ACE AVIATION

# Quarter 2 2008
# Management's Discussion and Analysis of Results of Operations and Financial Condition

August 8, 2008

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## 1. Preface

ACE Aviation Holdings Inc. ("ACE"), which was incorporated on June 29, 2004, is a holding company of aviation interests. During the first six months of 2008, ACE had two reportable segments: Air Canada and CIE. During 2007, in addition to Air Canada and CIE, ACE had the following additional reportable segments: Aeroplan Limited Partnership ("Aeroplan") up to March 14, 2007, Jazz Air LP ("Jazz") up to May 24, 2007 and ACTS LP ("ACTS") up to October 16, 2007.

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

This Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A") for Quarter 2 2008 should be read in conjunction with ACE's unaudited interim consolidated financial statements and notes for Quarter 2 2008 and its annual audited consolidated financial statements and notes and annual MD&A for 2007. Reference to "Corporation" in this MD&A refers to, as the context may require, ACE and its aviation interests collectively, ACE and one or more of its aviation interests, one or more of ACE's aviation interests, or ACE itself. Except where the context otherwise requires, all monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 16 "Glossary of Terms". Except as otherwise noted, this MD&A is current as of August 8, 2008.

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

The ACE Audit, Finance & Risk Committee has reviewed this MD&A and the Quarter 2 2008 unaudited interim consolidated financial statements and notes 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 SEDAR at www.sedar.com, EDGAR at www.sec.gov/edgar.shtml or ACE's website at www.aceaviation.com.

## 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 acts, changes in demand due to the seasonal nature of the business, the ability to reduce operating costs and employee counts, employee relations, labour negotiations or disputes, 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 identified in the "Risk Factors" section of ACE's 2007 MD&A dated February 7, 2008 and section 11 of this MD&A. The forward-looking statements contained in this discussion represent ACE's expectations as of the date of this MD&A, 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. Industry Interests

The following is a listing of ACE's aviation interests as at August 8, 2008.

| | **Aviation Interests** | **Ownership** |
|---|---|---|
| Air Canada<br>(TSX: AC.A, AC.B) | Air Canada is 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. Wholly-owned subsidiaries of Air Canada include:<br>• AC Cargo Limited Partnership ("Air Canada Cargo") which, together with Air Canada, are Canada's largest provider of air cargo services.<br>• ACGHS Limited Partnership ("Air Canada Ground Handling Services") which is a passenger and ground handling service provider.<br>• Touram Limited Partnership ("Air Canada Vacations") which is a major Canadian tour operator offering leisure travel packages. | 75.0 % |
| ACTS Aero | ACTS Aero is a full-service aircraft maintenance, repair and overhaul organization that competes on a global basis. (see Section 4) | 27.8 % |

## 4. Significant Events

The following significant events occurred during the period January 1, 2008 to August 7, 2008.

**Substantial Issuer Bid – January 2008**
On January 10, 2008, ACE accepted for purchase and cancellation a total of 40,023,427 Class A variable voting shares and 9,894,166 Class B voting shares at $30.00 per share for an aggregate purchase price of $1,498 million, in accordance with the terms of a substantial issuer bid. No convertible preferred shares of ACE were deposited on an as converted basis under the offer.

**Jazz**
On January 24, 2008, ACE sold 13,000,000 units of Jazz Air Income Fund on an exempt trade basis to certain funds and accounts managed by West Face Capital Inc. and to Sunrise Partners Limited Partnership at a price of $7.45 per unit representing total net proceeds to ACE of $97 million.

On June 2, 2008, ACE completed the sale in the market of a total of 11,726,920 units of Jazz Air Income Fund for total net proceeds to ACE of $85 million. ACE retains no further interest in Jazz Air Income Fund after that date.

**Aeroplan**
On April 21, 2008, ACE completed the sale of 20,400,000 units of Aeroplan Income Fund at a price of $17.50 per unit, for total net proceeds to ACE of $343 million.

On June 2, 2008, ACE completed the sale in the market of a total of 19,892,088 units of Aeroplan Income Fund for total net proceeds to ACE of $349 million. ACE retains no further interest in Aeroplan Income Fund after that date.

**ACTS Aero**
On January 14, 2008, cash proceeds of $40 million, representing the full balance of funds held in escrow on closing of the monetization of ACTS on October 16, 2007, were received by ACE.

In June 2008, an entity related to Grupo TACA exercised its put option and sold its 5% equity interest in ACTS Aero to ACE for $19 million (US$18 million), increasing ACE's ownership interest in ACTS Aero from 22.8% to 27.8%.

**Substantial Issuer Bid – June 2008**
On June 18, 2008, ACE accepted for purchase and cancellation a total of 12,537,084 Class A variable voting shares and 10,190,187 Class B voting shares at $22.00 per share for an aggregate purchase price of $500 million, in accordance with the terms of a substantial issuer bid. No convertible preferred shares of ACE were deposited on an as converted basis under the offer.

# 5. Accounting Policies

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 Quarter 2 2008 unaudited interim consolidated financial statements are described in Note 2 to ACE's 2007 audited consolidated financial statements.

ACE's results reflect the consolidation of Aeroplan only up to March 14, 2007, the consolidation of Jazz only up to May 24, 2007 and the consolidation of ACTS only up to October 16, 2007. After those dates, ACE's investments in Aeroplan (up to May 9, 2008), ACTS Aero, and Jazz (up February 7, 2008) are accounted for using the equity method. From May 9, 2008 for Aeroplan and from February 7, 2008 for Jazz, through to June 1, 2008, ACE's investments in these entities were classified as "available-for-sale" investments. Effective June 2, 2008, ACE no longer had an ownership interest in Aeroplan and Jazz. As a result of the above-noted changes, ACE's results of operations for 2008 are not directly comparable to its operating results for 2007.

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 evaluates 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. For a description of critical accounting estimates utilized in the preparation of ACE's consolidated financial statements, see "Critical Accounting Estimates" in ACE's 2007 MD&A dated February 7, 2008. There were no significant changes to ACE's critical accounting estimates from those disclosed at that time.

**Accounting for Aeroplan**

As a result of ACE's special distribution of Aeroplan Income Fund units and the conversion of its remaining units of Aeroplan LP into units of Aeroplan Income Fund on March 14, 2007, for the period March 14, 2007 to May 9, 2008, ACE no longer consolidated the results of operations, assets and liabilities and cash flows of Aeroplan and accounted for its investment using the equity method of accounting. With the reduction of the ownership interest below 20% and the termination of the Securityholders' Agreement between ACE and Aeroplan Income Fund on May 9, 2008, for the period May 9, 2008 to June 1, 2008, ACE no longer equity accounted for Aeroplan and ACE's investment in Aeroplan was classified as an "available-for-sale" investment under financial instruments. Unrealized period changes in fair value were recorded in "other comprehensive income" and distributions from Aeroplan Income Fund were recorded in "equity and other investment income" in non-operating expense income (expense) on ACE's consolidated statement of operations. On June 2, 2008, ACE completed the sale its remaining units of Aeroplan Income Fund. ACE retains no ownership interest in Aeroplan.

With the reduction of the ownership interest below 20% and the termination of the Securityholders' Agreement between ACE and Aeroplan Income Fund on May 9, 2008, ACE no longer had significant influence over Aeroplan.

**Accounting for Jazz**

As a result of the special distribution of Jazz Air Income Fund units on May 24, 2007, ACE no longer consolidated the results of operations, assets and liabilities and cash flows of Jazz after that date and accounted for its investment from May 24, 2007 to February 7, 2008 using the equity method of accounting. Subsequent to ACE's sale of Jazz Air Income Fund units on January 24, 2008 and the termination of the Securityholders' Agreement between ACE and Jazz Air Income Fund on February 7, 2008, for the period February 7, 2008 to June 1, 2008, ACE no longer equity accounted for Jazz and ACE's investment in Jazz was classified as an "available-for-sale" investment under financial instruments. Unrealized period changes in fair value were recorded in "other comprehensive income" and distributions from Jazz Air Income Fund were recorded in "equity and other investment income" in non-operating expense income (expense) on ACE's consolidated statement of operations. On June 2, 2008, ACE completed the sale of its remaining units of Jazz Air Income Fund. ACE retains no ownership interest in Jazz.

**Accounting for ACTS**
As a result of the monetization of ACTS on October 16, 2007, ACE no longer consolidates the results of operations, assets and liabilities and cash flows of ACTS after that date and accounts for its investment using the equity method of accounting.

**Changes in Accounting Policies**

Capital Disclosures and Financial Instruments – Presentation and Disclosure
Effective January 1, 2008, the Corporation adopted three new CICA accounting standards: section 1535, *Capital Disclosures*, section 3862, *Financial Instruments – Disclosures* and section 3863, *Financial Instruments – Presentation*.

Section 1535 establishes disclosure requirements about an entity's capital and how it is managed. The purpose is to enable users of the financial statements to evaluate the entity's objectives, policies and processes for managing capital.

Sections 3862 and 3863 replace section 3861, *Financial Instruments – Disclosure and Presentation*, revising and enhancing its disclosure requirements in certain areas, and carrying forward unchanged its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how the entity manages those risks. Refer to section 10 of this MD&A for information on the Corporation's financial instruments.

For additional information on these new accounting standards, refer to sections 8.8 and 10 of this MD&A.

Inventories
Effective January 1, 2008, the Corporation adopted CICA section 3031, *Inventories*, which replaced section 3030, *Inventories*. Section 3031 provides more extensive guidance on measurement, and expands disclosure requirements to increase transparency. The Corporation's accounting policy for aircraft fuel inventory is consistent with the measurement requirements in the new standard and, as a result, no adjustment was recorded on the transition, however, additional disclosures have been included in ACE's interim unaudited consolidated financial statements commencing in Quarter 1 2008.

Future Accounting Standard Changes
In February 2008, the CICA issued section 3064, *Goodwill and Intangible Assets,* which provides guidance on the recognition, measurement, presentation and disclosure for goodwill and intangible assets, other than the initial recognition of goodwill or intangible assets acquired in a business combination. The standard is effective for fiscal years beginning on or after October 1, 2008, and requires retroactive application to prior period financial statements. The Corporation is in the process of evaluating the impact of this new standard for adoption on January 1, 2009.

In February 2008, the Canadian Accounting Standards Board confirmed January 1, 2011 as the changeover date for Canadian publicly accountable enterprises to start using International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board. IFRS uses a conceptual framework similar to Canadian GAAP, but there are significant differences in recognition, measurement and disclosures.

As a result, the Corporation is developing a plan to convert its consolidated financial statements to IFRS. The plan addresses the impact of IFRS on:

- Accounting policies and implementation decisions
- Information technology and data systems
- Internal control over financial reporting
- Disclosure controls and procedures
- Financial reporting expertise
- Business activities

The Corporation has established a cross-functional IFRS team and is providing training to key employees.

The Corporation is currently in the process of assessing the differences between IFRS and the Corporation's current accounting policies, as well as the alternatives available on adoption. This assessment includes the impact of conversion on information technology and data systems, internal control over financial reporting, disclosure controls and procedures and business activities. Changes in accounting policies are likely. These changes may materially impact the Corporation's consolidated financial statements.

