the anticipated fair value of the aircraft and engines at the time of lease expiry.*

The table below summarizes the Corporation's principal repayment requirements at December 31, 2006 on long-term debt, capital lease obligations, and aircraft, engine and fuel facility debt consolidated as VIEs under AcG-15.

| **($ millions)** | **2007** | **2008** | **2009** | **2010** | **2011** | **Thereafter** |
|---|---|---|---|---|---|---|
| Direct Corporation debt | 67 | 85 | 485 | 55 | 70 | 973 |
| Debt consolidated under AcG-15 | 120 | 117 | 60 | 118 | 248 | 447 |
| Capital lease principal obligation | 180 | 179 | 92 | 90 | 87 | 653 |
| **Consolidated total** | **367** | **381** | **637** | **263** | **405** | **2,073** |

## Lease Obligations

As a result of the adoption of AcG-15, the Corporation has consolidated leasing entities covering aircraft and engine leasing agreements previously accounted for as operating leases. Future minimum lease payments under existing operating leases of aircraft and other property, excluding leases accounted for as capital leases and Variable Interest Entities (VIEs), amounted to $3.0 billion at December 31, 2006 compared to $3.4 billion at December 31, 2005. Refer to the table below for additional information on the Corporation's future minimum lease payments under existing operating leases.

The table below summarizes the Corporation's future minimum lease payments under existing operating leases at December 31, 2006.

| **($ millions)** | **2007** | **2008** | **2009** | **2010** | **2011** | **Thereafter** |
|---|---|---|---|---|---|---|
| **Air Canada Services** | | | | | | |
| Aircraft operating leases(1) | 403 | 334 | 304 | 269 | 200 | 1,072 |
| Other property | 53 | 46 | 32 | 27 | 24 | 140 |
| **Total Air Canada Services** | 456 | 380 | 336 | 296 | 224 | 1,212 |
| **Jazz** | | | | | | |
| Aircraft operating leases | 3 | 1 | 1 | 1 | - | - |
| Other property | 13 | 12 | 11 | 7 | 1 | 3 |
| **Total Jazz** | 16 | 13 | 12 | 8 | 1 | 3 |
| **Consolidated total** | 472 | 393 | 348 | 304 | 225 | 1,215 |

*(1) Includes aircraft leased and subleased to Jazz.*

## 9.3. Share Capital and Other Equity

At December 31, 2006, 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) |
|---|---|
| | At December 31, 2006 |
| **Issued and outstanding common shares** | |
| Class A variable voting shares | 79,499 |
| Class B voting shares | 22,772 |
| Shares held in escrow | - |
| **Total issued and outstanding common shares** | **102,271** |

| | Number of shares (000) |
|---|---|
| | At December 31, 2006 |
| **Common shares potentially issuable** | |
| Convertible preferred shares | 10,747 |
| Convertible notes | 7,354 |
| Stock options | 3,598 |
| **Total common shares potentially issuable** | **21,699** |

| | Number of shares (000) |
|---|---|
| | At December 31, 2006 |
| **Total outstanding and potentially issuable common shares** | **123,970** |

In connection with the special distribution of units of Aeroplan Income Fund to its shareholders as of a record date of January 10, 2007, the conversion rate of the 4.25 percent Convertible Senior Notes due 2035 (convertible notes) of ACE was adjusted resulting in the convertible notes being potentially convertible into 9.1 million shares. In a consistent manner, the number of ACE stock options outstanding was also adjusted. These adjustments are not included in the number of common shares potentially issuable in the table above.

ACE's share capital as at December 31, 2006 was as follows:

| | At December 31, 2006 |
|---|---|
| **Share capital** | |
| Common shares | 2,188 |
| Convertible preferred shares | 117 |
| Convertible notes | 92 |
| | 2,397 |
| Adjustment to shareholders' equity | (1,655) |
| | **742** |

Under fresh start reporting, the balance in shareholders' equity after a comprehensive revaluation is adjusted to the net value of identifiable assets and liabilities.

During 2006, as a result of a review of the outstanding provisions recorded at the time of exiting CCAA on September 30, 2004, it was determined that a portion of the provision amounting to $38 million ($23 million related to labour-related programs) was no longer required. The amount reversed was applied against share capital as these amounts related to plans established before the application of fresh start reporting.

For further information on ACE's common shares, convertible preferred shares and convertible notes, refer to Note 12 to ACE's audited consolidated financial statements.

## 9.4. 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 December 31, 2006, the Corporation had cash, cash equivalents and short-term investments of $3,178 million and positive working capital of $1,086 million. Compared to December 31, 2005, cash, cash equivalents (of which $313 million was held by ACE) and short term investments increased $997 million and working capital increased $743 million.

At December 31, 2006, Air Canada, Aeroplan and Jazz had unused credit facilities of $400 million, $175 million and $35 million, respectively.

## 9.5. Consolidated Cash flows

Cash flows from operations decreased $23 million in Quarter 4 2006 primarily as a result of pension plan funding of $146 million during Quarter 4 2006 versus $76 million during Quarter 4 2005, partially offset by improved operating results.

Cash flows from operations increased $57 million in 2006, primarily as a result of improved operating results before the special charges for Aeroplan miles and labour restructuring offset by higher pension plan funding, which reflected an increase of $171 million in 2006.

During 2006, as described in section 6 of this MD&A, the Corporation completed offerings for Air Canada shares and units of the Jazz Air Income Fund. Net proceeds from the Air Canada offering were $491 million, after offering costs of $34 million. The net proceeds from the Jazz offering, including the proceeds from the exercise of the over-allotment option, were $232 million, after offering costs of $18 million. Concurrent with the closing of the initial public offering, Jazz received net proceeds of $113 million representing the drawing under a new term credit facility.

Aircraft-related borrowings amounted to $76 million in Quarter 4 2006 and $397 million in 2006 related mainly to the delivery of three Embraer aircraft in the quarter and 16 Embraer aircraft in the year. Scheduled and other debt and capital lease payments in Quarter 4 2006 and in 2006 amounted to $71 million and $278 million, respectively.

In 2006, ACE disposed of 4.5 million shares of its holding in US Airways. The net proceeds from the sale transactions amounted to approximately $232 million.

Additions to capital assets totaled $228 million in Quarter 4 2006 and $920 million in 2006. These additions included $89 million related to the purchase of three Embraer aircraft in Quarter 4 2006 and $481 million related to 16 Embraer aircraft in 2006. Other additions to capital assets in Quarter 4 2006 and in 2006 included $50 million and $148 million, respectively, related to the aircraft interior refurbishment program and to the installation of an in-flight entertainment system on Jazz CRJ-705 aircraft. In addition, pre-delivery payments made on Boeing aircraft amounted to $44 million 2006.

## 9.6. Capital Expenditures

The table below provides projections for planned and committed expenditures, net of financing, for ACE's reportable segments for the years 2007 through to 2011.

| Projected planned and committed capital expenditures, net of financing (1) | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| **Air Canada Services** | | | | | |
| Projected planned and committed expenditures | $ 2,390 | $ 1,751 | $ 606 | $ 1,081 | $ 1,022 |
| Projected planned and committed financing | (1,533) | (1,293) | (302) | (834) | (732) |
| **Air Canada Services, net (2)** | 857 | 458 | 304 | 247 | 290 |
| **Jazz** | 27 | 28 | 23 | 23 | 23 |
| **Aeroplan** | 20 | 20 | 20 | 20 | 20 |
| **ACTS** | 71 | 44 | 35 | 27 | 27 |
| | **975** | **550** | **382** | **317** | **360** |
| Inter-company eliminations | (92) | (19) | - | - | - |
| **Consolidated total** | **883** | **531** | **382** | **317** | **360** |

(1) *The dollar amounts reflected above do not include obligations pertaining to day-to-day operations. US dollar amounts are converted using the December 31, 2006 noon day rate of $1.1653. Final aircraft delivery prices include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day USD LIBOR rate at December 31, 2006.*

(2) *The projected financing amounts include loan commitments obtained as at December 31, 2006.*

### Air Canada Services

In 2004, Air Canada signed definitive purchase agreements with Embraer - Empresa Brasileira de Aeronautica S.A. ("Embraer") for the acquisition of regional jet aircraft.

The agreement with Embraer covers firm orders for 15 Embraer 175 series aircraft as well as 45 Embraer 190 series aircraft. Deliveries of the 15 Embraer 175 series aircraft commenced in July 2005 and the last aircraft was delivered in January 2006. The Embraer 190 series deliveries commenced in December 2005. As at December 31, 2006, 18 of the Embraer 190 series firm aircraft orders have been completed and the last delivery is expected by January 2008. 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. As at December 31, 2006, 49 options remain exercisable.

In November 2005, Air Canada concluded agreements with Boeing for the acquisition of up to 36 Boeing 777 aircraft and up to 60 Boeing 787 aircraft. The order for the 36 Boeing 777 aircraft is comprised of firm orders for 18 aircraft plus purchase rights for 18 more, in a yet-to-be determined mix of the 777 family's newest models. As of December 31, 2006, Air Canada has confirmed with Boeing the delivery of eight Boeing 777-300ER aircraft and six Boeing 777-200LR aircraft. Delivery of the first Boeing 777 aircraft is scheduled for March 2007.

Air Canada has signed a 10-year lease for one Boeing 777-300ER from International Lease Finance Corporation ("ILFC"), which is scheduled to be delivered in May 2007.

In addition to acquiring new aircraft, Air Canada commenced a major refurbishment of the interior of its existing aircraft in April 2006. Air Canada has completed the refurbishment of its 16th Airbus A320 and its fourth Boeing 767-300 aircraft. The refurbishment for the Airbus A319, A321 and A330 aircraft is expected to begin in early 2007. The Embraer and Boeing 777 aircraft are being delivered with the new seats and entertainment systems already installed. The aircraft refurbishment program is scheduled to be completed by the middle of 2008. The capital expenditure associated with this program will be amortized over a five-year period.

**Aeroplan**

Aeroplan's projected planned and committed expenditures for the years 2007 through to 2011 mainly relate to software development and technology initiatives.

**Jazz**

Jazz's projected planned and committed expenditures for the years 2007 through to 2011 mainly relate to aircraft betterments, computer and information technology, ground equipment and facilities.

**ACTS**

ACTS' projected planned and committed capital expenditures for the years 2007 through to 2011 mainly relate to information technology projects development and investment in plant and equipment.

## 9.7. Pension Plan Cash Funding Obligations

As at December 31, 2006 and based on the January 1, 2006 solvency valuation, the table below provides projections for Air Canada's pension funding obligations for the years 2007 through to 2011. The final funding obligation for 2007 will be determined based on the January 1, 2007 valuation.

| ($ millions) | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| **Air Canada Services** | | | | | |
| Past service costs for domestic registered plans | 248 | 242 | 245 | 246 | 246 |
| Current service costs for domestic registered plans | 155 | 160 | 165 | 170 | 175 |
| Other pension arrangements[1] | 86 | 86 | 65 | 69 | 74 |
| **Total** | 489 | 488 | 475 | 485 | 495 |

*(1) Other pension arrangements include retirement compensation arrangements, supplemental plans and international plans.*

The above pension funding requirements are in respect of all Air Canada'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 valuations plus a projection of the current service contributions.

The deficit, on an accounting basis, at December 31, 2006 for pension benefits was $1.4 billion compared to $2.5 billion at December 31, 2005. The decrease in the accounting deficit was mainly the result of a return on plan assets of approximately 13.8 percent during 2006 and funding of past service employer contributions of $261 million. The solvency deficit on the registered pension plans at January 1, 2007 is also expected to decrease significantly compared to January 1, 2006 and, as a result, employer contributions determined in accordance with regulations are expected to decline by $90 million in 2007 and $120 million each year thereafter.

The table below provides projections for Jazz's pension funding obligations from 2006 to 2011:

| ($ millions) | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| **Jazz** | | | | | |
| Past service costs for domestic registered plans | 2 | 2 | 2 | 2 | - |
| Current service costs for domestic registered plans | 7 | 7 | 7 | 7 | 7 |
| Other pension arrangements | 6 | 6 | 6 | 6 | 7 |
| **Total** | 15 | 15 | 15 | 15 | 14 |

The above pension funding requirements are in respect to Jazz's pension arrangements. The funding requirements are based on the minimum past service contributions from the January 1, 2006 actuarial valuations plus a projection of the current plan assets and liabilities over the projection period.

## 9.8. Air Canada Fuel Risk Management

Aircraft fuel is a major expense in the airline industry. During the period from January 1, 2006 to December 31, 2006, the price of Western Texas Intermediate ("WTI") crude oil ranged from a low of US$55.86 to a high of US$76.95. Fuel prices continue to be susceptible to factors such as political unrest in various parts of the world, Organization of Petroleum Exporting Countries (OPEC) policy, the level of demand from emerging economies such as China, the level of inventory carried by the industry, the level of fuel reserves maintained by governments, disruptions to production and refining facilities, alternative fuels and the weather. Based on 2006 volumes and US exchange rates, Air Canada Management estimated that a US$1 per barrel movement in the price of WTI crude oil or in the refining spread between WTI and jet fuel impacted 2006 fuel expense by approximately C$27 million or US$24 million (excluding the impact of fuel surcharges and fuel hedging).

In order to manage the airline's exposure to the volatility of jet fuel prices, Air Canada has hedged a portion of its 2007 anticipated jet fuel requirements using mostly swap and collar option structures. The swap structure allows Air Canada to fix jet fuel price at a specific level, whereas the collar option structure creates a ceiling and a floor price, allowing Air Canada to protect itself against prices above the ceiling but exposing Air Canada to the floor if the price falls below the floor. As at December 31, 2006, Air Canada had 39 percent of its fuel requirement for 2007 hedged at prices that can fluctuate between an average of US$74 to US$85 per barrel for its heating oil-based contracts, an average of US$58 to US$69 per barrel for its WTI crude oil-based contracts and an average of US$81 to US$85 for jet-fuel based contracts. Since December 31, 2006, Air Canada has entered into new hedging positions, using collar option structures, which have added 5 percent coverage to 2007 increasing the total hedged volume for 2007 to 44 percent, as well as an additional 1 percent coverage to 2008. As at February 14, 2007, for 2007, Air Canada has hedged its projected fuel requirements as follows: 57 percent for Quarter 1, 44 percent for Quarter 2, 36 percent for Quarter 3 and 39 percent for Quarter 4.

For information on fuel hedging gains and losses recognized in fuel expense in 2006 and gains and losses recognized in "other" non-operating expense for derivative instruments that do not qualify for fuel hedging accounting, refer to section 11 of this MD&A.

## 10. Future Accounting Standard Changes

The Accounting Standards Board has issued three new standards dealing with financial instruments that the Corporation will be required to adopt in future years:

Financial Instruments — Recognition and Measurement;

Hedges;

Comprehensive Income.

The key principles under these standards are that all financial instruments, including derivatives, are to be included on a company's balance sheet and measured, either at their fair values or, in limited circumstances when fair value may not be considered most relevant, at cost or amortized cost. Financial instruments intended to be held-to-maturity should be measured at amortized cost. Existing requirements for hedge accounting are extended to specify how hedge accounting should be performed. Also, a new location for recognizing certain unrealized gains and losses — other comprehensive income — has been introduced. This provides the ability for certain unrealized gains and losses arising from changes in fair value to be temporarily recorded outside the income statement but in a transparent manner. The new standards are effective for the Corporation beginning January 1, 2007. The standards do not permit restatement of prior years' financial statements however the standards have detailed transition provisions. The Corporation has evaluated the consequences of the new standards, which may have a material impact on the Corporation's financial statements. Refer to Note 16 to ACE's consolidated financial statements for additional disclosure on the impact of the new standards.

## 11. Off-Balance Sheet Arrangements

Refer to Notes 16 and 17 to ACE's consolidated financial statements for additional information regarding derivative financial instruments and guarantees of the Corporation. The following is summary of the more significant off-balance sheet arrangements.

**Guarantees**

*Performance Obligations Relating to Aircraft Leasing Agreements*

With respect to 45 aircraft leases, the difference between the amended lease payments from the Companies' Creditors Arrangement Act ("CCAA") restructuring arrangements 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 by Air Canada and all future rent will be based on the original contracted rates. Rent expense is being recorded on the renegotiated lease agreements and any liability would be recorded only at the time Management believes a material default under the leases is likely to occur.

**Derivative Instruments**

Under its risk management policy, the Corporation manages its exposure to changes in interest rates, foreign exchange rates and jet fuel prices through the use of various derivative financial instruments. The Corporation uses derivative financial instruments only for risk management purposes, not for generating trading profit.

*Interest Rate Risk Management*

The Corporation from time to time enters into interest rate swaps to manage the risks associated with interest rate movement on US dollar. and Canadian dollar floating rate debt and investments, including anticipated debt transactions.

During 2006, Air Canada entered into 19 interest rate swaps with a notional value of US$414 million to receive floating rates and pay a weighted average fixed rate of 5.81 percent for the debt to be arranged in relation to the financing of Embraer 190 aircraft between June 2006 and November 2007. The swaps have 15-year terms from the expected delivery date of the aircraft and their maturities range from June 2021 to December 2022. Air Canada intends on settling the interest rate swaps upon delivery of the related aircraft. Before December 31, 2006, seven of these swaps were settled at a net loss of $4 million. As at December 31, 2006, the fair value of the remaining 12 swaps was $13 million in favour of the counterparty and is recorded in "other long-term liabilities" on Air Canada's combined consolidated statement of financial position. The Air Canada Services segment has recognized a net loss of $17 million in "other" non-operating expense on Air Canada's consolidated statement of operations since inception of these swaps in the second quarter of 2006.

During 2006, Jazz entered into interest rate swaps to hedge its exposure to changes in interest rates on its outstanding senior secured credit facility. The interest rate swap is with third parties with a notional value of $115 million, which has effectively resulted in a fixed interest rate of 7.09 percent for the term of the senior secured credit facility until February 2, 2009. Effective February 2, 2006, Jazz is applying hedge accounting to these financial instruments and no amount is recorded in Air Canada's combined consolidated financial statements. As at December 31, 2006, the fair value of these swaps was less than $1 million in favour of the counterparty.

Air Canada has interest rate swaps with a term to January 2024 and convert-lease payments related to two Boeing 767 aircraft leases consolidated under AcG-15, from fixed to floating rates. As at December 31, 2006, these two swaps have a fair value of $4 million in favour of Air Canada ($7 million in favour of Air Canada as at December 31, 2005).

*Foreign Exchange Risk Management*
Foreign exchange risk exposure is a common event to an international business such as Air Canada. To manage this risk exposure, Air Canada enters into various foreign currency hedging structures. These hedging structures provide protection to Air Canada in the form of reduced risk and volatility with respect to movements in the foreign exchange markets. At December 31, 2006, Air Canada had entered into foreign currency forward contracts and option agreements on US$503 million or approximately 31 percent of its projected net 2007 US dollar shortfall with the majority of hedges occurring in the first half of 2007. Based on foreign currency prices at December 31, 2006, the average price of the hedge portfolio is $1.1035. The fair value of the foreign currency contracts as at December 31, 2006 was $25 million in favour of Air Canada ($1 million in favour of third parties as at December 31, 2005 on currency forward contracts and option agreements on US$521 million). These derivative instruments have not been designated as hedges for accounting purposes. The unrealized gain has been recorded in "foreign exchange gain (loss)".

Air Canada has entered into currency swap agreements for 16 Bombardier regional jet operating leases until lease terminations between 2007 and 2011. Currency swaps for five Bombardier regional jet operating leases, with third parties, were put in place on the inception of the leases and have a fair value at December 31, 2006 of $10 million in favour of third parties ($13 million in favour of third parties as at December 31, 2005), taking into account foreign exchange rates in effect at that time. Currency swaps for 11 Bombardier regional jet operating leases with third parties have a fair value as at December 31, 2006 of $3 million in favour of Air Canada ($3 million in favour of Air Canada as at December 31, 2005). These swaps have not been designated as hedges for hedge accounting purposes. The unrealized changes in fair value have been recorded in "foreign exchange gain (loss)".

*Fuel Price Risk Management*
Air Canada enters into contracts with financial intermediaries to manage its exposure to jet fuel price volatility. As at December 31, 2006, Air Canada had collar option and swap structures in place to hedge a portion of its anticipated jet fuel requirements over the 2007 and 2008 period. Since jet fuel is not traded on an organized futures exchange, liquidity for hedging this commodity is mostly limited to a shorter time horizon. Crude oil and heating oil contracts are effective commodities for hedging jet fuel and Air Canada mainly uses these commodities for medium to longer term hedges.

Hedge accounting was applied prospectively from October 1, 2005. Under hedge accounting, gains or losses on fuel hedging contracts are recognized in earnings as a component of aircraft fuel expense when the underlying jet fuel being hedged is consumed. Prior to the commencement of Air Canada's hedge accounting being applied, an unrealized gain of $2 million was recorded in "other" non-operating expense.

In 2006, the Air Canada Services segment recognized a net loss of $43 million as a component of fuel expense on its combined consolidated statement of operations (net loss of $3 million in 2005) on the settlement of matured contracts and amortization of deferred costs. The fair value of Air Canada's fuel hedging contracts as at December 31, 2006 was $24 million (US$21 million) in favour of counterparties ($3 million in favour of the counterparties as at December 31, 2005).

During 2006, Air Canada entered into two three-way collar option structures which are composed of one short put option, one long call option and one short call option. This structure creates a ceiling on the potential benefit to be realized by Air Canada if commodity prices increase above the threshold of the short call strike price. Due to the ceiling in these derivative instruments, this type of derivative does not qualify as a hedging instrument under GAAP. As at December 31, 2006, one of the three-way collar option structures remains outstanding. The fair value of these derivative instruments was $1 million in favour of the counterparty and is recorded in "accounts payable and accrued liabilities" on Air Canada's consolidated statement of financial position.

During 2005, Air Canada de-designated one contract previously under hedge accounting that was combined into a new net-written option. The net-written option has a fair value of less than zero at the time of inception and so it does not qualify as a hedging instrument under GAAP. As at December 31, 2006, the fair value of the net written option was $2 million in favour of the counterparty (less than $1 million in favour of the counterparty as at December 31, 2005) and is recorded in "accounts payable and accrued liabilities" on Air Canada's consolidated statement of financial position.