## 6. Results of Operations – Quarter 2 2008

The following table reflects the results of the Corporation, the results of its reportable segments and certain non-GAAP measures for Quarter 2 2008. Segment information has been prepared consistent with how financial information is produced internally for the purposes of making business decisions.

| (Canadian dollars in millions) | Quarter 2 2008 Air Canada | CIE | ACE Total |
|---|---|---|---|
| **Operating revenue** | | | |
| Passenger revenue | $ 2,454 | $ - | $ 2,454 |
| Cargo revenue | 139 | - | 139 |
| Other revenue | 189 | 1 | 190 |
| | 2,782 | 1 | 2,783 |
| **Operating expenses** | | | |
| Wages, salaries and benefits | 480 | 7 | 487 |
| Aircraft fuel | 848 | - | 848 |
| Aircraft rent | 69 | - | 69 |
| Airport and navigation fees | 255 | - | 255 |
| Aircraft maintenance, materials, and supplies | 172 | - | 172 |
| Communications and information technology | 72 | - | 72 |
| Food, beverages and supplies | 81 | - | 81 |
| Depreciation, amortization and obsolescence | 173 | (2) | 171 |
| Commissions | 47 | - | 47 |
| Capacity purchase with Jazz | 233 | - | 233 |
| Other operating expenses | 345 | 5 | 350 |
| | 2,775 | 10 | 2,785 |
| **Operating income (loss)** | **7** | **(9)** | **(2)** |
| **Non-operating income (expense)** | | | |
| Interest income | 15 | 8 | 23 |
| Interest expense | (78) | (9) | (87) |
| Interest capitalized | 8 | - | 8 |
| Gain on disposal of assets | 7 | 908 | 915 |
| Gain on financial instruments recorded at fair value | 176 | - | 176 |
| Equity and other investment income (1) (2) | - | 5 | 5 |
| Other non-operating income | - | - | - |
| | 128 | 912 | 1,040 |
| **Income before the following items** | **135** | **903** | **1,038** |
| Non-controlling interest | (3) | (29) | (32) |
| Foreign exchange gain | 48 | - | 48 |
| Provision for income taxes | (58) | (166) | (224) |
| **Income for the period** | **122** | **708** | **830** |
| **EBITDAR/EBITDA (3)** | **$ 249** | **$ (11)** | **$ 238** |

(1) *Reflects ACE's investment in Aeroplan (from April 1, 2008 to May 9, 2008) and ACTS Aero (for Quarter 2 2008) using the equity method of accounting.*
(2) *Reflects distributions from Aeroplan Income Fund from May 10, 2008 to June 2008 and from Jazz Air Income Fund from April 1, 2008 to June 2008.*
(3) *Refer to section 15 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).*

The following table reflects the results of the Corporation, the results of its reportable segments and certain non-GAAP measures for Quarter 2 2007.

| | Quarter 2 2007 | | | | |
|---|---|---|---|---|---|
| **(Canadian dollars in millions)** | **Air Canada** | **Jazz [1]** | **ACTS** | **CIE** | **ACE Total** |
| **Operating revenue** | | | | | |
| Passenger revenue | $ 2,336 | $ - | $ - | $ - | $ 2,336 |
| Cargo revenue | 135 | - | - | - | 135 |
| Other revenue | 128 | 1 | 56 | 3 | 188 |
| External revenue | 2,599 | 1 | 56 | 3 | 2,659 |
| Inter-segment revenue | 40 | 248 | 202 | (490) | - |
| | 2,639 | 249 | 258 | (487) | 2,659 |
| **Operating expenses** | | | | | |
| Wages, salaries and benefits | 475 | 56 | 90 | 5 | 626 |
| Aircraft fuel | 636 | 54 | - | (53) | 637 |
| Aircraft rent | 75 | 22 | - | (6) | 91 |
| Airport and navigation fees | 257 | 33 | - | (34) | 256 |
| Aircraft maintenance, materials, and supplies | 205 | 20 | 79 | (183) | 121 |
| Communications and information technology | 67 | 1 | 4 | (3) | 69 |
| Food, beverages and supplies | 78 | 2 | - | 1 | 81 |
| Depreciation, amortization and obsolescence | 136 | 4 | 11 | (2) | 149 |
| Commissions | 51 | - | - | - | 51 |
| Capacity purchase with Jazz | 232 | - | - | (156) | 76 |
| Special charge for labour restructuring | - | - | 6 | - | 6 |
| Other operating expenses | 339 | 31 | 59 | (29) | 400 |
| | 2,551 | 223 | 249 | (460) | 2,563 |
| **Operating income (loss)** | **88** | **26** | **9** | **(27)** | **96** |
| **Non-operating income (expense)** | | | | | |
| Interest income | 23 | 1 | - | 4 | 28 |
| Interest expense | (86) | (1) | (5) | (4) | (96) |
| Interest capitalized | 28 | - | - | - | 28 |
| Gain on disposal of assets | 14 | - | - | 4 | 18 |
| Loss on financial instruments recorded at fair value | (6) | - | - | - | (6) |
| Equity and other investment income [2] | - | - | - | 24 | 24 |
| Other non-operating income (expense) | (6) | 1 | - | 4 | (1) |
| | (33) | 1 | (5) | 32 | (5) |
| **Income before the following items** | **55** | **27** | **4** | **5** | **91** |
| Non-controlling interest | (4) | - | - | (52) | (56) |
| Foreign exchange gain (loss) | 160 | - | (1) | (1) | 158 |
| Provision for income taxes | (56) | - | - | (19) | (75) |
| **Income (loss) for the period** | **$ 155** | **$ 27** | **$ 3** | **$ (67)** | **$ 118** |
| **EBITDAR/EBITDA [3]** | **$ 299** | **$ 52** | **$ 20** | **$ (35)** | **$ 336** |

(1) *Reflects the consolidation of Jazz results from April 1, 2007 to May 23, 2007.*
(2) *Reflects ACE's investment in Aeroplan (for Quarter 2 2007) and Jazz (from May 24, 2007 to June 30, 2007) using the equity method of accounting.*
(3) *Refer to section 15 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR/EBITDA to operating income (loss).*

**ACE's results of operations for Quarter 2 2008 are not directly comparable to its operating results for Quarter 2 2007. Refer to section 5 of this MD&A for additional information on the changes in accounting relating to Aeroplan, Jazz and ACTS Aero.**

ACE recorded an operating loss of $2 million in Quarter 2 2008 compared to operating income of $96 million in Quarter 2 2007. Air Canada reported operating income of $7 million in Quarter 2 2008 compared to operating income of $88 million in Quarter 2 2007, a decrease of $81 million from Quarter 2 2007. An increase in operating revenues at Air Canada of $143 million or 5% was more than offset by a fuel expense increase of $212 million or 33% versus Quarter 2 2007. ACE's consolidated results for Quarter 2 2007 included operating income from Jazz and ACTS of $26 million and $9 million, respectively.

EBITDAR of $238 million was recorded in Quarter 2 2008 compared to EBITDAR of $336 million in the same period in 2007. In Quarter 2 2008, Air Canada recorded EBITDAR of $249 million compared to EBITDAR of $299 million in the same period in 2007, a decrease of $50 million from Quarter 2 2007. In Quarter 2 2007, Jazz and ACTS recorded EBITDAR of $52 million and $20 million, respectively.

ACE recorded operating revenues of $2,783 million and operating expenses of $2,785 million in Quarter 2 2008. In the same period in 2007, ACE recorded operating revenues of $2,659 million and operating expenses of $2,563 million. As a result of the deconsolidation of Jazz and ACTS, ACE's Quarter 2 2008 operating revenues and expenses are not directly comparable to its operating revenues and expenses for Quarter 2 2007.

Non-operating income amounted to $1,040 million in Quarter 2 2008 compared to non-operating expense of $5 million in Quarter 2 2007. Included in Quarter 2 2008 were gains on ACE's sale of Aeroplan Income Fund units amounting to $830 million and a gain on ACE's sale of Jazz Air Income Fund units of $78 million.

Gains on financial instruments recorded at fair value amounted to $176 million in Quarter 2 2008 compared to losses on financial instruments of $6 million in Quarter 2 2007. Refer to section 10 of this MD&A for additional information on financial instruments.

Equity and other investment income of $5 million was recorded in Quarter 2 2008 compared to equity and other investment income of $24 million in Quarter 2 2007. A decrease in equity and other investment income for Aeroplan and Jazz was mainly driven by a reduction in ACE's ownership interest in these entities. In Quarter 2 2007, ACTS' operating results were consolidated within ACE's operating results. Refer to section 5 of this MD&A for additional information on changes in accounting policies.

Non-controlling interest of $32 million was recorded in Quarter 2 2008 versus non-controlling interest of $56 million in Quarter 2 2007, a decrease of $24 million from Quarter 2 2007. The reduction in non-controlling interest mainly reflected a deterioration in operating results for Air Canada and a change in accounting methodology for Jazz.

Net gains on foreign currency monetary items amounted to $48 million in Quarter 2 2008 versus gains of $158 million in Quarter 2 2007. The gain in Quarter 2 2008 was mainly attributable to a stronger Canadian dollar at June 30, 2008 compared to March 31, 2008. The June 30, 2008 noon day exchange rate was $1US = Cdn $1.0186 while the March 31, 2008 noon day exchange rate was $1US = Cdn $1.0279.

ACE recorded a provision for income taxes of $224 million in Quarter 2 2008 on pre-tax income of $1,054 million, mainly related to the gains on disposal of Aeroplan and Jazz units. ACE recorded a provision for income taxes of $75 million for the same period in 2007 on a pre-tax income of $193 million.

Net income in Quarter 2 2008 amounted to $830 million or $10.76 per diluted share. Net income in Quarter 2 2007 amounted to $118 million or $0.98 per diluted share. The net income in Quarter 2 2008 included the significant gains on disposal of the remaining units of Aeroplan Income Fund and Jazz Air Income Fund.

## 6.1. Air Canada

In Quarter 2 2008, Air Canada reported operating income of $7 million compared to operating income of $88 million in Quarter 2 2007, a decrease of $81 million. An increase in operating revenues of $143 million or 5% was more than offset by a fuel expense increase of $212 million or 33%.

In Quarter 2 2008, EBITDAR amounted to $249 million compared to EBITDAR of $299 million in the same period in 2007, a decrease of $50 million.

Passenger revenues increased $118 million or 5.1% to $2,454 million in Quarter 2 2008 due to growth in both system traffic and yield. System yield improved 2.5% reflecting higher fares and increased fuel surcharges to partially offset higher fuel prices. An increase in the proportion of higher-yielding business travelers, reflecting in part, the attractiveness of Air Canada's new Executive First product, was also a factor in the yield growth. RASM increased 2.6% due to the growth in yield. Traffic grew 2.4% on a capacity increase of 2.4%, resulting in a passenger load factor unchanged from Quarter 2 2007. All markets reflected traffic growth with the exception of the US transborder market. Traffic in the US transborder market decreased 7.7% on a capacity reduction of 5.8%. Overall, the US transborder market was negatively impacted by the softening economy in the United States. A stronger Canadian dollar in Quarter 2 2008, which lowers the Canadian dollar value of sales in foreign countries, had a negative impact on foreign currency denominated revenues, accounting for a decrease of $61 million to Quarter 2 2008 passenger revenues.