*Concentration of Credit Risk*

The Corporation does not believe it is subject to any significant concentration of credit risk. Cash and short-term investments are in place with major financial institutions, Canadian governments and major corporations. Accounts receivable are generally the result of sales of tickets to individuals through geographically dispersed travel agents, corporate outlets or other airlines, often through the use of major credit cards.

## 12. Changes in Accounting Policies

On July 6, 2006, the Emerging Issues Committee of the Accounting Standards Board of Canada issued EIC-162 – Stock-based compensation for employees eligible to retire before the vesting date ("EIC-162"). EIC-162 requires that the compensation cost for a stock option award attributable to an employee who is eligible to retire at the grant date be recognized on the grant date, if the employee can retire from the entity at any point and the award's exercisability does not depend on continued service. It further requires that the compensation cost for a stock option award attributable to an employee who will become eligible to retire during the vesting period be recognized over the period from the grant date to the date the employee becomes eligible to retire.

Prior to the adoption of EIC-162, the fair value of stock options granted was recognized as a charge to salaries and wages expense on a straight-line basis over the applicable vesting period, without regard to when an employee was eligible to retire. EIC-162 is applicable to ACE as the terms of ACE's stock option plan specify that upon the retirement of the employee, options granted may be exercised as the rights to exercise accrue.

ACE adopted EIC-162 during 2006 with restatement of prior periods. The impact on ACE's financial statements of adopting EIC-162 is a charge to retained earnings of $16 million as at January 1, 2005 and $13 million as at January 1, 2006, a decrease to salaries, wages and benefits expense of $3 million for the year ended December 31, 2005 offset against Contributed Surplus. The basic and diluted earnings per share increased by $0.03 for the year ended December 31, 2005, as a result of adopting EIC-162.

The fair value of stock options granted to the Corporation's employees is recognized as compensation expense and a credit to contributed surplus within ACE's consolidated financial statements on a straight-line basis over the applicable vesting period. For a stock option award attributable to an employee who is eligible to retire at the grant date, the fair value of the stock option award is expensed on the grant date. For a stock option award attributable to an employee who will become eligible to retire during the vesting period, the fair value of the stock option award is recognized over the period from the grant date to the date the employee becomes eligible to retire. The amount of compensation cost recognized at any date at least equals the value of the vested portion of the options at that date.

## 13. 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 areas that contain critical accounting estimates utilized in the preparation of its financial statements:

### Passenger and Cargo Revenues

Air Canada passenger and cargo advance sales are deferred and included in current liabilities. Advance sales include the proceeds from the sale of flight tickets to Aeroplan which provides loyalty program services to Air Canada and purchase seats from Air Canada under the CPSA. Passenger and cargo revenues are recognized when the transportation is provided, except for revenue on unlimited flight passes which is recognized on a straight-line basis over the period during which the travel pass is valid. Air Canada 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.

Air Canada performs regular evaluations on the deferred revenue 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 that are different from estimates, however, these differences have historically not been material.

### Employee Future Benefits

Air Canada maintains several defined benefit and defined contribution plans providing pension, other retirement and post-employment benefits to its employees, including those employees of Air Canada who are contractually assigned to ACTS and Aeroplan. These employees are members of Air Canada's sponsored defined benefit pension plans and also participate in Air Canada's sponsored health, life and disability future benefit plans. Air Canada's combined consolidated financial statements include all of the assets and liabilities of all the Air Canada sponsored plans.

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

| | December 31, 2006 | December 31, 2005 |
|---|---|---|
| **Weighted average assumptions used to determine accrued benefit obligation** | | |
| Discount rate as at period-end | 5.00% | 5.00% |
| Rate of compensation increase (1) | 2.50% | 4.00% |
| **Weighted average assumptions used to determine pension costs** | | |
| Discount rate as at period-end | 5.00% | 5.75% |
| Expected long-term rate of return on plan assets | 7.50% | 7.50% |
| Rate of compensation increase (2) | 4.00% | 4.00% |

*(1) As a result of the pay awards during 2006, a rate of compensation increase of 1.75 percent was used for the years 2006 to 2008 in determining the net benefit obligation for the pension plan and 2.5 percent for the remaining years.*

*(2) A rate of compensation increase of 0 percent in 2005 and 2 percent in 2006 was used in determining the net benefit pension expense and 4 percent for the remaining years.*

*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*

Air Canada'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 Air Canada, 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 composition of the Domestic Registered Plan assets and the target allocation consists of the following:

| | November 30 2005 | November 30 2006 | Target allocation |
|---|---|---|---|
| Equity | 62.3% | 59.1% | 59.0% |
| Bonds and Mortgages | 32.1% | 34.7% | 41.0% |
| Real Estate | 0.1% | 0.0% | 0.0% |
| Short-term and Other | 5.5% | 6.2% | 0.0% |
| **Total** | **100.0%** | **100.0%** | **100.0%** |

*Domestic Registered Plans*

For the Domestic Registered Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Master Trust Fund (Fund). The investment return objective of the Fund is to achieve a total annualized rate of return that exceeds inflation by at least 3.75 percent over the long term.

In addition to the broad 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 37 percent to 43 percent 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 40 percent of the total return of the Scotia Capital Universe Bond Index and 60 percent of the total return of the Scotia Capital Long Term Bond Index.

Similar investment policies are established for the other pension plans sponsored by Air Canada.

*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 Domestic Registered Plans, the actual 2005 and 2006 contributions are as follows:

| ($ millions) | 2005 Contributions | 2006 Contributions |
|---|---|---|
| Past service cost for registered pension plans | 99 | 224 |
| Current service cost for registered pension plans | 127 | 140 |
| Other pension arrangements (1) | 52 | 83 |
| **Air Canada Services(2)** | **278** | **447** |
| **Jazz** | **6** | **8** |
| **Consolidated total** | **284** | **455** |

*(1) Other pension arrangements include retirement compensation arrangements, supplemental plans and international plans.*

*(2) Includes obligations relating to employees who have been assigned to related parties.*

*Sensitivity Analysis*

Sensitivity analysis on the 2006 pension expense based on different actuarial assumptions with respect to discount rate and expected return on plan assets is as follows:

| | 0.25 percentage point | |
|---|---|---|
| **Impact on 2006 pension expense in $ millions** | **Decrease** | **Increase** |
| Discount rate on obligation assumption | 29 | (19) |
| Long-term rate of return on plan assets assumption | 25 | (25) |

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 9.75 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 2006 (10 percent was assumed for 2005). The rate is assumed to decrease gradually to 5 percent 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 $17 million. A one percentage point decrease in assumed health care trend rates would have decreased the service and interest costs by $1 million and the obligation by $16 million.

## 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 income tax consequences attributable to differences between the financial statement carrying value amount and the tax basis of assets and liabilities. Management uses judgement and estimates in determining the appropriate rates and amounts in recording future taxes, giving consideration to timing and probability. Actual taxes could significantly vary from these estimates as a result of future events, including changes in income tax law or the outcome of reviews by tax authorities and related appeals. The resolution of these uncertainties and the associated final taxes may result in adjustment to the Corporation's tax assets and tax liabilities.

Future income tax assets are recognized to the extent that realization is considered more likely than not. The Corporation considers past results, current trends and outlooks for future years in assessing realization of income tax assets. In 2006, the Corporation has determined that it is more likely than not that $575 million of future income tax assets will be realized through a combination of future reversals of temporary differences and taxable income. A change in assessment of these factors could affect the future tax asset. Refer to Note 8 to ACE's consolidated financial statements for additional information.

### Impairment of Long-Lived Assets

Long-lived assets are tested for impairment whenever circumstances indicate that the carrying value may not be recoverable. When events or circumstances indicate that the carrying value of long-lived assets, other than indefinite life intangibles, are not recoverable, the long-lived assets are tested for impairment by comparing the estimate of future expected cash flows to the carrying amount of the assets or groups of assets. If the carrying value of long-lived assets 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.

### 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. On the application of fresh start accounting effective September 30, 2004, the cost of the Corporation's property and equipment was adjusted to fair value. In addition, the estimated useful lives of certain assets were adjusted, including buildings where useful lives were extended to periods not exceeding 50 years.

Property and equipment are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Property and equipment under capital leases and variable interest entities are depreciated to estimated residual values over the life of the lease. The Corporation's aircraft and flight equipment are depreciated over 20 to 30 years, with 10 to 20 percent estimated residual values. Aircraft reconfiguration costs are amortized over 3 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 40 to 50 years on a straight line basis. 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 5 years. Ground and other equipment is depreciated over 3 to 25 years.

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 the Corporation's historical experience with regard to the sale of aircraft and spare parts, as well as forward-looking valuations prepared by independent third parties.

### Intangible Assets

The identifiable intangible assets of the Corporation were recorded at their estimated fair values at September 30, 2004. Indefinite-life intangible assets are subject to impairment tests under Canadian GAAP on an annual basis or when events or circumstances indicate a potential impairment. If the carrying value of such assets exceeds the fair values, the assets are written down to fair value.

Fair value 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". Assessing the fair value of intangible assets requires significant management estimates on future cash flows to be generated by the assets, including the estimated useful life of the assets.

**Loyalty Program**

The Corporation's loyalty program, Aeroplan, awards mileage credits 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.

Based on historical experience and current program policies, the Corporation estimates the percentage of miles that are not expected to be redeemed, defined as breakage. Breakage is estimated by the Corporation based on the terms and conditions of membership and historical accumulation and redemption patterns as adjusted for changes to any terms and conditions that affect members' redemption practices. The estimated breakage factor is 17 percent. Changes in the breakage factor are accounted for as follows: in the period of change, the deferred revenue balance is adjusted as if the revised estimate had been used in prior periods with the offsetting amount recorded as an adjustment to "other" revenue; and for subsequent periods, the revised estimate is used. The amount allocated to breakage is recognized in "other" revenue on a straight-line basis over a period of 30 months, which is the estimated average life of a mile.

The current portion of Aeroplan loyalty program deferred revenues of $857 million (2005 – $680 million) 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 Aeroplan deferred revenues.

At December 31, 2006, the Corporation's estimated outstanding number of miles was approximately 190 billion, as compared to 183 billion at the end of the prior year. Management has recorded a liability of $1,763 million for the estimated number of miles expected to be redeemed and the unamortized portion of breakage. 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 2006, 58 billion miles (2005 – 52 billion) were redeemed principally for travel. These redemptions represented approximately 10 percent of Air Canada's total revenue passenger miles in 2006 (2005 - 10 percent). Inventory controls over seat allocations keeps displacement of revenue passengers to a minimum. Total miles redeemed for travel on Air Canada in 2006, including awards and upgrades, represented 73 percent of the total miles redeemed, of which 63 percent were used for travel within the US and Canada. In addition to the awards issued for travel on Air Canada, approximately 18 percent of the total miles redeemed in 2006 were used for travel on partner airlines and 10 percent 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.

## 14. Risk Factors

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

## Risks Related to ACE

*Reliance on Key Personnel*

The success of ACE depends on the abilities, experience, industry knowledge and personal efforts of senior management of ACE. The loss of the services of such key personnel could have a material adverse effect on the business, financial condition or future prospects of ACE. In addition, ACE may not be able to attract and retain additional qualified management as needed in the future.

*Proposed Changes to the Canadian Federal Income Tax Treatment of Income Trusts*

On October 31, 2006, the Minister of Finance (Canada) announced new tax proposals concerning the taxation of income trusts and other flow-through entities and tabled a Notice of ways and means motion to amend the Tax Act in that regard (the "October Proposal"). The October Proposal was followed on December 21, 2006 by the release of draft legislation by the Department of Finance (Canada) (the "draft legislation" and, together with the October Proposal, the "2006 Proposed Amendments") concerning the distribution tax on income trusts and partnerships. The 2006 Proposed Amendments, if enacted as currently drafted, will subject Aeroplan Income Fund and Jazz Air Income Fund to trust level taxation as of January 1, 2011, which will reduce the amount of cash available for distributions by income trusts. Loss of the benefit of the deferred application of the new tax regime until 2011 could have a material adverse effect on the value of ACE's interest in Aeroplan and Jazz.

*Dependence upon Principal Investments*

ACE is an investment holding company of various aviation interests and most of ACE's assets are its ownership interest in Air Canada, Aeroplan, Jazz and ACTS. ACE's cash flows and ability to distribute earnings to its shareholders are dependent upon the ability of these entities to pay dividends or distributions to ACE.

The ability of these entities to pay dividends or distributions will be dependent upon their operating performance and profitability, and will be subject to applicable laws and regulations and contractual restrictions that may be contained in the instruments governing any indebtedness of those entities. Each of these separate legal entities has no legal obligation to pay dividends or distributions to ACE.

## Risks Related to the ACE Segments

### *Air Canada Services*

*Operating Results*

In the recent past, Air Canada has sustained significant operating losses and may sustain significant losses in the future. On September 30, 2004, Air Canada and certain of its subsidiaries emerged from protection under the CCAA and implemented the plan of arrangement. For the years ended December 31, 2003, 2002 and 2001, Air Canada incurred operating losses before reorganization and restructuring items and non-recurring labour expenses of $684 million, $192 million and $731 million, respectively. For the nine-month period ended September 30, 2004, Air Canada realized operating income before reorganization and restructuring items of $120 million and, for the three-month period ended December 31, 2004, Air Canada incurred an operating loss of $59 million. For the years ended December 31, 2006 and 2005, Air Canada realized operating income of $259 million and $318 million, respectively. Prior to September 30, 2004, the operations of Air Canada included the operations of various entities included in the Air Canada Services segment, as well as those of Jazz, Aeroplan and ACTS and, as such, those prior results may not be comparable. Despite Air Canada's emergence from creditor protection under the CCAA, the resulting and ongoing business initiatives and efforts at cost reductions and its recent results, Air Canada may not be able to successfully achieve planned business initiatives and cost reductions, including those which seek to offset significant fuel and other expenses or restore positive net profitability and may sustain significant losses in the future

*Leverage and Liquidity*

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

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

*Need for Additional Capital*

Air Canada faces a number of challenges in its current business operations, including high fuel prices and increased competition from international, transborder and low-cost domestic carriers. In order to meet such challenges and to support Air Canada's business strategy, significant operating and capital expenditures are, and may in the future be, required. There can be no assurance that Air Canada will continue to be able to obtain on a timely basis sufficient funds on terms acceptable to Air Canada to provide adequate liquidity and to finance the operating and capital expenditures necessary to support its business strategy if cash flows from operations and cash on hand are insufficient.

Failure to generate additional funds, whether from operations or additional debt or equity financings, may require Air Canada to delay or abandon some or all of its anticipated expenditures or to modify its business strategy, which could have a material adverse effect on Air Canada'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 Air Canada.

In addition, Air Canada's credit ratings influence its ability to access capital markets. There can be no assurance that Air Canada's credit ratings will not be downgraded, which would add to Air Canada'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 Air Canada's business, results from operations and financial condition.

*Limitations Due to Restrictive Covenants*

Some of the financing and other major agreements of Air Canada contain restrictive covenants which affect and, in some cases, significantly limit or prohibit, among other things, the manner in which Air Canada may structure or operate its business, including by limiting Air Canada's ability to incur indebtedness, create liens, sell assets, make capital expenditures and engage in acquisitions, mergers or restructurings. In addition, certain financing arrangements require Air Canada to maintain financial ratios. Any future borrowings may also be subject to similar covenants which limit Air Canada's operating and financial flexibility, which could have a material adverse effect on Air Canada's profitability.

A failure by Air Canada to comply with its contractual obligations (including restrictive covenants), or to pay its indebtedness and fixed costs could result in a variety of material adverse consequences, including the acceleration of its indebtedness, the withholding of credit card proceeds by the credit card service providers and the exercise of remedies by its creditors and lessors, and such defaults could trigger additional defaults under other indebtedness or agreements. In such a situation, it is unlikely that Air Canada would be able to repay the accelerated indebtedness or fulfill its obligations under certain contracts, make required lease payments or otherwise cover its fixed costs. Also, the lenders under the financing arrangements could foreclose upon all or substantially all of the assets of Air Canada which secure Air Canada's obligations.

*Fuel Costs*

Fuel costs constituted the largest percentage of the total operating costs of Air Canada in 2006. Fuel prices fluctuate widely depending on many factors including international market conditions, geopolitical events and the Canada/U.S. dollar exchange rate. Air Canada cannot accurately predict fuel prices. During 2004, 2005 and 2006, fuel prices increased and fluctuated near or at historically high levels. Should fuel prices continue at, or continue to increase above, such high levels, fuel costs could have a material adverse effect on Air Canada's business, results from operations and financial condition. Due to the competitive nature of the airline industry, Air Canada may not be able to pass on increases in fuel prices to its customers by increasing its fares. Based on 2006 volumes, Management estimates that a US$1 per barrel movement in the average price of West Texas Intermediate crude oil would have resulted in an approximate C$27 million change in 2006 fuel expense for Air Canada (excluding any impact of fuel surcharges and fuel hedging), 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.

*Labour Costs and Labour Relations*

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

Most of Air Canada's employees are unionized and long-term collective agreements were concluded in 2003 and 2004. No strikes or lock-outs may lawfully occur during the term of the collective agreements expiring in 2009. However, there can be no assurance that there will not be a labour conflict that could lead to an interruption or stoppage in Air Canada's service or otherwise adversely affect the ability of Air Canada to conduct its operations, all of which could have a material adverse effect on its business, results from operations and financial condition.

If there is a labour disruption or work stoppage by any of the unionized work groups of Jazz, there could also likely be a material adverse effect on Air Canada's business, results from operations and financial condition. In addition, labour problems at Air Canada's Star Alliance® partners could result in lower demand for connecting traffic with Air Canada and, ultimately, could have a material adverse effect on Air Canada's business, results from operations and financial condition.

*Airport User Fees and Air Navigation Fees*

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

*Competition*

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

Canadian low-cost carriers have entered or announced their intention to compete in many of Air Canada's key domestic markets and have also entered the U.S. transborder market. U.S. carriers currently operate routes in Air Canada's transborder market. Air Canada is also facing increasing competition in international markets as carriers increase their international capacity, both by expansion and by shifting existing domestic capacity to international operations to avoid low-cost domestic competition.

If Canadian low-cost carriers are successful in entering or continuing their expansion into the domestic and the U.S. transborder markets, if U.S. carriers were to enter Air Canada's transborder market or if carriers are successful in their expansion in international markets of Air Canada, Air Canada's business, results from operations and financial condition could be materially adversely affected.

Air Canada 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 Air Canada's 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 Air Canada's business, results from operations and financial condition. Furthermore, Air Canada's ability to reduce its fares in order to effectively compete with other carriers may be limited by government policies to encourage competition.

Internet travel websites have enabled consumers to more efficiently find lower fare alternatives by providing them with access to more pricing information. The increased price awareness 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.

In addition, consolidation in the airline industry could result in increased competition as some airlines emerging from such consolidations may be able to compete more effectively against Air Canada which could have a material adverse effect on Air Canada's business, results from operations and financial condition.

*Strategic, Business, Technology and Other Important Initiatives*

In order to operate its business, achieve its goals and remain competitive, Air Canada continuously seeks to identify and devise, invest in and implement strategic, business, technology and other important initiatives, such as those relating to the aircraft fleet restructuring program, the aircraft refurbishment program, the new revenue model, the reservation and airport customer service initiative (which will also support the revenue model), the business process initiatives as well as other initiatives. These initiatives, including activities relating to their development and implementation, may be adversely impacted by a wide range of factors, many of which are beyond Air Canada's control. Such factors include the performance of third parties, including suppliers, the implementation and integration of such initiatives into Air Canada's other activities and processes as well as the adoption and acceptance of initiatives by Air Canada's customers, suppliers and personnel. A delay or failure to sufficiently and successfully identify and devise, invest in or implement these initiatives could adversely affect Air Canada's ability to operate its business, achieve its goals and remain competitive and could have a material adverse effect on Air Canada's business, results from operations and financial condition.

For instance, a key component of Air Canada's business plan is the restructuring of its aircraft fleet, including the elimination and replacement of older, less efficient aircraft, the introduction of new regional jet aircraft, and the modernization of its international wide-body fleet through the acquisition of new and more efficient aircraft. A delay or failure in the completion of Air Canada's fleet restructuring, including a delay by the manufacturers in the delivery of the regional jet or wide-body aircraft, or an inability to remove, as planned, certain aircraft from the fleet in coordination with the planned entry into service of new aircraft, could adversely affect the implementation of Air Canada's business plan which may, in turn, have a material adverse effect on Air Canada's business, results from operations and financial condition.

Another important component of Air Canada's business plan is the replacement of its legacy systems for passenger reservation and airport customer service with a newly developed web-enabled system in order to support the rapid and efficient implementation of Air Canada's revenue model. The new system is expected to be deployed in phases from late 2007 to early 2008. A delay or failure in the implementation of Air Canada's new system could adversely affect the implementation of Air Canada's business plan which may, in turn, have a material adverse effect on Air Canada's business, results from operations and financial condition.

*Dependence on Technology*

Air Canada relies on technology, including computer and telecommunications equipment and software and Internet-based systems, to operate its business, increase its revenues and reduce its costs. These systems include those relating to Air Canada's telecommunications, websites, computerized airline reservations and airport customer services and flight operations.

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

*Key Supplies and Suppliers*

Air Canada is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and services in a timely manner, including those required for Air Canada's operations such as fuel, aircraft and related parts and aircraft and engine maintenance services (including maintenance services obtained from ACTS). In certain cases, such goods and services may only be available from a limited number of suppliers. Such failure, refusal or inability may arise as a result of a wide range of causes, many of which are beyond Air Canada's control. Any failure or inability of Air Canada to successfully source goods and services, including by reason of a failure, refusal or inability of a supplier, or to source goods and services on terms and pricing and within the timeframes acceptable to Air Canada, could have a material adverse effect on Air Canada's business, results from operations and financial condition.