Operating expenses were $2,775 million in Quarter 2 2008, an increase of $224 million or 9% from Quarter 2 2007, reflecting a significant increase in fuel expense. Excluding the fuel expense increase of $212 million in Quarter 2 2008, operating expenses increased only $12 million, when compared to the same period in 2007, on a capacity increase of 2.4%.

Including fuel expense, CASM increased 6.3% from Quarter 2 2007. Excluding fuel expense, CASM declined 1.7% from Quarter 2 2007. The airline is aggressively managing the costs of all controllable parts of its operation and continues in its efforts to mitigate the significant increase in its fuel expense. Unit cost reductions were recorded in all major categories with the exception of fuel expense, ownership costs and communications and information technology expenses. The stronger Canadian dollar versus the US dollar, unit cost savings related to the Boeing 777 aircraft and other cost reductions programs were among the more important factors in the overall unit cost decrease, excluding fuel expense, from Quarter 2 2007. The higher unit cost of ownership reflects Air Canada's investment in new aircraft and the aircraft interior refurbishment program.

Non-operating income amounted to $128 million in Quarter 2 of 2008 compared to non-operating expense of $33 million in Quarter 2 2007. Gains relating to fair value adjustments on derivatives instruments amounted to $176 million in Quarter 2 2008 versus losses of $6 million in the same quarter of 2007. Refer to section 10 of this MD&A for additional information on Air Canada's derivative instruments. Net interest expense increased $20 million over Quarter 2 2007. A lower amount of capitalized interest related to new aircraft and a decrease in interest income due to lower cash balances more than offset the $8 million decrease in interest expense. Air Canada recorded gains amounting to $7 million pertaining to the sale of aircraft-related inventory in Quarter 2 2008. In Quarter 2 2007, Air Canada recorded a gain on disposal of $14 million from insurance proceeds relating to a CRJ-100 aircraft owned by Air Canada and leased to Jazz which was damaged beyond repair.

Net gains on foreign currency monetary items amounted to $48 million in Quarter 2 2008 versus gains of $160 million in Quarter 2 2007. The gain in Quarter 2 2008 was mainly attributable to a stronger Canadian dollar at June 30, 2008 compared to March 31, 2008. The June 30, 2008 noon day exchange rate was $1US = Cdn $1.0186 while the March 31, 2008 noon day exchange rate was $1US = Cdn $1.0279.

Air Canada recorded a provision for income taxes of $58 million in Quarter 2 2008, representing an effective income tax rate of 32%, compared to a provision for income taxes of $56 million, at an effective income tax rate of 27%, for the same period in 2007. The 2007 effective income tax rate was favourably impacted by the capital portion of certain foreign exchange gains which were tax-effected at 50% of the income tax rate and which were higher in Quarter 2 2007 compared to the same period in 2008.

Segment income of $122 million was recorded in Quarter 2 2008 compared to segment income of $155 million recorded in Quarter 2 2007.

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

CIE includes the corporate, financing and investing activities of ACE. As a result of the change in the accounting for ACE's investment in Aeroplan, effective March 14, 2007, certain consolidation adjustments relating to Aeroplan are no longer recorded in CIE. As previously discussed, the accounting for ACE's investment in ACTS Aero was changed during October 2007 from consolidation to the equity method of accounting reported under the CIE segment. Up until the time of deconsolidating ACTS Aero, the CIE segment also included certain consolidation adjustments related to revenue recognition differences for maintenance services provided by ACTS (completed contract basis of accounting for engine and component maintenance services versus the expense recognition basis in Air Canada and Jazz, which is as the work is completed). In addition, consolidation adjustments were previously made related to the timing of revenue and expense recognition pertaining to power-by-the-hour contracts. Subsequent to the change in the accounting for ACE's investment in ACTS, these consolidation adjustments are no longer required.

CIE recorded an operating loss of $9 million in Quarter 2 2008 compared to an operating loss of $27 million in Quarter 2 2007. Negative EBITDAR of $11 million was recorded in Quarter 2 2008 compared to negative EBIDTAR of $35 million in Quarter 2 2007.

Equity and other investment income of $5 million was recorded in Quarter 2 2008 compared to equity and other investment income of $24 million in Quarter 2 2007, a decrease of $19 million.

Non-controlling interest of $29 million was recorded in Quarter 2 2008 versus non-controlling interest of $52 million in Quarter 2 2007, a decrease of $23 million from Quarter 2 2007.

In Quarter 2 2008, ACE realized a gain of $413 million ($340 million after tax) on the sale of 20,400,000 units of Aeroplan Income Fund in April 2008, a gain of $417 million ($344 million after tax) on the sale of 19,892,088 units of Aeroplan Income Fund in June 2008 and a gain of $78 million ($62 million after tax) on the sale of 11,726,920 units of Jazz Air Income Fund in June 2008. Effective June 2, 2008, ACE no longer retains any ownership interest in Aeroplan and Jazz.

## 7. Results of Operations – First Six Months of 2008

The following table reflects the results of the Corporation, the results of its reportable segments and certain non-GAAP measures for the first six months of 2008. Segment information has been prepared consistent with how financial information is produced internally for the purposes of making business decisions.

| | First Six Months of 2008 | | |
|---|---|---|---|
| **(Canadian dollars in millions)** | **Air Canada** | **CIE** | **ACE Total** |
| **Operating revenue** | | | |
| Passenger revenue | $ 4,765 | $ - | $ 4,765 |
| Cargo revenue | 263 | - | 263 |
| Other revenue | 480 | 1 | 481 |
| External revenue | 5,508 | 1 | 5,509 |
| Inter-segment revenue | 1 | (1) | - |
| | 5,509 | - | 5,509 |
| **Operating expenses** | | | |
| Wages, salaries and benefits | 961 | 22 | 983 |
| Aircraft fuel | 1,563 | - | 1,563 |
| Aircraft rent | 132 | - | 132 |
| Airport and navigation fees | 496 | - | 496 |
| Aircraft maintenance, materials, and supplies | 375 | - | 375 |
| Communications and information technology | 145 | - | 145 |
| Food, beverages and supplies | 158 | - | 158 |
| Depreciation, amortization and obsolescence | 344 | (4) | 340 |
| Commissions | 100 | - | 100 |
| Capacity purchase with Jazz | 468 | - | 468 |
| Other operating expenses | 772 | 6 | 778 |
| | 5,514 | 24 | 5,538 |
| **Operating loss before under-noted item** | **(5)** | **(24)** | **(29)** |
| Provision for cargo investigations | (125) | - | (125) |
| **Operating loss** | **(130)** | **(24)** | **(154)** |
| **Non-operating income (expense)** | | | |
| Interest income | 33 | 15 | 48 |
| Interest expense | (159) | (24) | (183) |
| Interest capitalized | 25 | - | 25 |
| Gain (loss) on disposal of assets | (29) | 990 | 961 |
| Gain on financial instruments recorded at fair value | 153 | - | 153 |
| Equity and other investment income (1) (2) | - | 17 | 17 |
| Other non-operating income (expense) | (2) | 1 | (1) |
| | 21 | 999 | 1,020 |
| **Income (loss) before the following items** | **(109)** | **975** | **866** |
| Non-controlling interest | (6) | 38 | 32 |
| Foreign exchange loss | (41) | - | (41) |
| Recovery of (provision for) income taxes | (10) | (199) | (209) |
| **Income (loss) for the period** | **(166)** | **814** | **648** |
| **EBITDAR/EBITDA before the provision for cargo investigations (3)** | **$ 471** | **$ (28)** | **$ 443** |
| **EBITDAR/EBITDA (3)** | **$ 346** | **$ (28)** | **$ 318** |

*(1) Reflects ACE's investment in Aeroplan (up to May 9, 2008), ACTS Aero (for the first six months of 2008) and Jazz (up to February 7, 2008) using the equity method of accounting.*
*(2) Reflects distributions from Jazz Air Income Fund from February 8, 2008 to June 2008 and distributions from Aeroplan Income Fund from May 10, 2008 to June 2008.*
*(3) Refer to section 15 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before the provision for cargo investigations to operating income (loss) and EBITDAR/EBITDA to operating income (loss).*

The following table reflects the results of the Corporation, the results of its reportable segments and certain non-GAAP measures for the first six months of 2007.

| | First Six Months of 2007 | | | | | |
|---|---|---|---|---|---|---|
| **(Canadian dollars in millions)** | **Air Canada** | **Aeroplan [1]** | **Jazz [2]** | **ACTS** | **CIE** | **ACE Total** |
| **Operating revenue** | | | | | | |
| Passenger revenue | $ 4,473 | $ - | $ - | $ - | $ 15 | $ 4,488 |
| Cargo revenue | 275 | - | - | - | - | 275 |
| Other revenue | 337 | 198 | 3 | 113 | (130) | 521 |
| External revenue | 5,085 | 198 | 3 | 113 | (115) | 5,284 |
| Inter-segment revenue | 94 | 3 | 610 | 398 | (1,105) | - |
| | **5,179** | **201** | **613** | **511** | **(1,220)** | **5,284** |
| **Operating expenses** | | | | | | |
| Wages, salaries and benefits | 974 | 17 | 139 | 176 | 18 | 1,324 |
| Aircraft fuel | 1,221 | - | 125 | - | (124) | 1,222 |
| Aircraft rent | 154 | - | 57 | - | (16) | 195 |
| Airport and navigation fees | 500 | - | 80 | - | (81) | 499 |
| Aircraft maintenance, materials, and supplies | 429 | - | 50 | 158 | (374) | 263 |
| Communications and information technology | 138 | 7 | 2 | 8 | (10) | 145 |
| Food, beverages and supplies | 158 | | 6 | | - | 164 |
| Depreciation, amortization and obsolescence | 264 | 3 | 9 | 20 | (1) | 295 |
| Commissions | 110 | - | - | - | - | 110 |
| Capacity purchase with Jazz | 462 | - | - | - | (386) | 76 |
| Special charge for labour restructuring | - | - | - | 15 | - | 15 |
| Other operating expenses | 759 | 134 | 83 | 122 | (189) | 909 |
| | 5,169 | 161 | 551 | 499 | (1,163) | 5,217 |
| **Operating income (loss)** | **10** | **40** | **62** | **12** | **(57)** | **67** |
| **Non-operating income (expense)** | | | | | | |
| Interest income | 49 | 3 | 2 | - | 7 | 61 |
| Interest expense | (177) | (3) | (3) | (10) | (26) | (219) |
| Interest capitalized | 64 | - | - | - | - | 64 |
| Gain on disposal of assets | 21 | - | - | - | 4 | 25 |
| Gain on financial instruments recorded at fair value | 28 | - | - | - | - | 28 |
| Equity and other investment income [3] | - | - | - | - | 27 | 27 |
| Other non-operating income (expense) | (10) | (1) | 1 | - | 9 | (1) |
| | (25) | (1) | - | (10) | 21 | (15) |
| **Income (loss) before the following items** | **(15)** | **39** | **62** | **2** | **(36)** | **52** |
| Non-controlling interest | (6) | - | - | - | (73) | (79) |
| Foreign exchange gain | 193 | - | - | (1) | (1) | 191 |
| Recovery of (provision for) income taxes | (51) | - | - | - | (67) | (118) |
| **Income (loss) for the period** | **$ 121** | **$ 39** | **$ 62** | **$ 1** | **$ (177)** | **$ 46** |
| **EBITDAR/EBITDA [4]** | **$ 428** | **$ 43** | **$ 128** | **$ 32** | **$ (74)** | **$ 557** |