*Aeroplan*

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

*Jazz*

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

*Pension Plans*

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

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 the Office of the Superintendent of Financial Institutions agreed on a protocol pursuant to which the solvency funding requirements for Air Canada's registered pension plans provided for in the then existing regulations were amended retroactive to January 1, 2004. Air Canada is required 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. Underfunded pension plans or a failure or inability by Air Canada to make required cash contributions to its registered pension plans could have a material adverse effect on Air Canada's business, results from operations and financial condition.

*Equal Pay Litigation*

CUPE, which represents Air Canada’s flight attendants, has two complaints before the Canadian Human Rights Commission where it alleges gender-based wage discrimination. CUPE claims the predominantly female flight attendant group should be paid the same as the predominantly male pilot and mechanics groups because their work is of equal value. The complaints date from 1991 and 1992 but have not been investigated on the merits because of a legal dispute over whether the three groups work in the same "establishment" within the meaning of the Canadian Human Rights Act. On January 26, 2006, the Supreme Court of Canada ruled that they do work in the same "establishment" and sent the case back to the Canadian Human Rights Commission, which may now proceed to assess the merits of CUPE's complaints.

As part of the restructuring under the CCAA, it was agreed that any resolution of the complaints would have no retroactive financial impact prior to September 30, 2004. It is the view of Air Canada that any investigation will show that Air Canada has complied and continues to comply with the equal pay provisions of the Canadian Human Rights Act. Nonetheless, should these complaints succeed, the accrued liability and future costs could be very significant and Air Canada'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 Star Alliance® or otherwise fail to meet its obligations thereunder, Air Canada's business, results from operations and financial condition could be materially adversely affected.

*Interruptions or Disruptions in Service*

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

*Foreign Exchange*

Air Canada's financial results are sensitive to the changing value of the Canadian dollar. In particular, Air Canada has a significant annual net outflow of U.S. dollars and is affected by fluctuations in the Canada/U.S. dollar exchange rate. Management estimates that during 2006, a $0.01 increase in the Canada/U.S. dollar exchange rate (i.e., $1.13 to $1.14 per U.S. dollar) would have had an estimated $16 million unfavourable impact on operating income and an estimated $48 million unfavourable impact on pre-tax income. Conversely, an opposite change in the exchange rate would have had the opposite effect on operating income. Air Canada incurs significant expenses in U.S. 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 U.S. dollar would increase the costs of Air Canada relative to its U.S. competitors and could have a material adverse effect on Air Canada's business, results from operations and financial condition. In addition, Air Canada may be unable to appropriately hedge the risks associated with fluctuations in exchange rates.

*Current Legal Proceedings*

The European Commission, the United States Department of Justice and the Competition Bureau in Canada, among other competition authorities, are investigating alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including Air Canada. Competition authorities have sought or requested information from Air Canada as part of their investigations. Air Canada is cooperating fully with these investigations. Air Canada is also 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 at this time to predict with any degree of certainty the outcome of these proceedings. It is Air Canada's policy to conduct its business in full compliance with all applicable competition laws.

In October 2006, ACPA commenced proceedings before the Ontario Superior Court of Justice against Air Canada, ACE and certain members of the board of directors of Air Canada alleging that certain past and future actions are oppressive to them. A variety of remedies were sought against the parties including an injunction to impose, among other things, limits on corporate distributions including those contemplated under the ACE plan of arrangement which became effective on October 10, 2006. Following a hearing in December, 2006, Mr. Justice Cumming of the Ontario Superior Court of Justice dismissed ACPA's application for an injunction and granted the Corporation's motion to dismiss ACPA's claim. ACPA has not appealed the dismissal of the injunction application but has appealed the order dismissing its claim.

***Aeroplan***

*Dependency on Top Three Partners*

Aeroplan's top three commercial partners were responsible for 91 percent of Gross Billings for the year ended 2006. A decrease in sales of Aeroplan miles to any of Aeroplan's significant partners for any reason, including a decrease in pricing or activity, or a decision to either utilize another service provider or to no longer outsource some or all of the services Aeroplan provides could have a material adverse effect on gross billings. Subject to the minimum number of Aeroplan miles to be purchased by Air Canada under the CPSA, Air Canada can change the number of Aeroplan miles awarded per flight without Aeroplan's consent, which could result in a significant reduction in gross billings. Aeroplan cannot ensure that its contracts with these, or other, partners will be renewed on similar terms, or at all when they expire.

*Reduction in Activity Usage and Accumulation of Aeroplan Miles*

A decrease in gross billings from any of Aeroplan's partners for any reason, including a decrease in pricing or activity, or a decision to either utilize another service provider or to no longer outsource some or all of the services Aeroplan provides, or a decrease in the accumulation of Aeroplan Miles by members could have a material adverse effect on Aeroplan's gross billings and revenue.

*Greater than Expected Redemptions for Rewards*

A significant portion of Aeroplan's profitability is based on its estimate of the number of Aeroplan Miles that will never be redeemed by the member base. The percentage of Aeroplan Miles that are not expected to be redeemed is known as "Breakage" in the loyalty industry. Aeroplan's current estimate of Breakage is based on two independent studies conducted in 2006 on behalf of Aeroplan. Breakage may decrease from the current estimate of 17 percent as the Aeroplan program grows and a greater diversity of rewards become available. If actual redemptions are greater than Aeroplan's current estimates, its profitability could be adversely affected due to the cost of the excess redemptions. Furthermore, the actual mix of redemptions between air and non-air rewards could adversely affect Aeroplan's profitability. Total “Broken” Miles still outstanding, amounted to 70.0 billion miles as at December 31, 2006 and include 46.7 billion Aeroplan Miles. Responsibility to provide rewards for these 70.0 billion Aeroplan Miles rests with Aeroplan should such Aeroplan Miles ever be redeemed. There can be no assurances that a material portion of these estimated Broken Aeroplan Miles will not be redeemed.

*Labour Relations*

Call centre agents are currently covered by a collective agreement between the National Automobile, Aerospace, Transportation and General Workers' Union of Canada (“CAW”) and Air Canada in place until 2009. While Aeroplan enjoys positive employee relations with the unionized call centre agents, if Air Canada faces labour disturbances resulting in work stoppages or other action instigated from within the larger bargaining unit, this could have a material adverse effect on Aeroplan's business. Furthermore, if at the expiration of the applicable collective agreement, the relevant parties are unable to renegotiate the collective agreement with the CAW, it could result in work stoppages and other labour disturbances which would similarly have a material adverse effect on Aeroplan's business. In addition, if the general services agreement between Aeroplan and Air Canada is terminated by Air Canada, it could have a material adverse effect on Aeroplan's business in the event that Aeroplan is unable to hire a sufficient number of call centre agents during the six month termination period under the agreement.

*Technological Disruptions and Inability to use Third Party Software*

Aeroplan's ability to protect its data and call centres against damage from fire, power loss, telecommunications failure and other disasters is critical. In order to provide many of its services, Aeroplan must be able to store, retrieve, process and manage large databases and periodically expand and upgrade its capabilities. While Aeroplan 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 damage to Aeroplan's data and call centres, any failure of Aeroplan's telecommunication links that interrupts its operations or any impairment of Aeroplan's ability to use software licensed to it could adversely affect its ability to meet Aeroplan's partners' and members' needs and their confidence in utilizing Aeroplan in the future.

In addition, proper implementation and operation of technology initiatives is fundamental to Aeroplan's ability to operate a profitable business. Aeroplan continuously invests in new technology initiatives to remain competitive, and its continued ability to invest sufficient amounts to enhance technology will affect Aeroplan's ability to operate successfully. An inability to invest in technological initiatives would have a material adverse effect on Aeroplan's business, results from operations and financial condition.

*Leverage and Restrictive Covenants in Current and Future Indebtedness*

The ability of Aeroplan Income Fund, Aeroplan Trust and Aeroplan to make distributions, pay dividends or make other payments or advances will be subject to applicable laws and contractual restrictions contained in the instruments governing any indebtedness of Aeroplan Trust and/or Aeroplan (including Aeroplan's credit facilities). The degree to which Aeroplan is leveraged could have important consequences to the holders of units of Aeroplan Income Fund, including: (i) that Aeroplan's ability to obtain additional financing for working capital, capital expenditures or acquisitions in the future may be limited; (ii) that a significant portion of Aeroplan's cash flow from operations may be dedicated to the payment of the principal of and interest on its indebtedness, thereby reducing funds available for future operations; (iii) that certain of Aeroplan's borrowings will be at variable rates of interest, which exposes Aeroplan to the risk of increased interest rates; and (iv) that Aeroplan may be more vulnerable to economic downturns and be limited in its ability to withstand competitive pressures. These factors may increase the sensitivity of distributable cash to interest rate variations.

In addition, Aeroplan's credit facilities contain a number of financial and other restrictive covenants that require Aeroplan to meet certain financial ratios and financial condition tests and limit Aeroplan’s ability to enter into certain transactions. A failure to comply with the obligations in Aeroplan's credit facilities could result in a default which, if not cured or waived, could result in a termination of distributions by Aeroplan and permit acceleration of the relevant indebtedness. If the indebtedness under Aeroplan's credit facilities, including any possible hedge contracts with the lenders, were to be accelerated, there can be no assurance that the assets of Aeroplan would be sufficient to repay in full that indebtedness.

Aeroplan may need to refinance its available credit facilities or other debt and there can be no assurance that Aeroplan will be able to do so or be able to do so on terms as favourable as those presently in place. If Aeroplan is unable to refinance these credit facilities or other debt, or is only able to refinance these credit facilities or other debt on less favourable and/or more restrictive terms, this may have a material adverse effect on Aeroplan's financial position, which may result in a reduction or suspension of cash distributions to unitholders of Aeroplan Income Fund. In addition, the terms of any new credit facility or debt may be less favourable or more restrictive than the terms of the existing credit facilities or other debt, which may indirectly limit or negatively impact the ability of Aeroplan Income Fund to pay cash distributions.

*Economic Downturn*

Aeroplan derives its revenues principally from the sale of Aeroplan Miles to its partners which is, ultimately dependant on consumer spending. Cyclical deviations in the economy, a prolonged recession or an increase in interest rates could have a material adverse effect on members spending with Aeroplan partners or the use of credit or charge cards. This could decrease Aeroplan's attractiveness to its commercial partners and their participation in the Aeroplan program. These factors, individually or in combination, could have a material adverse effect on Aeroplan's business, results from operations and financial condition.

*Cash Distributions Are Not Guaranteed and Will Fluctuate with the Business Performance*

Although Aeroplan Income Fund intends to distribute cash distributions received in respect of Aeroplan Trust units, less expenses and amounts, if any, paid by Aeroplan Income Fund in connection with the redemption of units, there can be no assurance regarding the amounts of income to be generated by Aeroplan's business or ultimately distributed to Aeroplan Income Fund. The actual amount distributed in respect of units is not guaranteed and will depend upon numerous factors, including Aeroplan's profitability and its ability to sustain EBITDA margins and the fluctuations in Aeroplan's working capital and capital expenditures, all of which are susceptible to a number of risks.

*Restrictions on Certain Unitholders and Liquidity of Units*

The declaration of trust of Aeroplan Income Fund imposes various restrictions on unitholders. Non-resident unitholders are prohibited from beneficially owning more than 49.9 percent of the units of Aeroplan Income Fund. These restrictions may limit (or inhibit the exercise of) the rights of certain unitholders, including non-residents of Canada and U.S. persons, to acquire units, to exercise their rights as unitholders and to initiate and complete take-over bids in respect of the units. As a result, these restrictions may limit the demand for units of Aeroplan Income Fund from certain unitholders and thereby adversely affect the liquidity and market value of the units of Aeroplan Income Fund held by the public.

***Jazz***

Many of the risk factors in the nature of those described under "Risk Factors – Risks related to the ACE Segments – Air Canada Services" and " – Risks Related to the Airline Industry" could have a material adverse effect on Jazz's business, results from operations and financial condition. In addition to those risk factors, the following risk factors could also have a material adverse effect on Jazz's business, results from operations and financial condition.

*Dependence on Air Canada*

Jazz is directly affected by the financial and operational strength of Air Canada and its competitive position. In the event of any decrease in the financial or operational strength of Air Canada, Jazz's ability to receive payments from Air Canada, and the amount of such payments, may be adversely affected.

Air Canada is the sole marketing agent for Jazz's aircraft capacity covered by the Jazz CPA (the "Covered Aircraft") and is solely responsible for establishing schedule, routes, frequency and ticket prices for Jazz. To the extent Air Canada does not effectively and competitively market the routes serviced through Jazz, the utilization of the Covered Aircraft could be reduced with the result that Jazz's operating margin in dollar terms would be reduced.

*Termination of the Jazz CPA*

Substantially all of Jazz's current revenues are received pursuant to the Jazz CPA with Air Canada which currently covers all of Jazz's existing operating fleet (except two Dash 8 aircraft). The Jazz CPA will terminate on December 31, 2015 and is subject to renewal on terms to be negotiated for two additional periods of five years unless either party terminates the agreement by providing a notice not less than one year prior to December 31, 2015 or the end of the first renewal term. In addition, either party is entitled to terminate the Jazz CPA at any time upon the occurrence of certain events of default.

If the Jazz CPA is terminated, Jazz's revenue and earnings would be significantly reduced or eliminated unless Jazz is able to enter into satisfactory substitute arrangements. There is no assurance that Jazz would be able to enter into satisfactory substitute arrangements or that such arrangements would be as favourable to Jazz as the Jazz CPA.

*Labour Costs and Labour Relations*

Labour costs constitute the largest percentage of Jazz's total operating costs that are borne by Jazz. There can be no assurance that the estimates of Jazz's future labour costs will be accurate. If such costs exceed Jazz's estimates, Jazz may realize decreased profits or even losses under the Jazz CPA. Most of Jazz's employees are unionized and new or modified collective bargaining agreements were concluded in 2003 and 2004. No strikes or lock-outs may lawfully occur until after the agreements expire in 2009. However, there can be no assurance that there will not be a labour conflict that could lead to an interruption or stoppage in Jazz's service. Any labour disruption or work stoppage could adversely affect the ability of Jazz to conduct its operations and have a material adverse effect on its ability to carry out its obligations under the Jazz CPA and on its business, results from operations and financial condition. There can be no assurance that future agreements with employees' unions will be on terms in line with Jazz's expectations or comparable to agreements entered into by other regional airlines, and any future agreements may increase labour costs or otherwise adversely affect Jazz.

If there is a labour disruption or work stoppage by any unionized work group of Air Canada which provides services to Jazz under the Jazz CPA, Jazz may lose access to such services and there can be no reassurance that sufficient replacement services could be obtained or that replacement services could be obtained on a cost effective basis.

*Impact of Competition on Air Canada's Need to Utilize Jazz's Services*

The airline industry is highly competitive. Air Canada competes with other major carriers as well as low cost carriers on its routes, including routes that Jazz flies. Competitors could rapidly enter markets Jazz serves for Air Canada, and quickly discount fares, which could lessen the economic benefit of Jazz's regional jet operations to Air Canada.

*Impact of Increased Competition in the Regional Airline Industry on Jazz's Growth Opportunities*

Aside from the limitations under the Jazz CPA and the regulatory prohibition on cabotage, Jazz's ability to provide regional air service to a major United States airline is limited by existing relationships that all of the United States network airlines have with other regional operators. Additionally, most of the network airlines are subject to scope clause restrictions under their collective bargaining agreements with employees that restrict their ability to add new regional jet capacity.

In addition, new competitors may enter the regional airline industry. Such new or existing competitors may enter into capacity purchase agreements with airlines, including Air Canada, in respect of routes currently operated by Jazz. Capacity growth by other regional airlines in the regional jet market would lead to significantly greater competition and may result in lower rates of return in the regional airline industry. Further, many of the network airlines are focused on reducing costs, which may also result in lower operating margins in the regional airline industry.

*Cash Distributions are not Guaranteed and will Fluctuate with the Business Performance*

Although Jazz Air Income Fund intends to distribute the interest received in respect of the Jazz Air Trust trust notes and the cash distributions received in respect of the Jazz Air Trust trust units, less expenses and amounts, if any, paid by Jazz Air Income Fund in connection with the redemption of units of Jazz Air Income Fund, there can be no assurance regarding the amounts of income to be generated by Jazz's business or ultimately distributed to Jazz Air Income Fund. The actual amount distributed in respect of the units of Jazz Air Income Fund is not guaranteed and depends upon numerous factors, including Jazz's profitability and its ability to sustain EBITDA and the fluctuations in Jazz's working capital and capital expenditures, all of which are susceptible to a number of risks.

*Restrictions on Certain Unitholders and Liquidity of Units*

The declaration of trust of Jazz Air Income Fund imposes various restrictions on unitholders of Jazz Air Income Fund. Non-resident unitholders are prohibited from beneficially owning more than 49.9 percent of the units of Jazz Air Income Fund. In addition, the voting rights of non-resident unitholders are limited to 25 percent of the aggregate number of outstanding votes attaching to all outstanding units and 25 percent of the aggregate number of votes that may be cast at any meeting of the unitholders. These restrictions may limit (or inhibit the exercise of) the rights of certain unitholders of Jazz Air Income Fund, including non-residents of Canada and United States persons, to acquire units of Jazz Air Income Fund, to exercise their rights as unitholders and to initiate and complete take-over bids in respect of the units. As a result, these restrictions may limit the demand for units of Jazz Air Income Fund from certain investors and thereby adversely affect the liquidity and market value of the units of Jazz Air Income Fund held by the public.

***ACTS***

*Dependency on Air Canada and other Significant Customers*

For the year ended December 31, 2006, Air Canada was responsible for approximately 69 percent of ACTS' revenues. A significant decrease in revenues generated from Air Canada or from any of ACTS' other major customers for any reason, including a decrease in activity, or a decision to either utilize another service provider could have a material adverse effect on ACTS' revenues. ACTS cannot ensure that it contracts with Air Canada and other significant customers will be renewed on similar terms, or at all when they expire.

ACTS is directly affected by the financial and operational strength of its major customers, including Air Canada and their competitive position. In the event of any decrease in the financial or operational strength of these customers, ACTS' ability to receive payments from customers, and the amount of such payments, could be adversely affected.

*Dependency on the Airline Industry*

ACTS' business is highly dependent on the performance of the airline industry. Economic and regulatory factors and passenger security concerns that affect the airline industry also impact ACTS' business. Many of the risk factors in the nature of those described under "Risk Factors – Risks Related to the Airline Industry" could result in lower demand for ACTS' products and services and, as a result, could have a material adverse effect on ACTS' business, results from operations and financial condition.

*Key Supplies and Suppliers*

ACTS is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods in a timely manner, including aircraft, aircraft engine and other related parts. Such goods may only be available from a limited number of suppliers. Such failure, refusal or inability may arise as a result of a wide range of causes, many of which are beyond ACTS' control. Any failure or inability of ACTS to successfully source goods, including by reason of a failure, refusal or inability of a supplier, or to source goods on terms and pricing and within the timeframes acceptable to ACTS, could have a material adverse effect on ACTS' business, results from operations and financial condition.

*Labour Relations*

Most of the non-management personnel of ACTS are currently covered by a collective agreement between the International Association of Machinists and Aerospace Workers ("IAMAW") and Air Canada in place until 2009. While ACTS enjoys positive employee relations, if Air Canada faces labour disturbances resulting in work stoppages or other action instigated from within the larger bargaining unit, this could have a material adverse effect on ACTS' business. Furthermore, if at the expiration of the applicable collective agreement, the relevant parties are unable to renegotiate the collective agreement with the IAMAW, it could result in work stoppages and other labour disturbances which would similarly have a material adverse effect on ACTS' business. In addition, if the general services agreements between ACTS and Air Canada are terminated by Air Canada, it could have a material adverse effect on ACTS' business in the event that ACTS is unable to hire a sufficient number of employees prior to the termination of the agreements.

*Highly Regulated Industry*

ACTS operates in a highly regulated industry. Governmental agencies throughout the world regulate the manufacture, repair and overhaul of aircraft and related parts and accessories. Regulatory authorities monitoring the ACTS' business include Transport Canada, the Federal Aviation Authority in the U.S., and the European Aviation Safety Agency. Regulatory authorities perform regular compliance audits, including to ensure that all ACTS' technical and administrative processes, procedures, equipment and facilities are being maintained within the regulatory requirements. New and more stringent regulatory requirements, if adopted and enacted, could have a material adverse effect on ACTS' business, financial condition and results of operations.

In addition, ACTS' repair and overhaul operations are subject to certification, including pursuant to regulations established by Transport Canada and the Federal Aviation Authority. Specific regulations vary from country to country, although compliance with Transport Canada and Federal Aviation Authority requirements generally satisfies regulatory requirements in other countries. Any failure to comply with regulatory requirements or maintain the necessary regulatory approvals or any other of ACTS' material authorizations or approvals could have a material adverse effect on ACTS' business, financial condition and results of operations.

## Risks Related to the Airline Industry

*Airline Reorganizations*

Since September 11, 2001, a number of U.S. air carriers have sought to reorganize under Chapter 11 of the United States Bankruptcy Code or outside the scope of formal reorganization proceedings. Successful completion of such reorganizations could present Air Canada with competitors having reduced levels of indebtedness and significantly lower operating costs derived from labour, supply and financing contracts renegotiated under the protections of the United States Bankruptcy Code or outside the scope of formal reorganization proceedings. In addition, certain air carriers, including those involved in reorganizations, may undertake substantial fare discounting in order to maintain cash flows and to enhance continued customer loyalty. Such fare discounting could result in lower yields for Air Canada which, in turn, could have a material adverse effect on Air Canada's business, results from operations and financial condition.

*Economic and Geopolitical Conditions*

Airline operating results are sensitive to economic and geopolitical conditions which can 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. Air Canada is not able to predict with certainty market conditions and the fares that Air Canada may be able to charge. Customer expectations can change rapidly and the demand for lower fares may limit revenue opportunities. Travel, especially leisure travel, is a discretionary consumer expense. A downturn in economic growth in North America, as well as geopolitical instability in various areas of the world, could have the effect of reducing demand for air travel in Canada and abroad and, together with the other factors discussed herein, could have a material adverse effect on Air Canada's profitability. Any prolonged or significant weakness of the Canadian or world economies could have a material adverse effect on Air Canada's business, results from operations and financial condition, especially given Air Canada's substantial fixed cost structure.