*(1) Reflects the consolidation of Aeroplan results from January 1 to March 13, 2007.*
*(2) Reflects the consolidation of Jazz results from January 1 to May 23, 2007.*
*(3) Reflects ACE's investment in Aeroplan (from March 14, 2007 to June 30, 2007) and for Jazz (from May 24, 2007 to June 30, 2007) using the equity method of accounting.*
*(4) Refer to section 15 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR/EBITDA to operating income (loss).*

**ACE's results of operations for the first six months of 2008 are not directly comparable to its operating results for the first six months of 2007. Refer to section 5 of this MD&A for additional information on the changes in accounting relating to Aeroplan, Jazz and ACTS Aero.**

ACE recorded an operating loss of $29 million, before a provision for cargo investigations, in the first six months of 2008 compared to operating income of $67 million in the first six months of 2007. Air Canada reported an operating loss of $5 million, before a provision for cargo investigations, in the first six months of 2008 compared to operating income of $10 million in the first six months of 2007, a decrease of $15 million versus the same period in 2007. In the first six months of 2008, Air Canada recorded a provision for cargo investigations of $125 million relating to alleged anti-competitive cargo pricing activities. ACE's consolidated results for the first six months of 2007 included operating income from Aeroplan, Jazz and ACTS of $40 million, $62 million and $12 million, respectively.

EBITDAR of $443 million, before the provision for cargo investigations, was recorded in the first six months of 2008 compared to EBITDAR of $557 million in the same period in 2007. In the first six months of 2008, Air Canada recorded EBITDAR of $471 million, before the provision for cargo investigations, compared to EBITDAR of $428 million in the same period in 2007, an improvement of $43 million, despite an increase in fuel expense of $342 million when compared to the first six months of 2007. In the first six months of 2007, Aeroplan, Jazz and ACTS recorded EBITDAR of $43 million, $128 million and $32 million, respectively.

ACE recorded operating revenues of $5,509 million and operating expenses of $5,538 million in the first six months of 2008. In the same period in 2007, ACE recorded operating revenues of $5,284 million and operating expenses of $5,217 million. As a result of the deconsolidation of Aeroplan, Jazz and ACTS, ACE's operating revenues and expenses for the first six months of 2008 are not directly comparable to its operating revenues and expenses for the first six months of 2007.

Non-operating income amounted to $1,020 million in the first six months of 2008 compared to non-operating expense of $15 million in the first six months of 2007. Included in the first six months of 2008 were gains totalling $830 million on ACE's sale of Aeroplan Income Fund units and gains of $167 million on ACE's sale of Jazz Air Income Fund units. In the first six months of 2008, Air Canada recorded an impairment charge of $38 million related to the planned retirement of its fleet of Boeing 767-200 aircraft. Gains on financial instruments recorded at fair value amounted to $153 million in the first six months of 2008 compared to gains of $28 million in the first six months of 2007. Refer to section 10 of this MD&A for additional information on financial instruments.

Net losses on foreign currency monetary items amounted to $41 million in the first six months of 2008 versus gains of $191 million in the first six months of 2007. The loss in the first six months of 2008 was largely attributable to a weaker Canadian dollar at June 30, 2008 compared to December 31, 2007, partially offset by gains of $83 million related to foreign currency derivatives. The June 30, 2008 noon day exchange rate was $1US = Cdn $1.0186 while the December 31, 2007 noon day exchange rate was $1US = Cdn $0.9881.

Non-controlling interest was an income of $32 million in the first six months of 2008 versus non-controlling interest expense of $79 million in the first six months of 2007, a change of $111 million from the first six months of 2007. The reduction in non-controlling interest mainly reflected a deterioration in operating results for Air Canada and a change in accounting methodology for Aeroplan and Jazz.

Provisions for income taxes were $209 million in the first six months of 2008 on pre-tax income of $857 million, mainly related to the disposal of Aeroplan and Jazz units. No tax recovery was recorded by Air Canada on the provision for cargo investigations. Provisions for income taxes of $118 million were recorded in the first six months of 2007 and included $44 million related to special distributions of Aeroplan and Jazz units.

Net income in the first six months of 2008 amounted to $648 million or $8.18 per diluted share. Net income in the first six months of 2007 amounted to $46 million or $0.44 per diluted share. The net income in the first six months of 2008 included the significant gains on disposal of the remaining units of Aeroplan Income Fund and Jazz Air Income Fund partially offset by the provision for cargo investigations of $125 million recorded by Air Canada.

## 7.1. Air Canada

In the first six months of 2008, Air Canada reported an operating loss of $5 million, before a provision for cargo investigations of $125 million, compared to operating income of $10 million in the first six months of 2007, a decrease of $15 million versus the same period in 2007.

In the first six months of 2008, EBITDAR amounted to $471 million, before the provision for cargo investigations, compared to EBITDAR of $428 million in the same period in 2007, an improvement of $43 million, despite an increase in fuel expense of $342 million when compared to the first six months of 2007.

Passenger revenues increased $292 million or 6.5% to $4,765 million in the first six months of 2008 due to growth in both system traffic and yield. A system yield improvement of 3% reflected higher fares and increased fuel surcharges to offset higher fuel prices. Yield improvements were recorded in all markets with the exception of the Pacific market and the South Pacific, Caribbean, Mexico and South America market. An increase in the proportion of higher-yielding business travelers was also a factor in the yield growth. Traffic grew 3.4% on a capacity increase of 3.4%, resulting in a passenger load factor unchanged from the first six months of 2007. Traffic growth was reflected in all markets with the exception of the US transborder market. The traffic decrease on the US transborder market was in line with the capacity reduction. A stronger Canadian dollar in the first six months of 2008, which lowers the Canadian dollar value of sales in foreign countries, had a negative impact on foreign currency denominated revenues, accounting for a decrease of $123 million passenger revenues for the first six months of 2008. A RASM improvement of 3% reflected the growth in yield.

Operating expenses were $5,514 million in the first six months of 2008, an increase of $345 million or 7% from the first six months of 2007, reflecting a significant increase in fuel expense. Excluding the increase in fuel expense of $342 million in the first six months of 2007, operating expenses increased only $3 million versus the same period in 2007 on a capacity increase of 3.4%. Including fuel expense, CASM increased 3.1% from the first six months of 2007. Excluding fuel expense, CASM declined 3.3% from the first six months of 2007. Unit cost reductions were recorded in all major categories with the exception of fuel expense, ownership costs and communications and information technology expenses.

Non-operating income amounted to $21 million in the first six months of 2008 compared to non-operating expense of $25 million in the first six months of 2007. Gains relating to fair value adjustments on derivatives instruments amounted to $153 million in the first six months of 2008 versus gains on financial instruments of $28 million in the first six months of 2007. Net interest expense increased $37 million from the same period in 2007. A lower amount of capitalized interest related to new aircraft and a decrease in interest income due to lower cash balances more than offset the $18 million decrease in interest expense. In Quarter 1 2008, Air Canada recorded an impairment charge of $38 million related to the planned retirement of its fleet of Boeing 767-200 aircraft. In Quarter 2 2007, Air Canada recorded a gain on disposal of $14 million from insurance proceeds relating to a CRJ-100 aircraft owned by Air Canada and leased to Jazz which was damaged beyond repair.

Net losses on foreign currency monetary items amounted to $41 million in the first six months of 2008 versus net gains of $193 million in the first six months of 2007. The loss in the first six months of 2008 was largely attributable to a weaker Canadian dollar at June 30, 2008 compared to December 31, 2007, partially offset by gains of $83 million related to foreign currency derivatives. The June 30, 2008 noon day exchange rate was $1US = Cdn $1.0186 while the December 31, 2007 noon day exchange rate was $1US = Cdn $0.9881.

Air Canada recorded a provision for income taxes of $10 million in the first six months of 2008 on a pre-tax loss of $156 million, as no tax recovery was recorded on the provision for cargo investigations. This compared to a provision for income taxes of $51 million, at an effective income tax rate of 30%, for the same period in 2007.

A segment loss of $166 million was recorded in the first six months of 2008 compared to segment income of $121 million in the first six months of 2007. The segment loss in the first six months of 2008 included the provision for cargo investigations of $125 million.

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

CIE includes the corporate, financing and investing activities of ACE. As a result of the change in the accounting for ACE's investment in Aeroplan, effective March 14, 2007, certain consolidation adjustments relating to Aeroplan are no longer recorded in CIE. As previously discussed, the accounting for ACE's investment in ACTS Aero was changed during October 2007 from consolidation to the equity method of accounting reported under the CIE segment. Up until the time of deconsolidating ACTS Aero, the CIE segment also included certain consolidation adjustments related to revenue recognition differences for maintenance services provided by ACTS (completed contract basis of accounting for engine and component maintenance services versus the expense recognition basis in Air Canada and Jazz, which is as the work is completed). In addition, consolidation adjustments were previously made related to the timing of revenue and expense recognition pertaining to power-by-the-hour contracts. Subsequent to the change in the accounting for ACE's investment in ACTS, these consolidation adjustments are no longer required.

CIE recorded an operating loss of $24 million in the first six months of 2008 compared to an operating loss of $57 million in the first six months of 2007. Negative EBITDAR of $28 million was recorded in the first six months of 2008 compared to negative EBIDTAR of $74 million in the first six months of 2007.

CIE results for the first six months reflected $17 million of equity and other investment income compared to equity and other investment income of $27 million in the same period in 2007.

The following gains on disposals were recorded in CIE during the first six months of 2008:

- A gain on sale of $89 million ($71 million after tax) from the sale by ACE of 13,000,000 units of Jazz Air Income Fund in Quarter 1 2008.
- A gain on sale of $413 million ($340 million after tax) from the sale by ACE of 20,400,000 units of Aeroplan Income Fund in Quarter 2 2008.
- A gain of $417 million ($344 million after tax) from the sale by ACE of 19,892,088 units of Aeroplan Income Fund in Quarter 2 2008.
- A gain of $78 million ($62 million after tax) from the sale by ACE of 11,726,920 units of Jazz Air Income Fund in Quarter 2 2008.