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

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

*Terrorist Attacks and Security Measures*

The September 11, 2001 terrorist attacks and subsequent terrorist activity, notably in the Middle East, Southeast Asia and Europe, caused uncertainty in the minds of the traveling public. The occurrence of a major terrorist attack (whether domestic or international and whether involving Air Canada or another carrier or no carrier at all) and increasingly restrictive security measures, such as the current restrictions on the content of carry-on baggage, could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on Air Canada's flights. It could also lead to a substantial increase in insurance, airport security and other costs. Any resulting reduction in passenger revenues and/or increases in insurance, security or other costs could have a material adverse effect on Air Canada's business, results from operations and financial condition.

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

As a result of the international outbreaks of Severe Acute Respiratory Syndrome (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 seven day 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. The WHO warns that there is a substantial risk of an influenza pandemic within the next few years. An outbreak of SARS or of another epidemic disease such as influenza (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 Air Canada's business, results from operations and financial condition.

*Casualty Losses*

Due to the nature of its core operating business, Air Canada may be subject to liability claims arising out of accidents or disasters involving aircraft on which Air Canada's customers are traveling or involving aircraft of other carriers maintained or repaired by Air Canada, including claims for serious personal injury or death. There can be no assurance that Air Canada's insurance coverage will be sufficient to cover one or more large claims and any shortfall may be material. Additionally, any accident or disaster involving one of Air Canada's aircraft or an aircraft of another carrier maintained or repaired by Air Canada may significantly harm Air Canada's reputation for safety, which would have a material adverse effect on Air Canada'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 preference of a high number of leisure travelers to travel during the spring and summer months. Air Canada has substantial fixed costs that do not meaningfully fluctuate with passenger demand in the short term.

As described elsewhere, demand for air travel is also affected by factors such as economic conditions, war or the threat of war or terrorist attacks, fare levels and weather conditions. Due to these and other factors, operating results for an interim period are not necessarily indicative of operating results for an entire year, and operating results for 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, among other things, security, safety, licensing, competition, noise levels and the environment and, in some measure, pricing. Additional laws and regulations may be proposed, and decisions rendered, from time to time which could impose additional requirements or restrictions on airline operations. The implementation of additional regulations or decisions by Transport Canada, the Competition Bureau and/or the Competition Tribunal, the Canadian Transportation Agency, the Treasury Board or other domestic or foreign governmental entities may have a material adverse effect on Air Canada's business, results from operations and financial condition. Air Canada cannot give any assurances that new regulations or revisions to the existing legislation, or decisions, will not be adopted or rendered. The adoption of such new laws and regulations or revisions, or the rendering of such decisions, could have a material adverse effect on Air Canada's business, results from operations and financial condition.

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

In July 2000, the Government of Canada amended the Canada Transportation Act, the Competition Act and the Air Canada Public Participation Act to address the competitive airline environment in Canada and ensure protection for consumers. This legislation included airline-specific provisions concerning "abuse of dominance" under the Competition Act, later supplemented by creating "administrative monetary penalties" for a breach of the abuse of dominance provisions by a dominant domestic air carrier.

In July 2003, the Competition Tribunal released its reasons and findings in a proceeding between the Commissioner of Canada and Air Canada which had considered the approach to be taken in determining whether Air Canada was operating below "avoidable costs" in violation of one of the new airline-specific abuse of dominance provisions. The Competition Tribunal applied a very broadly crafted cost test in its decision. In September 2004, the Commissioner of Competition published a letter describing the enforcement approach that would be taken in future cases involving the airline-specific abuse of dominance provisions, which included a statement that the Tribunal's approach to avoidable costs remains relevant.

In addition, on November 2, 2004, the Minister of Industry tabled amendments to the Competition Act in Bill C-19 which, if enacted, would have removed the airline-specific "abuse of dominance" provisions from the Competition Act. However, on November 29, 2005, the 38th Parliament of Canada was dissolved. As a result, the legislative process relating to the adoption of Bill C-19 was terminated. Management cannot predict if or when such proposed legislation will be re-introduced in the House of Commons.

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 Air Canada's business, results from operations and financial condition.

Air Canada is subject to domestic and foreign laws regarding privacy of passenger and employee data that are not consistent in all countries in which Air Canada operates. Compliance with these regulatory regimes is expected to result in additional operating costs and could have a material adverse effect on Air Canada's business, results from operations and financial condition.

*Increased Insurance Costs*

Since September 11, 2001 the aviation insurance industry has been continually reevaluating the terrorism risks that it covers and this activity may adversely affect some of Air Canada's existing insurance carriers or Air Canada's ability to obtain future insurance coverage. To the extent that Air Canada's existing insurance carriers are unable or unwilling to provide it with insurance coverage, and in the absence of measures by the Government of Canada to provide the required coverage, Air Canada's insurance costs may increase further and may result in Air Canada being in breach of regulatory requirement or contractual arrangements requiring that specific insurance be maintained, which may have a material adverse effect on Air Canada'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 currently provides to Air Canada and certain other carriers in Canada. In the event that the Government of Canada does not continue to provide such indemnity or amends such indemnity, Air Canada and other industry participants would have to turn to the commercial insurance market to seek such coverage. Air Canada estimates that such coverage would cost Air Canada approximately $15 million per year. Alternative solutions, such as those envisioned by the International Civil Aviation Organization ("ICAO") and the International Air Transport Association ("IATA"), have not developed as planned, due to actions taken by other countries and the recent availability of supplemental insurance products. ICAO and IATA are continuing their efforts in this area, however the achievement of a global solution is not likely in the immediate or near future. The U.S. federal government has set up its own facility to provide war risk coverage to U.S. carriers, thus removing itself as a key component of any global plan.

Furthermore, the London aviation insurance market has introduced a new standard war and terrorism exclusion clause which is applicable to aircraft hull and spares war risk insurance, and intends to introduce similar exclusions to airline passenger and third party liability policies. Such clause excludes claims caused by the hostile use of a dirty bomb, electromagnetic pulse device, or biochemical materials. The Government of Canada indemnity program is designed to address these types of issues as they arise, but the Government of Canada has not yet decided to extend the existing indemnity to cover this exclusion. Unless and until the Government of Canada does so, the loss of coverage exposes Air Canada to this new uninsured risk and may result in Air Canada being in breach of certain regulatory requirements or contractual arrangements, which may have a material adverse effect on Air Canada's business, results from operations and financial condition.

ACE AVIATION

## 15. Quarterly Financial Data

The table below describes quarterly financial results for ACE for the eight most recent quarters.

| **($ millions, except per share amounts)** | **Q1 2005** | **Q2 2005** | **Q3 2005** | **Q4 2005** | **Q1 2006** | **Q2 2006** | **Q3 2006** | **Q4 2006** |
|---|---|---|---|---|---|---|---|---|
| Operating revenues | $2,177 | $2,458 | $2,833 | $2,362 | $2,484 | $2,682 | $2,947 | $2,544 |
| Special charge for Aeroplan miles [(1)] | - | - | - | - | - | - | (102) | - |
| **Operating revenues** | **$2,177** | **$2,458** | **$2,833** | **$2,362** | **$2,484** | **$2,682** | **$2,845** | **$2,544** |
| Operating expenses [(2)] | (2,187) | (2,280) | (2,512) | (2,396) | (2,546) | (2,501) | (2,642) | (2,471) |
| **Operating income (loss)** | **(10)** | **178** | **321** | **(34)** | **(62)** | **181** | **203** | **73** |
| Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax [(3)] | (67) | (9) | (50) | (68) | 180 | 55 | (100) | (122) |
| **Net income (loss)** | **($77)** | **$169** | **$271** | **($102)** | **$118** | **$236** | **$103** | **($49)** |
| **Earnings (loss)** | | | | | | | | |
| **Per share – basic** | **($0.87)** | **$1.68** | **$2.67** | **($1.01)** | **$1.15** | **$2.32** | **$1.01** | **($0.48)** |
| **Per share – diluted** | **($0.87)** | **$1.50** | **$2.33** | **($1.01)** | **$1.12** | **$2.05** | **$0.95** | **($0.48)** |

(1) *Quarter 3 2006 includes a special charge of $102 million in connection with Air Canada's obligations for the redemption of pre-2002 Aeroplan miles.*

(2) *Quarter 1 2006 includes a special charge for labour restructuring of $33 million. Quarter 4 2006 includes a $8 million reduction to the special charge for labour due to the favourable impact of attrition and other factors which reduced the cost of achieving the target to $25 million.*

(3) *Quarter 3 2005 includes a dilution gain of $190 million and a tax provision of $28 million as a result of ACE's IPO of Aeroplan Income Fund. Quarter 1 2006 includes a dilution gain of $220 million and a tax provision of $10 million as a result of ACE's IPO of Jazz Income Fund. Quarter 2 2006 includes a gain of $100 million and a tax provision of $17 million relating to the sale of 3.25 million shares of its holdings in US Airways. Quarter 3 2006 includes a gain of $52 million and a tax provision of $9 million relating to the sale of 1.25 million shares of its holdings in US Airways. Quarter 4 2006 includes a dilution gain of $25 million and a tax expense of $4 million related to the Air Canada initial public offering.*

### Seasonality

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 cost structure of the Corporation is such that its fixed costs do not fluctuate proportionately with passenger demand in the short-term.

## 16. Selected Annual Information

The following table provides selected annual information for ACE for the years 2006 and 2005, as well as the combination of the financial results of Air Canada for the nine-month period ended September 30, 2004 and for ACE for the three-month period ended December 31, 2004. This combination is referred to as "2004 Combined". The financial results of Air Canada prior to September 30, 2004 reflected the operations of the various entities included in the Air Canada Services segment, as well as those of Jazz, Aeroplan and ACTS.

| | 2006 | 2005 | 2004 Combined |
|---|---|---|---|
| Operating revenues | $10,657 | $9,830 | $8,900 |
| Special charge for Aeroplan miles (1) | (102) | - | - |
| **Operating revenues** | **10,555** | **9,830** | **8,900** |
| Operating expenses (2) | (10,160) | (9,375) | (8,783) |
| **Operating income before reorganization and restructuring items** | **395** | **455** | **117** |
| Reorganization and restructuring items | - | - | (871) |
| Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax | 13 | (194) | (126) |
| **Net income (loss)** | **408** | **261** | **(880)** |
| **EBITDAR (3)** | **1,412** | **1,354** | |
| **EBITDAR excluding special charges (3)** | **1,539** | **1,354** | |
| **Earning (loss) per share** | | | |
| **- Basic** | **$4.01** | **$2.66** | **n/a** |
| **- Diluted** | **$3.80** | **$2.48** | **n/a** |
| **Cash, cash equivalents and short-term investments** | **3,178** | **2,181** | **1,632** |
| **Total assets** | **13,441** | **11,847** | **9,386** |
| **Total long-term liabilities (4)** | **4,137** | **3,989** | **3,848** |