## 8. Financial and Capital Management

The following table summarizes ACE's consolidated statement of financial position as at June 30, 2008 and as at December 31, 2007.

| **Condensed Consolidated Statement of Financial Position (Canadian dollars in millions)** | **June 30, 2008** | **December 31, 2007** |
|---|---|---|
| **Assets** | | |
| Cash, cash equivalents and short-term investments | $ 2,325 | $ 3,139 |
| Other current assets | 1,615 | 1,465 |
| Current assets | 3,940 | 4,604 |
| Property and equipment | 7,502 | 7,925 |
| Intangible assets | 660 | 647 |
| Other assets | 699 | 578 |
| | **$ 12,801** | **$ 13,754** |
| **Liabilities** | | |
| Current liabilities | $ 3,356 | $ 3,235 |
| Long-term debt and capital lease obligations | 4,141 | 4,006 |
| Pension and other benefits liabilities | 1,738 | 1,824 |
| Other long-term liabilities | 755 | 715 |
| | **9,990** | **9,780** |
| **Non-controlling interest** | **724** | **757** |
| **Shareholders' equity** | **2,087** | **3,217** |
| | **$ 12,801** | **$ 13,754** |

### 8.1. Analysis of Financial Position

At June 30, 2008, ACE consolidated cash, cash equivalents and short-term investments amounted to $2,325 million, a decrease of $814 million from December 31, 2007. ACE's unconsolidated cash, cash equivalents and short-term investments amounted to $828 million, a decrease of $1,072 million from December 31, 2007. The change in ACE's unconsolidated cash balances was mainly the result of substantial issuer bids aggregating $1,998 million, partially offset by the proceeds of $874 million from the sale of ACE's investments in Aeroplan Income Fund and Jazz Air Income Fund. Air Canada's cash, cash equivalents and short-term investments amounted to $1,497 million at June 30, 2008, an increase of $258 million from December 31, 2007. ACE's shareholders' equity totalled $2,087 million at June 30, 2008, a reduction of $1,130 million from December 31, 2007. The change in shareholders' equity was mainly due to the substantial issuer bids partly offset by net income and net gains on fuel derivatives recorded in other comprehensive income in the first six months of 2008.

Fuel derivatives are comprised of both derivatives designated and not designated under fuel accounting. The current portion of the derivative asset of $382 million (included in fuel derivatives in the consolidated statement of financial position) and the long-term portion of the derivative asset of $118 million (included in deposits and other assets in the consolidated statement of financial position) are included in other current assets in the table above. Refer to section 10 for additional information on fuel derivative instruments.

## 8.2. Air Canada Revolving Credit Facility

Air Canada has a secured revolving credit facility of $400 million, as further described in Note 11 to the 2007 annual consolidated financial statements of the Corporation, which is not available to Air Canada until and unless Air Canada and the lenders conclude amendments satisfactory to each of them relating to a financial covenant and other business terms. Subsequent to June 30, 2008, Air Canada and the lenders have entered into an amending agreement pursuant to which the parties undertake to negotiate such further amendments to the facility and Air Canada agrees not to request any funding under the facility until such further amendments are agreed. The outcome of the negotiations remain uncertain such that there can be no assurance that amendments satisfactory to the parties will be concluded, that amounts under the facility will ever be available to Air Canada, that Air Canada will not decide to terminate the facility, or that a replacement facility will be concluded.

## 8.3. Consolidated Cash flows

As previously discussed, ACE's results reflect the consolidation of Aeroplan's operations only up to March 14, 2007, the consolidation of Jazz's operations only up to May 24, 2007 and the consolidation of ACTS' operations only up to October 16, 2007. Consequently, ACE's consolidated statement of cash flows for Quarter 2 2008 and the first six months of 2008 is not comparable to its consolidated statement of cash flows for Quarter 2 2007 and the first six months of 2007.

The following table summarizes ACE's consolidated statement of cash flows for the indicated periods.

| | Quarter 2 | | | First Six Months | | |
|---|---|---|---|---|---|---|
| **(Canadian dollars in millions)** | **2008** | **2007** | **$ Change** | **2008** | **2007** | **$ Change** |
| Cash from operating activities | $ 217 | $ 131 | $ 86 | $ 446 | $ 447 | $ (1) |
| Cash from (used for) financing activities | (664) | 435 | (1,099) | (2,297) | 434 | (2,731) |
| Cash from (used for) investing activities | 674 | (878) | 1,552 | 1,032 | (1,694) | 2,726 |
| **Net change in cash and cash equivalents during the period** | **227** | **(312)** | **539** | **(819)** | **(813)** | **(6)** |
| **Cash and cash equivalents - Beginning of period** | **1,254** | **1,353** | **(99)** | **2,300** | **1,854** | **446** |
| **Cash and cash equivalents - End of period** | **$ 1,481** | **$ 1,041** | **$ 440** | **$ 1,481** | **$ 1,041** | **$ 440** |

### ACE unconsolidated

The following summarizes significant transactions or factors which impacted ACE's unconsolidated cash, cash equivalents and short-term investments in Quarter 2 2008:

- On April 21, 2008, ACE completed the sale of 20,400,000 units of Aeroplan Income Fund at a price of $17.50 per unit, for total net proceeds to ACE of $343 million.
- On June 2, 2008, ACE completed the sale in the market of a total of 11,726,920 units of Jazz Air Income Fund for total net proceeds to ACE of $85 million.
- On June 2, 2008, ACE completed the sale in the market of a total of 19,892,088 units of Aeroplan Income Fund for total net proceeds to ACE of $349 million.
- On June 18, 2008, ACE accepted for purchase and cancellation a total of 12,537,084 Class A variable voting shares and 10,190,187 Class B voting shares at $22.00 per share for an aggregate purchase price of $500 million, in accordance with the terms of a substantial issuer bid.

- In June 2008, an entity related to Grupo TACA exercised its put option and sold its 5% equity interest in ACTS Aero to ACE for $19 million.

The following summarizes significant transactions or factors which impacted ACE's unconsolidated cash, cash equivalents and short-term investments in Quarter 1 2008:

- On January 10, 2008, ACE accepted for purchase and cancellation a total of 40,023,427 Class A variable voting shares and 9,894,166 Class B voting shares at $30.00 per share for an aggregate purchase price of $1,498 million, in accordance with the terms of a substantial issuer bid.

- On January 14, 2008, cash proceeds of $40 million representing the full balance of funds held in escrow on closing of the monetization of ACTS on October 16, 2007 were received by ACE.

- On January 24, 2008, ACE completed the sale of 13,000,000 units of Jazz Air Income Fund at a price of $7.45 per unit for net proceeds of approximately $97 million.

In Quarter 2 2007, cash flows used for investing activities included the Jazz cash of $138 million which was removed from ACE's consolidated statement of financial position as a result of the deconsolidation of Jazz effective May 24, 2007.

In Quarter 1 2007, cash flows used for investing activities included cash payments of $53 million in connection with the acquisition of Aeroman and the Aeroplan cash of $231 million which was removed from ACE's consolidated statement of financial position as a result of the deconsolidation of Aeroplan effective March 14, 2008.

**Air Canada**

The following summarizes significant transactions or factors which impacted Air Canada's consolidated cash, cash equivalents and short-term investments in Quarter 2 2008 and in the first six months of 2008:

- Cash flows from operating activities increased $104 million from Quarter 2 2007 and $94 million from the first six months of 2007. The improvement in both periods was largely related to favourable changes in non-cash working capital items.

- Cash used for financing activities amounted to $193 million in Quarter 2 2008 and $328 million in the first six months of 2008. In Quarter 2 2008, Air Canada had new aircraft borrowings of $126 million which were more than offset by reduction of long-term debt and capital lease obligations of $319 million. In the first six months of 2008, aircraft-related borrowings amounted to $313 million while reduction of long-term debt and capital lease obligations totalled $641 million.

- Cash flows used for investing activities in Quarter 2 2008 amounted to $142 million and included proceeds of $297 million relating to the sale and leaseback of two Boeing 777 aircraft. Additions to capital assets at Air Canada, including the expenditures relating to the two Boeing 777 aircraft which were sold and leased back, amounted to $225 million. In the first six months of 2008, proceeds from the sale and leaseback of five Boeing 777 aircraft totaled $708 million while additions to capital assets, including the expenditures relating to the five Boeing 777 aircraft which were sold and leased back, amounted to $628 million. Other additions to capital assets at Air Canada included two additional Boeing 777 aircraft, three Embraer ERJ-190 aircraft, expenditures related to the aircraft interior refurbishment program and inventory and spare engines.

## 8.4. Contractual Obligations

The table below provides the Corporation's current contractual obligations for the remainder of 2008, for the next four years and after 2012. All obligations are related to Air Canada with the exception of the convertible senior notes which are an ACE unconsolidated obligation.

| (Canadian dollars in millions) | Remainder of 2008 | 2009 | 2010 | 2011 | 2012 | Thereafter | Total |
|---|---|---|---|---|---|---|---|
| Convertible senior notes (1) | $ 7 | $ 14 | $ 330 | $ - | $ - | $ - | $ 351 |
| Long-term debt obligations (1) | 153 | 299 | 278 | 283 | 287 | 2,009 | 3,309 |
| Debt consolidated under AcG-15 (1) | 101 | 106 | 153 | 338 | 93 | 304 | 1,095 |
| Capital lease obligations (1) | 119 | 161 | 157 | 151 | 192 | 604 | 1,384 |
| Operating lease obligations (2) | 148 | 300 | 289 | 226 | 208 | 718 | 1,889 |
| Committed capital expenditures (3) | 195 | 75 | 84 | 83 | 453 | 3,745 | 4,635 |
| **Total contractual obligations (4)** | **$ 723** | **$ 955** | **$ 1,291** | **$ 1,081** | **$ 1,233** | **$ 7,380** | **$ 12,663** |
| Pension funding obligations (5) | $ 302 | $ 462 | $ 469 | $ 476 | $ 483 | N/A | N/A |

*(1) Includes both the principal and the interest component of the payment obligations and is based on interest rates and the applicable foreign exchange rate effective as at June 30, 2008.*
*(2) Mainly related to US dollar aircraft operating leases.*
*(3) Mainly related to US dollar aircraft-related expenditures. Also includes purchases relating to system development costs, facilities and leasehold improvements.*
*(4) Excludes commitments for goods and services required in the ordinary course of business. Also excluded are future income taxes and other long-term liabilities mainly due to reasons of uncertainty of timing of cash flows and items which are non-cash in nature.*
*(5) Refer to section 8.5 of this MD&A for additional information on Air Canada's pension plan funding obligations.*

## 8.5. Air Canada Pension Funding Obligations

Air Canada's pension cash funding obligations are updated from those disclosed in ACE's annual 2007 MD&A dated February 7, 2008.

As at January 1, 2008, the solvency deficit in the registered domestic plans was $1,175 million compared to $542 million at January 1, 2007. The increase in the solvency deficit of the plans represents a deterioration in the financial position of the plans with the solvency ratio for all plans, on a combined basis, decreasing from 95% to 90%. This decrease resulted mainly from a below target return on fund assets of (0.5%) on the Master Trust, net of expenses.

Changes in the economic conditions, mainly the return on fund assets and the change in interest rates, will impact projected required contributions. The required contributions and solvency deficit disclosed below assume no future gains and losses on plan assets and liabilities over the projection period and especially do not reflect the economic experience and fund performance of 2008 to date.

Based on the January 1, 2008 actuarial valuation, Air Canada's projected pension cash funding obligations for the remainder of 2008, for the full year 2008 and for the next four years are as follows:

| (Canadian dollars in millions) | Remainder of 2008 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Past service domestic registered plans | $ 148 | $ 194 | $ 223 | $ 223 | $ 223 | $ 223 |
| Current service domestic registered plans | 89 | 170 | 174 | 178 | 184 | 189 |
| Other pension arrangements (1) | 65 | 92 | 65 | 68 | 69 | 71 |
| **Projected pension funding obligations** | **$ 302** | **$ 456** | **$ 462** | **$ 469** | **$ 476** | **$ 483** |

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

The above pension funding requirements are in respect of the Corporation's pension arrangements. For domestic registered pension plans, the funding requirements are based on the minimum past service contributions disclosed in the January 1, 2008 actuarial valuations plus a projection of the current service contributions. The next actuarial valuations are due on January 1, 2009.

## 8.6. Air Canada Capital Expenditures and Related Financing Arrangements

**Boeing**

As at June 30, 2008, 14 of the 16 Boeing 777 firm aircraft under the purchase agreement with Boeing had been delivered, with the remaining two firm deliveries expected by the end of 2008. The seven aircraft delivered in 2007 were financed under a loan guarantee facility with the Export-Import Bank of the United States ("EXIM"). In January 2008, the Corporation received a commitment for loan guarantee support from EXIM for all nine 2008 Boeing 777 firm aircraft deliveries. The loan guarantee, subject to certain conditions, covers a 12-year loan term for 85% of the capital expenditure at an interest rate based on a floating rate. As at August 7, 2008, seven of the nine 2008 Boeing 777 aircraft had been delivered, two of these aircraft were financed using the EXIM facility and the other five aircraft were, concurrently with their purchase, sold by and leased back to Air Canada. The five leases are accounted for as operating leases with 12-year terms. All leases are at market rates at their inception date. These sale and leaseback transactions replace an equivalent number of aircraft loan guarantee commitments provided by EXIM. The table below assumes that Air Canada's remaining two Boeing 777 firm aircraft scheduled for delivery by the end of 2008 will be financed under the loan guarantee facility with EXIM. The Corporation continues to review alternative financing options including sale and leaseback transactions for the remaining two Boeing 777 aircraft.

In Quarter 1 2008, Boeing notified Air Canada that its first Boeing 787 aircraft originally scheduled for delivery in 2010 was rescheduled for delivery in 2012, with additional deliveries, originally scheduled for completion between 2010 and 2014, being delayed by approximately two to two and a half years. Air Canada will be seeking compensation from Boeing. Air Canada is evaluating alternatives to mitigate any potential impact of this delay.

**Projected Planned and Committed Capital Expenditures**

The table below provides Air Canada's current projected planned and committed capital expenditures for the full year 2008, for the next four years and after 2012.

| (Canadian dollars in millions) | 2008 | 2009 | 2010 | 2011 | 2012 | Thereafter |
|---|---|---|---|---|---|---|
| Projected committed expenditures | $ 471 | $ 75 | $ 84 | $ 83 | $ 453 | $ 3,745 |
| Projected planned but uncommitted expenditures | 222 | 127 | 151 | 116 | 85 | |
| Total projected expenditures (1) (2) | 693 | 202 | 235 | 199 | 538 | |
| Projected financing on committed expenditures | (493) | - | - | - | (400) | |
| **Total projected expenditures, net of financing** | **$ 200** | **$ 202** | **$ 235** | **$ 199** | **$ 138** | |

(1) *US dollar amounts are converted using the June 30, 2008 noon day exchange rate of 1US$ = Cdn$1.0186. Final aircraft delivery prices include estimated escalation and interest on deferred delivery payments, which is calculated based on the 90-day USD LIBOR rate at June 30, 2008.*

(2) *The dollar amounts reflected above do not include obligations pertaining to day-to-day operations.*

## 8.7. Air Canada Fleet

In Quarter 2 2008, Air Canada took delivery of three Boeing 777-300 aircraft for a total of 15 Boeing 777 aircraft delivered to date. At the same time as the new aircraft are being added to its fleet, Air Canada is removing older and less efficient aircraft. In Quarter 1 2008, Air Canada took the decision to retire its fleet of Boeing 767-200 aircraft, consisting of 10 aircraft, by the end of 2008. These older aircraft are high unit cost aircraft from both a fuel consumption and maintenance perspective.

In response to record high fuel prices, on June 17, 2008, Air Canada announced a reduction in capacity which will impact fleet and staffing levels effective with the implementation of its fall and winter schedule. The Corporation is continually evaluating its fleet requirements and planned aircraft events may be subject to further review and change.

Pursuant to the Jazz CPA, Jazz operates an operating fleet of 133 aircraft.

**Aircraft Interior Refurbishment Program**

Air Canada commenced a refurbishment program of the interiors of its existing aircraft (Boeing 767-300, Airbus A330-300, A321, A320 and A319 aircraft) in 2006 in order to offer its customers a world class product. As at August 7, 2008, Air Canada has completed the refurbishment of 26 Boeing 767-300, 10 Airbus A321, 39 Airbus A320 and 35 Airbus A319, for a total of 110 aircraft to date. Air Canada expects all remaining operating aircraft in its fleet to be refurbished by the end of February 2009.

## 8.8. Capital Management

Each of the ACE and Air Canada Boards of Directors approves the ACE or Air Canada objectives and policies for managing capital as the case may be. Capital management is discussed separately for each entity below.

**ACE**

ACE views capital as the sum of parent company debt consisting of convertible senior notes, convertible preferred shares, non-controlling interest and shareholders' equity. This definition of capital used by management may not be comparable to measures presented by other public companies. Capital managed by ACE, summarized from the consolidated statement of financial position, follows:

| (Canadian dollars in millions) | June 30, 2008 | December 31, 2007 |
|---|---|---|
| Convertible senior notes | $ 278 | $ 273 |
| Convertible preferred shares | 194 | 182 |
| Non-controlling interest | 724 | 757 |
| Shareholders' equity | 2,087 | 3,217 |
| **Capital** | **$ 3,283** | **$ 4,429** |

Since December 31, 2007, ACE's capital declined $1,146 million to $3,283 million mainly due to the purchase and cancellation of common shares by way of substantial issuer bids partly offset by net income in the first six months of 2008 and net gains recorded in other comprehensive income.

**Air Canada**

Air Canada views capital as the sum of long-term debt, non-controlling interest, capitalized operating leases and shareholders' equity. Air Canada currently has pre-delivery financing arranged, which is related to future deliveries, and, as the aircraft have not yet been delivered, this debt is excluded from the capital base. Air Canada includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. The value is based on annualized aircraft rent expense multiplied by 7.5, which is a factor commonly used in the airline industry. The measure used may not necessarily reflect the fair value or net present value related to the future minimum lease payments as the measure is not based on the remaining contractual payments and the factor may not recognize discount rates implicit in the actual leases or current rates for similar obligations with similar terms and risks. This definition of capital is used by management and may not be comparable to similar measures presented by other public companies.

Air Canada also monitors its ratio of adjusted net debt to net debt plus equity, with equity defined as shareholders' equity. Adjusted net debt is calculated as the sum of long-term debt, non-controlling interest and capitalized operating leases less cash, cash equivalents and short-term investments.

At June 30, 2008, adjusted net debt and non-controlling interest, including capitalized operating leases, and excluding the pre-delivery payment ("PDP") financing, decreased $191 million from December 31, 2007 to $4,767 million. The adjusted net debt to net debt plus equity ratio for Air Canada decreased to 65.9% at June 30, 2008 from 67.0% at December 31, 2007. The 1.1 percentage point improvement from December 31, 2007 was in part attributable to a stronger cash position.

## 8.9. Share Information

At July 31, 2008, the issued and outstanding common shares of ACE, along with common shares potentially issuable, pursuant to convertible preferred shares, convertible senior notes and stock options were as follows:

| Number of shares (000) | July 31, 2008 | December 31, 2007 |
|---|---|---|
| **Issued and outstanding common shares** | | |
| Class A variable voting shares | 24,279 | 82,229 |
| Class B voting shares | 10,628 | 23,709 |
| **Total issued and outstanding common shares** | **34,907** | **105,938** |
| **Common shares potentially issuable** | | |
| Convertible preferred shares | 11,620 | 11,291 |
| Convertible senior notes | 13,133 | 12,210 |
| Stock options | 70 | 1,682 |
| **Total common shares potentially issuable** | **24,823** | **25,183** |
| **Total outstanding and potentially issuable common shares** | **59,730** | **131,121** |

**Substantial Issuer Bid – January 2008**

On January 10, 2008, ACE accepted for purchase and cancellation a total of 40,023,427 Class A variable voting shares and 9,894,166 Class B voting shares at $30.00 per share for an aggregate purchase price of $1,498 million under the terms of a substantial issuer bid. No convertible preferred shares of ACE were deposited on an as converted basis under the offer.

In connection with the share purchase and cancellation by ACE, the conversion rate of ACE's 4.25% Convertible Senior Notes Due 2035 was adjusted from 37.6879 to 39.0341 Class A variable voting shares or Class B voting shares per $1,000 principal amount of convertible senior notes. The adjustment was effective January 11, 2008 and was determined in accordance with the terms of the indenture governing the convertible senior notes.

**Substantial Issuer Bid – June 2008**

On June 18, 2008, ACE accepted for purchase and cancellation a total of 12,537,084 Class A variable voting shares and 10,190,187 Class B voting shares at $22.00 per share for an aggregate purchase price of $500 million, in accordance with the terms of a substantial issuer bid. No convertible preferred shares of ACE were deposited on an as converted basis under the offer.

In connection with the share purchase and cancellation by ACE, the conversion rate of ACE's 4.25% Convertible Senior Notes Due 2035 was adjusted from 39.0341 to 40.6917 Class A variable voting shares or Class B voting shares per $1,000 principal amount of convertible senior notes. The adjustment was effective June 19, 2008 and was determined in accordance with the terms of the indenture governing the convertible senior notes.

## 9. Related Party Transactions

At June 30, 2008, ACE held a 75% ownership interest in Air Canada. Air Canada has various related party transactions with ACTS Aero, an ACE-related entity.

The related party balances resulting from the application of the related party agreements were as follows:

| (Canadian dollars in millions) | June 30, 2008 | December 31, 2007 |
|---|---|---|
| **Accounts receivable** | | |
| ACTS Aero (Air Canada) | $ 99 | $ 99 |
| | **$ 99** | **$ 99** |
| **Accounts payable and accrued liabilities** | | |
| ACTS Aero (Air Canada) | $ 37 | $ 88 |
| | **$ 37** | **$ 88** |

The related party revenues and expenses with ACTS Aero are summarized as follows:

| (Canadian dollars in millions) | Quarter 2 2008 | First Six Months 2008 |
|---|---|---|
| **Revenues** | | |
| Property rental revenues (ACTS Aero) | $ 9 | $ 17 |
| Revenues from information technology services (ACTS Aero) | 4 | 7 |
| Revenues from corporate services and other (ACTS Aero) | 5 | 18 |
| | **$ 18** | **$ 42** |
| **Expenses** | | |
| Maintenance expense for services (ACTS Aero) | $ 134 | $ 275 |
| Recovery of wages, salary and benefit expense for employees assigned to ACTS Aero | (68) | (135) |
| | **$ 66** | **$ 140** |

## 10. Financial Instruments and Risk Management

As described in section 5 of this MD&A, the Corporation adopted CICA sections 3862 and 3863 effective January 1, 2008. These new standards enhance disclosures with respect to financial instruments.