(1) *2006 includes a special charge of $102 million in connection with Air Canada's obligation for the redemption of pre-2002 Aeroplan miles.*
(2) *2006 includes a special charge for labour restructuring of $25 million.*
(3) *Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).*
(4) *Total long-term liabilities include long-term debt and capital leases and other long-term liabilities*

## 17. Controls and Procedures

### Disclosure Controls and Procedures

Management of the Corporation, with the participation of the Corporation's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the U.S. Securities Exchange Act of 1934, as amended (the "U.S. Exchange Act"), and the rules of the Canadian Securities Administrators ("CSA")). Based on that evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer have concluded that, as of December 31, 2006, the Corporation's disclosure controls and procedures were effective to provide reasonable assurance that the information required to be disclosed by the Corporation in reports that it files or submits under the U.S. Exchange Act or Canadian securities laws is (i) recorded, processed, summarized and reported, within the time periods specified in the rules and forms of the Securities and Exchange Commission and Canadian securities regulators, and (ii) accumulated and communicated to management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

### Management's Report on Internal Control over Financial Reporting

Management of the Corporation is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a – 15(f) under the U.S. Exchange Act). Internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Corporation; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation and fair presentation of published financial statements, and that receipts and expenditures of the Corporation are being made only in accordance with authorizations of Management and the Board of Directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Corporation's assets that could have a material affect on the financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Corporation's internal control over financial reporting as at December 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control Integrated Framework. This assessment identified one material weakness in the Corporation's internal control over financial reporting as at December 31, 2006 with respect to accounting for income taxes. There were limitations in the Corporation's ability to identify all future income tax assets and liabilities with respect to non-routine and complex business transactions in the Corporation's December 31, 2006 consolidated financial statements. This control deficiency resulted in audit adjustments to the December 31, 2006 consolidated financial statements. In addition, this control deficiency could result in a material misstatement in the Corporation's consolidated financial statements that would not be prevented or detected. Based solely on the material weakness with respect to accounting for income taxes, Management (including the Corporation's Chief Executive Officer and Chief Financial Officer) has concluded, the Corporation did not maintain effective internal control over financial reporting as at December 31, 2006.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Management's assessment of the effectiveness of internal control over financial reporting as at December 31, 2006, has been audited by PricewaterhouseCoopers LLP, the independent auditors, as stated in their report which is included herein and which expressed an unqualified opinion on Management's assessment and an adverse opinion on the effectiveness of the Corporations' internal control over financial reporting as of December 31, 2006.

**Remedial Action Plan**

Management has taken remedial action which includes the following:

- Engaged the services of a leader in professional recruitment searches in order to add additional qualified income tax professionals with the appropriate knowledge and experience; and

- Engaged the services of a qualified third party firm to provide supplementary assistance in the area of accounting for income taxes on non-routine and complex business transactions.

**Changes in Internal Control over Financial Reporting**

There have been no changes in the Corporation's internal control over financial reporting during the year ended December 31, 2006, that have materially affected, or are reasonably likely to materially affect its internal control over financial reporting.

## 18. Subsequent Events

### Initial Distribution of Units of Aeroplan Income Fund Under a Plan of Arrangement

At a special meeting of shareholders on October 5, 2006, the shareholders of ACE approved a statutory arrangement pursuant to the Canada Business Corporations Act. On October 6, 2006, the Québec Superior Court issued a final order approving the statutory arrangement, which became effective October 10, 2006. The arrangement grants authority to the board of directors of ACE to make from time to time one or more special distributions to ACE shareholders in an aggregate amount of up to $2 billion by way of reduction of the stated capital of the Class A variable voting shares, Class B voting shares and the preferred shares of ACE.

ACE shareholders, on January 10, 2007, the record date for the distribution, received a non-cash distribution of 50,000,000 units of Aeroplan Income Fund representing 0.442 units per Class A variable voting share, Class B voting share and preferred share (on an as converted basis) of ACE. Based on a closing price of $17.97 per unit of Aeroplan Income Fund on the Toronto Stock Exchange on January 10, 2007, the distribution is valued at approximately $899 million or $7.95 per ACE share.

On January 10, 2007, ACE exchanged 60,000,000 units of Aeroplan LP into 60,000,000 units of Aeroplan Income Fund. Following the exchange, ACE continues to hold a 50.3 percent direct interest in Aeroplan LP, comprised of a 20.3 percent direct interest in Aeroplan LP and a 37.6 percent direct interest in Aeroplan Income Fund. Aeroplan Income Fund now has 159,454,165 units issued and outstanding and holds a 79.7 percent interest in Aeroplan LP.

In connection with the initial distribution, the conversion rate of the 4.25 percent Convertible Senior Notes Due 2035 (convertible notes) of ACE was adjusted from 22.2838 to 27.6987 Class A variable voting shares or Class B voting shares per $1,000 principal amount of convertible notes. The adjustment was effective on January 29, 2007 and was determined in accordance with the terms of the indenture dated April 6, 2005 governing the convertible notes.

## 19. Outlook

In 2007, ACE plans to continue to execute its strategic plan in order to maximize shareholder value. In particular, ACE will continue to execute the initiatives announced on August 11, 2006 including the monetization of ACTS and the pursuit of opportunities that realize the value of its investments.

## 20. 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 to view operating results before depreciation, amortization and obsolescence, as these costs can vary significantly among companies due to differences in the way companies finance their assets. 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:

| | Quarter 4 | | | | | |
|---|---|---|---|---|---|---|
| *($ millions)* | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| **Air Canada Services** | | | | | | |
| GAAP operating income (loss) | (5) | (91) | 86 | 114 | 191 | (77) |
| Add back: | | | | | | |
| Aircraft rent | 75 | 90 | (15) | 314 | 341 | (27) |
| Depreciation, amortization and obsolescence | 135 | 106 | 29 | 493 | 404 | 89 |
| **EBITDAR** | **205** | **105** | **100** | **921** | **936** | **(15)** |
| Add back: | | | | | | |
| Special charge for labour restructuring | (8) | - | (8) | 20 | - | 20 |
| Special charge for Aeroplan miles | - | - | - | 102 | - | 102 |
| **EBITDAR excluding special charges** | **197** | **105** | **92** | **1,043** | **936** | **107** |
| **Aeroplan** | | | | | | |
| GAAP operating income | 37 | 30 | 7 | 140 | 102 | 38 |
| Add back: | | | | | | |
| Depreciation, amortization and obsolescence | 3 | 3 | - | 14 | 8 | 6 |
| **EBITDA** | **40** | **33** | **7** | **154** | **110** | **44** |
| **Jazz** | | | | | | |
| GAAP operating income | 33 | 34 | (1) | 144 | 129 | 15 |
| Add back: | | | | | | |
| Aircraft rent | 34 | 28 | 6 | 134 | 80 | 54 |
| Depreciation, amortization and obsolescence | 5 | 4 | 1 | 21 | 18 | 3 |
| **EBITDAR** | **72** | **66** | **6** | **299** | **227** | **72** |
| **ACTS** | | | | | | |
| GAAP operating income (loss) | 12 | (8) | 20 | (2) | 47 | (49) |
| Add back: | | | | | | |
| Depreciation, amortization and obsolescence | 8 | 8 | - | 31 | 32 | (1) |
| **EBITDA** | **20** | **-** | **20** | **29** | **79** | **(50)** |
| Add back: | | | | | | |
| Special charge for labour restructuring | - | - | - | 5 | - | 5 |
| **EBITDA excluding special charges** | **20** | **-** | **20** | **34** | **79** | **(45)** |
| **Consolidated Total** | | | | | | |
| GAAP operating income (loss) | 73 | (34) | 107 | 395 | 455 | (60) |
| Add back: | | | | | | |
| Aircraft rent | 107 | 117 | (10) | 441 | 417 | 24 |
| Depreciation, amortization and obsolescence | 157 | 125 | 32 | 576 | 482 | 94 |
| **EBITDAR** | **337** | **208** | **129** | **1,412** | **1,354** | **58** |
| Add back: | | | | | | |
| Special charge for labour restructuring | (8) | - | (8) | 25 | - | 25 |
| Special charge for Aeroplan miles | - | - | - | 102 | - | 102 |
| **EBITDAR excluding special charges** | **329** | **208** | **121** | **1,539** | **1,354** | **185** |

**Operating Income excluding the Special Charge for Aeroplan miles and the Special Charge for Labour Restructuring**

ACE uses operating income excluding the special charges for Aeroplan miles and labour restructuring to assess the operating performance of its ongoing business without the effects of these special charges. These items are excluded from ACE financial results and from Air Canada Services and ACTS segment results as they could potentially distort the analysis of trends in business performance. The special charge for Aeroplan miles is the full and final settlement between the parties in connection with Air Canada's obligations for the redemption of pre-2002 miles. The special charge for labour restructuring is the total cost of the 20 percent non-unionized workforce reduction plan announced in February 2006. The special charges for Aeroplan miles and labour restructuring are not reflective of ACE underlying financial performance.

The following measure is not a recognized measure for financial statement presentation under Canadian GAAP and does not have a standardized meaning and is therefore not likely to be comparable to similar measures presented by other public companies.

Operating income excluding the special charge for Aeroplan miles and the special charge for labour restructuring is reconciled to operating income as follows:

| *($ millions)* | Quarter 4 | | | | | |
|---|---|---|---|---|---|---|
| | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| **ACE** | | | | | | |
| GAAP operating income (loss) | 73 | (34) | 107 | 395 | 455 | (60) |
| Add back: | | | | | | |
| Special charge for Aeroplan miles | - | - | - | 102 | - | 102 |
| **Operating income (loss), excluding the special charge for Aeroplan miles** | **73** | **(34)** | **107** | **497** | **455** | **42** |
| Add back: | | | | | | |
| Special charge for labour restructuring | (8) | - | (8) | 25 | - | 25 |
| **Operating income (loss), excluding the special charges for Aeroplan miles and labour restructuring** | **65** | **(34)** | **99** | **522** | **455** | **67** |

| *($ millions)* | Quarter 4 | | | | | |
|---|---|---|---|---|---|---|
| | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| **ACTS** | | | | | | |
| GAAP operating income (loss) | 12 | (8) | 20 | (2) | 47 | (49) |
| Add back: | | | | | | |
| Special charge for labour restructuring | - | - | - | 5 | - | 5 |
| **Operating income (loss), excluding the special charge for labour restructuring** | **12** | **(8)** | **20** | **3** | **47** | **(44)** |

| *($ millions)* | Quarter 4 | | | | | |
|---|---|---|---|---|---|---|
| | **2006** | **2005** | **Change** | **2006** | **2005** | **Change** |
| **Air Canada Services** | | | | | | |
| GAAP operating income (loss) | (5) | (91) | 86 | 114 | 191 | (77) |
| Add back: | | | | | | |
| Special charge for Aeroplan miles | - | - | - | 102 | - | 102 |
| **Operating income (loss), excluding the special charge for Aeroplan miles** | **(5)** | **(91)** | **86** | **216** | **191** | **25** |
| Add back: | | | | | | |
| Special charge for labour restructuring | (8) | - | (8) | 20 | - | 20 |
| **Operating income (loss), excluding the special charges for Aeroplan miles and labour restructuring** | **(13)** | **(91)** | **78** | **236** | **191** | **45** |