**Risk Management**
The Corporation is exposed to the following risks as a result of holding financial instruments: fuel price risk, interest rate risk, foreign exchange risk, liquidity risk and market risk. The following is a description of these risks and how they are managed.

**Fuel Price Risk**
To manage its exposure to jet fuel prices and minimize volatility in operating cash flows, Air Canada enters into derivative contracts with financial intermediaries.

As at June 30, 2008, Air Canada had hedged 40% of its fuel requirement for Quarter 2 2008, 43% of its projected fuel requirement for the remainder of 2008, 20% of its projected fuel requirement for 2009 and 7.5% of its projected fuel requirement for 2010. The remainder of 2008 was hedged at prices that fluctuate between an average of US$108 to US$116 per barrel for jet-fuel based contracts, an average of US$95 to US$99 per barrel for heating oil-based contracts and an average of US$111 to US$125 per barrel for West Texas Intermediate ("WTI") crude-oil based contracts. On an equivalent WTI basis, the remainder of 2008 was hedged at prices that fluctuate between an average of US$91 to US$97 per barrel.

Since June 30, 2008, Air Canada has entered into new hedging positions, using costless collar option structures. As at August 7, 2008, Air Canada had hedged 49% of its projected fuel requirement for the remainder of 2008, 24% of its projected fuel requirement for 2009 and 9.4% of its projected fuel requirement for 2010. With these new hedging positions, the remainder of 2008 is hedged at prices that can fluctuate between an average of US$108 to US$116 per barrel for jet-fuel based contracts, an average of US$98 to US$102 per barrel for heating oil-based contracts and an average of US$116 to US$129 per barrel for WTI crude-oil based contracts. On an equivalent WTI basis, the remainder of 2008 is hedged at prices that fluctuate between an average of US$94 to US$101 per barrel.

The total increase in the fair value of the Corporation's fuel derivatives, including derivatives under hedge accounting and not under hedge accounting, amounted to $449 million in Quarter 2 2008 ($568 million in the first six months of 2008). Of the fair value gain, $255 million was deferred in other comprehensive income ("OCI") in Quarter 2 2008 to be applied as a reduction to fuel expense in the future as the contracts mature ($401 million in the first six months of 2008), and the remaining $194 million was recorded as a gain in non-operating income in Quarter 2 2008 ($167 million in the first six months of 2008). The accounting treatment in either OCI or non-operating expense, as described further below, does not alter the economic impact of the Corporation's fuel hedging program.

The following information summarizes the financial statement impact of derivatives designated under fuel hedge accounting, before the impact of tax:

- The fair value of outstanding fuel derivatives under hedge accounting at June 30, 2008 was $463 million in favour of the Corporation. At July 30, 2008, the fair value of the outstanding fuel derivatives was $281 million.

- The change in fair value of derivatives in Quarter 2 2008 was $370 million ($483 million in the first six months of 2008):

  - The unrealized effective change in the fair value of derivatives recorded in other comprehensive income ("OCI") in Quarter 2 2008 was $213 million before tax expense of $68 million ($347 million before tax expense of $110 million in the first six months of 2008). The realized effective change in the fair value of derivatives recorded in OCI in Quarter 2 2008 was $42 million before tax expense of $14 million ($54 million before tax expense of $18 million in the first six months of 2008). OCI amounts for Quarter 2 2008 and for the six months ended June 30, 2008 of $173 million and $273 million, respectively, are presented net of this tax expense on the consolidated statement of comprehensive income.

  - The ineffective change in the fair value of derivatives recorded in non-operating income (expense) in Quarter 2 2008 was a gain of $115 million ($82 million in the first six months of 2008). The ineffective portion is calculated as the difference between the change in the intrinsic value and the change in the fair market value of the derivatives over the period as well as the difference between the Air Canada proxy derivative value and the counterparty derivative value. The gain in non-operating income (expense) was due to the change in the fair market value of the derivatives being higher than the change in the intrinsic value.

- In Quarter 1 2008, hedge accounting was discontinued for certain fuel hedge contracts, with a fair value of $8 million, where the hedging relationship ceased to satisfy the conditions for hedge accounting. Certain of these contracts were re-designated under hedge accounting in Quarter 2 2008. The Corporation still continues to hold these derivatives as it believes they continue to be good economic hedges in managing its exposure to jet fuel prices. The value of the accumulated other comprehensive income ("AOCI") balance recognized in connection with these derivatives will be taken into fuel expense upon the maturity of the contracts. No further de-designations were required in Quarter 2 2008.

- In Quarter 2 2008, fuel derivative contracts matured with fair values in favour of the Corporation for $93 million.

- In Quarter 2 2008, the benefit to fuel expense was $92 million before tax expense of $30 million ($126 million before tax of $41 million in the first six months of 2008). This benefit was recognized through the removal of the amount from AOCI. The after tax amount of $62 million in Quarter 2 2008 was reflected in "reclassification of net realized (gains) losses on fuel derivatives to income" on the consolidated statement of comprehensive income ($85 million in the first six months of 2008).

- In Quarter 2 2008, the net impact to AOCI was an increase of $163 million before tax expense of $52 million ($275 million before tax expense of $87 million in the first six months of 2008). As at June 30, 2008, the balance in AOCI was $359 million before tax. The estimated net amount of existing gain and losses reported in AOCI that is expected to be reclassified to net income (loss) in the following 12 months is $308 million before tax.

The following information summarizes the financial statement impact of derivatives not designated under fuel hedge accounting, but held as economic hedges, before the impact of tax:

- In Quarter 2 2008, fuel derivative contracts matured in favour of the Corporation for $12 million ($19 million in the first six months of 2008).

- The fair value of outstanding fuel derivatives not under hedge accounting at June 30, 2008 was $37 million in favour of the Corporation.

- The change in fair value of the derivative contracts in Quarter 2 2008 was a gain of $79 million ($85 million in the first six months of 2008) and was recorded in non-operating income (expense).

**Interest Rate Risk**

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

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

The ratio of fixed to floating rate debt outstanding is designed to maintain flexibility in the Corporation's capital structure and is based upon a long-term objective of 60% fixed and 40% floating. The current ratio is 60% fixed and 40% floating, including the effects of interest rate swap positions.

The following are the current derivatives employed in interest rate risk management activities and the adjustments recorded in the first six months of 2008:

- The Corporation entered into three cross-currency interest rate swap agreements with terms of March 2019, May 2019, and June 2019 respectively, relating to Boeing 777 aircraft financing with an aggregate notional value of $294 million (US$289 million) as at June 30, 2008. These swaps convert US denominated debt principal and interest payments into Canadian denominated debt at a foreign exchange rate of par (US$1/CAD$1) and convert from a fixed rate of 5.208% to a floating rate. These derivative instruments have not been designated as hedges for accounting purposes and are fair valued on a quarterly basis. As at June 30, 2008, the fair value of these contracts was $13 million in favour of the counterparty. The Corporation recorded a loss of $19 million in Quarter 2 2008.
- During Quarter 1 2008, the Corporation's one remaining Embraer 190 aircraft interest rate swap contract matured, with a fair value of $2 million in favour of the counterparty. No gain or loss was recorded during the period.

**Foreign Exchange Risk**

Foreign exchange risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

The majority of the Corporation's outstanding debt is denominated in US dollars. The US dollar debt acts as an economic hedge against the related aircraft, which is routinely purchased and sold by Air Canada in US dollars.

The Corporation is also exposed to foreign exchange risk on foreign currency denominated trade receivables and foreign currency denominated net cash flows.

The Corporation's risk management objective is to reduce cash flow risk related to foreign denominated cash flows. To help manage this risk, the Corporation enters into certain foreign exchange forward contracts or currency swaps to manage the risks associated with foreign currency exchange rates. At as June 30, 2008, the Corporation had entered into foreign currency forward contracts and option agreements converting US dollars and Euros into Canadian dollars on $1,993 million (US$1,958 million) and $30 million (EUR 19 million) which mature in 2008, 2009 and 2010. The fair value of these foreign currency contracts as at June 30, 2008 was $1 million in favour of the Corporation (December 31, 2007 - $124 million in favour of third parties on $2,132 million (US$2,158 million) and $26 million (EUR 18 million) which mature in 2008 and 2009). In Quarter 2 2008, a gain of $4 million (a gain of $83 million in the first six months of 2008) was recorded in foreign exchange gain (loss) related to these derivatives. These derivative instruments have not been designated as hedges for accounting purposes.

The cross-currency swap as described above under interest rate risk acts as an economic hedge of the foreign exchange risk on the financing related to two Boeing 777 aircraft with a principal amount of $294 million (US$289 million) as at June 30, 2008.

The Corporation had also entered into currency swap agreements for 11 CRJ aircraft. These agreements matured in January 2008 with a nominal fair value. No gain or loss was recorded during the period.

**Liquidity risk**

Liquidity risk is the risk that the Corporation will encounter difficulty in meeting obligations associated with its financial liabilities. The long-term debt issued by the Corporation generally has fixed principal and interest repayment requirements over the term of the instrument.

The Corporation monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as security in financing arrangements, and maintaining flexibility in financing arrangements.

**Market Risk**

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: foreign exchange risk, interest rate risk and other price risk, which includes commodity price risk. Refer to the section "Asset-Backed Commercial Paper" below for information regarding these instruments held by the Corporation.

The Corporation is exposed to market risks through the derivative instruments entered into. The Corporation uses derivative instruments only for risk management purposes and not for generating trading profit. As such, any change in cash flows associated with derivative instruments due to their exposure to market risks is designed to be offset by changes in cash flows related to the risk being hedged.

**Asset-Backed Commercial Paper ("ABCP")**

The Corporation has $37 million ($29 million, net of a fair value adjustment) in non-bank sponsored ABCP which has been recorded in deposits and other assets. These investments were scheduled to mature during the third quarter 2007. An agreement in principle to restructure the ABCP investments was approved by the Pan-Canadian Committee for Third Party Structured ABCP ("Committee") on December 23, 2007 and approved by vote, which occurred on April 25, 2008. Under the terms of the restructuring, all of the ABCP would be exchanged for longer-term notes that will match the maturity of the underlying assets in the proposed structure. Air Canada is not accruing interest on these investments.

The carrying value as at June 30, 2008 was based on a number of assumptions as to the fair value of the investments including factors such as estimated cash flow scenarios and risk adjusted discount rates. The assumptions used in estimating the fair value of the investments are subject to change, which may result in further adjustments to non-operating results in the future. No adjustment to the carrying value was recorded during the first six months of 2008.

## 11. Risk Factors

For a detailed description of the risk factors associated with the Corporation, refer to the section entitled "Risk Factors" in ACE's 2007 MD&A dated February 7, 2008. Certain risk factors in ACE's 2007 MD&A are revised to provide for the following updates:

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 the Corporation, a number of whom, including the Corporation, have received a statement of objections from the European Commission that sets out the European Commission's preliminary assessment in relation to such matter. The Corporation has provided its reply to the statement of objections. Competition authorities have sought or requested information from the Corporation as part of their investigations. The Corporation is cooperating with these investigations, which are likely to lead to proceedings against the Corporation and a number of airlines and other cargo operators in certain jurisdictions. The Corporation 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.

During Quarter 1 2008, the Corporation recorded a provision of $125 million as a preliminary estimate. This estimate is based upon the current status of the investigations and proceedings and the Corporation's assessment as to the potential outcome for certain of them. This provision does not address the proceedings in all jurisdictions, but only where there is sufficient information to do so. Management has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings. Additional material provisions may be required.

The risk factor describing the Air Canada Pilots Association ("ACPA") claim under Current Legal Proceedings is amended to reflect the Ontario Court of Appeal's decision, on June 27, 2008, to reject ACPA's appeal of the order dismissing its claim.

The description of the risk factor related to Regulatory Matters is expanded to reference legislation being considered or enacted by governments (and which may apply to the airline industry), in relation to carbon emission trading schemes (such as the European Union's emissions trading scheme legislation), aimed at reducing carbon emissions.

## 12. Quarterly Financial Information

The quarterly information presented below may not be directly comparable as a result of changes in accounting policies relating to Aeroplan, Jazz and ACTS Aero. Refer to section 5 of this MD&A for additional information.

| ($ millions, except per share amounts) | Q3 2006 | Q4 2006 | Q1 2007 (2) | Q2 2007 (3) | Q3 2007 | Q4 2007 (4) | Q1 2008 | Q2 2008 |
|---|---|---|---|---|---|---|---|---|
| Operating revenues | $ 2,947 | $ 2,544 | $ 2,625 | $ 2,659 | $ 3,022 | $ 2,520 | $ 2,726 | $ 2,783 |
| Special charge for Aeroplan miles (1) | (102) | - | - | - | - | - | - | - |
| **Operating revenues** | **2,845** | **2,544** | **2,625** | **2,659** | **3,022** | **2,520** | **2,726** | **2,783** |
| Operating expenses | (2,642) | (2,471) | (2,654) | (2,563) | (2,682) | (2,474) | (2,753) | (2,785) |
| **Operating income (loss) before under-noted item (5)** | **203** | **73** | **(29)** | **96** | **340** | **46** | **(27)** | **(2)** |
| Provision for cargo investigations (6) | - | - | - | - | - | - | (125) | - |
| **Operating income (loss)** | **203** | **73** | **(29)** | **96** | **340** | **46** | **(152)** | **(2)** |
| Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax(7) | (100) | (122) | (43) | 22 | (116) | 1,082 | (30) | 832 |
| **Net income (loss)** | **$ 103** | **$ (49)** | **$ (72)** | **$ 118** | **$ 224** | **$ 1,128** | **$ (182)** | **$ 830** |
| **Earnings (loss) (8)** | | | | | | | | |
| **Per share – basic** | **$ 1.01** | **$ (0.48)** | **$ (0.70)** | **$ 1.14** | **$ 2.17** | **$ 10.81** | **$ (2.96)** | **$ 15.46** |
| **Per share – diluted** | **$ 0.95** | **$ (0.48)** | **$ (0.70)** | **$ 0.98** | **$ 1.84** | **$ 8.88** | **$ (2.96)** | **$ 10.76** |

(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) *ACE ceased consolidating Aeroplan's results effective March 14, 2007.*
(3) *ACE ceased consolidating Jazz's results effective May 24, 2007.*
(4) *ACE ceased consolidating ACTS' results effective October 16, 2007.*
(5) *Quarter 1 2007 and Quarter 2 2007 include special charges for labour restructuring of $9 million and $6 million, respectively.*
(6) *Air Canada recorded a provision for cargo investigations of $125 million in Quarter 1 2008.*
(7) *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. Quarter 2 2007 includes a gain of $4 million and a tax provision of $1 million relating to the sale of 0.249 million shares of its holdings in US Airways. Quarter 3 2007 includes a gain of $4 million and a tax provision of $1 million relating to the sale of 0.251 million shares of its holdings in US Airways. Quarter 4 2007 includes an aggregate gain on disposal of $1,339 million and a tax provision of $214 million mainly comprised of a gain on disposal of $565 million and a tax provision of $82 million related to the monetization of ACTS which was completed on October 16, 2007, a gain on disposal of $539 million and a tax provision of $91 million related to the secondary offering of 22,000,000 trust units of Aeroplan Income Fund and a gain on disposal of $233 million and a tax provision of $41 million related to the secondary offering of 35,500,000 trust units of Jazz Air Income Fund. Quarter 1 2008 includes a gain of $89 million ($71 million, net of tax) on ACE's sale of 13,000,000 units of Jazz Air Income Fund and an impairment provision of $38 million recorded by Air Canada related to its fleet of Boeing 767-200 aircraft. Quarter 2 2008 includes a gain of $413 million ($340 million, net of tax) on ACE's sale of 20,400,000 units of Aeroplan Income fund, a gain of $417 million ($344 million, net of tax) on ACE's sale of 19,892,088 units of Aeroplan Income Fund and a gain on of $78 million ($62 million, net of tax) on ACE's sale of 11,726,920 units of Jazz Air Income Fund.*
(8) *Includes the impact of a substantial issuer bid completed by ACE on January 10, 2008 whereby ACE accepted for purchase and cancellation a total of 40,023,427 Class A variable voting shares and 9,894,166 Class B voting shares and a substantial issuer bid completed by ACE on June 18, 2008 whereby ACE accepted for purchase and cancellation a total of 12,537,084 Class A variable voting shares and 10,190,187 Class B voting shares*

## 13. Off-Balance Sheet Arrangements

There were no significant changes to ACE's off-balance sheet arrangements from what was disclosed in ACE's 2007 MD&A dated February 7, 2008.

## 14. Controls and Procedures

**Disclosure Controls and Procedures**
Disclosure controls and procedures within ACE are designed to provide reasonable assurance that all relevant information is identified to its Disclosure Policy Committee to ensure appropriate and timely decisions are made regarding public disclosure.

ACE's 2007 Annual Report contains a statement that the Chairman, President and Chief Executive Officer and the Executive Vice President and Chief Financial Officer have concluded that ACE's disclosure controls and procedures are effective based upon an evaluation of these controls and procedures conducted at December 31, 2007.

**Changes in Internal Controls over Financial Reporting**
There were no changes to ACE's internal controls over financial reporting during the three months ended June 30, 2008 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

## 15. Non-GAAP Financial Measures

**EBITDAR/EBITDA**
EBITDAR (earnings before interest, taxes, depreciation, amortization, obsolescence and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before aircraft rent, 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 businesses 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. The Corporation presents EBITDAR before and after the provision for cargo investigations as this item could potentially distort the analysis of trends in business performance. 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.

**ACE's EBITDAR for Quarter 2 2008 and for the first six months of 2008 is not directly comparable to its EBITDAR for Quarter 2 2007 and for the first six months of 2007. Refer to section 5 of this MD&A for additional information.**

EBITDAR and EBITDA and EBITDAR before the provision for cargo investigations are reconciled to operating income (loss) as follows:

| (Canadian dollars in millions) | Quarter 2 2008 | Quarter 2 2007 | Quarter 2 $ Change | First Six Months 2008 | First Six Months 2007 | First Six Months $ Change |
|---|---|---|---|---|---|---|
| **Air Canada** | | | | | | |
| GAAP operating loss before the provision for cargo investigations | $ 7 | $ 88 | $ (81) | $ (5) | $ 10 | $ (15) |
| Add back: | | | | | | |
| Aircraft rent | 69 | 75 | (6) | 132 | 154 | (22) |
| Depreciation and amortization | 173 | 136 | 37 | 344 | 264 | 80 |
| **EBITDAR before the provision for cargo investigations** | **249** | **299** | **(50)** | **471** | **428** | **43** |
| Provision for cargo investigations | - | - | - | (125) | - | (125) |
| **EBITDAR** | **$ 249** | **$ 299** | **$ (50)** | **$ 346** | **$ 428** | **$ (82)** |
| **Aeroplan** | | | | | | |
| GAAP operating income | $ - | $ - | $ - | $ - | $ 40 | $ (40) |
| Add back: | | | | | | |
| Depreciation and amortization | - | - | - | - | 3 | (3) |
| **EBITDA** | **$ -** | **$ -** | **$ -** | **$ -** | **$ 43** | **$ (43)** |
| **Jazz** | | | | | | |
| GAAP operating income | $ - | $ 26 | $ (26) | $ - | $ 62 | $ (62) |
| Add back: | | | | | | |
| Aircraft rent | - | 22 | (22) | - | 57 | (57) |
| Depreciation and amortization | - | 4 | (4) | - | 9 | (9) |
| **EBITDAR** | **$ -** | **$ 52** | **$ (52)** | **$ -** | **$ 128** | **$ (128)** |
| **ACTS** | | | | | | |
| GAAP operating income | $ - | $ 9 | $ (9) | $ - | $ 12 | $ (12) |
| Add back: | | | | | | |
| Depreciation and amortization | - | 11 | (11) | - | 20 | (20) |
| **EBITDA** | **$ -** | **$ 20** | **$ (20)** | **$ -** | **$ 32** | **$ (32)** |
| **ACE Consolidated (1)** | | | | | | |
| GAAP operating loss before the provision for cargo investigations | $ (2) | $ 96 | $ (98) | $ (29) | $ 67 | $ (96) |
| Add back: | | | | | | |
| Aircraft rent | 69 | 91 | (22) | 132 | 195 | (63) |
| Depreciation, amortization and obsolescence | 171 | 149 | 22 | 340 | 295 | 45 |
| **EBITDAR before the provision for cargo investigations** | **238** | **336** | **(98)** | **443** | **557** | **(114)** |
| Provision for cargo investigations | - | - | - | (125) | - | (125) |
| **EBITDA/EBITDAR** | **$ 238** | **$ 336** | **$ (98)** | **$ 318** | **$ 557** | **$ (239)** |

*(1) ACE ceased consolidating the results of Aeroplan, Jazz and ACTS effective March 14, 2007, May 24, 2007 and October 16, 2007, respectively.*

## 16. Glossary of Terms

**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;

**CASM —** Operating expense per ASM;

**EBITDA** — EBITDA is earnings before interest, taxes, depreciation, amortization and obsolescence and is a non-GAAP financial measure;

**EBITDAR** — EBITDAR is earnings before interest, taxes, depreciation, amortization, obsolescence and aircraft rent and is a non-GAAP financial measure;

**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.