

# **ACE AVIATION**

**Consolidated Financial Statements and Notes  
2009**

**February 11, 2010**

February 10, 2010

## Auditors' Report

### To the Shareholders of ACE Aviation Holdings Inc.

We have audited the consolidated statement of financial position of **ACE Aviation Holdings Inc.** as at December 31, 2009 and December 31, 2008 and the consolidated statements of operations, changes in shareholders' equity, comprehensive income (loss) and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Corporation as at December 31, 2009 and December 31, 2008 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*PricewaterhouseCoopers LLP<sup>1</sup>*

**Chartered Accountants**

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<sup>1</sup> Chartered accountant auditor permit No. 18144

**Consolidated Statement of Operations**

For the year ended December 31 (Canadian dollars in millions except per share figures)	2009 * Notes 1 & 3	2008
<b>Operating revenues</b>		
Passenger	\$ 7,196	\$ 9,713
Cargo	282	515
Other	728	852
	8,206	11,080
<b>Operating expenses</b>		
Aircraft fuel	2,056	3,419
Wages, salaries and benefits	1,472	1,908
Airport and navigation fees	822	1,001
Capacity purchase with Jazz	Note 2J 825	948
Depreciation and amortization	Notes 4 & 5 545	686
Aircraft maintenance	625	659
Food, beverages and supplies	248	314
Communications and information technology	255	286
Aircraft rent	276	279
Commissions	156	194
Other	1,170	1,460
	8,450	11,154
<b>Operating loss before under noted item</b>	<b>(244)</b>	<b>(74)</b>
Provision for cargo investigations	-	(125)
<b>Operating loss</b>	<b>(244)</b>	<b>(199)</b>
<b>Non-operating income (expense)</b>		
Interest income	17	84
Interest expense	(321)	(373)
Interest capitalized	4	37
Loss on ACE's investment in Air Canada	Note 3 (630)	-
Gain on sale of Aeroplan and Jazz units	Note 3 -	997
Loss on other assets	Note 5 (70)	(51)
Loss on repurchase of ACE convertible senior notes and preferred shares	Notes 7 & 12 (44)	-
Gain on financial instruments recorded at fair value	Note 15 94	92
Equity and other investment loss	Note 3 (7)	(64)
Other	(5)	(2)
	(962)	720
<b>Gain (loss) before the following items</b>	<b>(1,206)</b>	<b>521</b>
Non-controlling interest	(13)	238
Foreign exchange gain (loss)	531	(655)
Recovery of (provision for) income taxes	Note 8	
Current	2	(3)
Future	(6)	(221)
<b>Loss for the year</b>	<b>\$ (692)</b>	<b>\$ (120)</b>
<b>Loss per share</b>	Note 13	
Basic	\$ (19.56)	\$ (2.59)
Diluted	\$ (19.56)	\$ (2.59)

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

The accompanying notes are an integral part of these financial statements.

**Consolidated Statement of Financial Position**

As at December 31 (Canadian dollars in millions)		2009 * Notes 1 & 3	2008
<b>ASSETS</b>			
Cash and cash equivalents	Note 2C	\$ 71	\$ 1,307
Short-term investments	Note 2C	-	506
		71	1,813
Restricted cash	Note 2T	-	45
Accounts receivable		3	700
Aircraft fuel inventory		-	97
Spare parts and supplies		-	20
Collateral deposits for fuel derivatives	Note 15	-	328
Prepaid expenses and other current assets	Note 17	-	206
Equity investment in Air Canada	Note 3	99	-
Loan receivable from Air Canada	Note 3	150	-
Equity investment in ACTS Aero	Note 3	-	-
		323	3,209
Property and equipment	Note 4	-	7,469
Intangible assets	Note 5	-	698
Deposits and other assets	Note 6	-	495
		\$ 323	\$ 11,871
<b>LIABILITIES</b>			
Accounts payable and accrued liabilities		\$ 3	\$ 1,288
Fuel derivatives	Note 15	-	420
Advance ticket sales		-	1,333
Current portion of long-term debt and capital leases	Note 7	-	663
		3	3,704
Long-term debt and capital leases	Note 7	-	4,980
Convertible preferred shares	Note 12	-	206
Future income taxes	Note 8	-	50
Pension and other benefit liabilities	Note 9	-	1,585
Other long-term liabilities	Note 10	-	370
		3	10,895
Non-controlling interest		-	512
<b>SHAREHOLDERS' EQUITY</b>			
Share capital and other equity	Note 12	104	307
Contributed surplus		358	163
Retained earnings (deficit)		(92)	600
Accumulated other comprehensive loss	Notes 2R & 12	(50)	(606)
		320	464
		\$ 323	\$ 11,871

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

The accompanying notes are an integral part of these financial statements.

Guarantees - Refer to Note 3.

On behalf of the Board of Directors:

*(signed) Robert A. Milton*

**Robert A. Milton**  
Chief Executive Officer

*(signed) David I. Richardson*

**David I. Richardson**  
Chair of the Audit, Finance and Risk Committee

**Consolidated Statement of Changes in Shareholders' Equity**

For the year ended December 31 (Canadian dollars in millions)	2009 * Notes 1 & 3	2008
<b>Share capital</b>		
Common shares, beginning of year	\$ 100	\$ 243
Repurchase and cancellation of common shares	-	(180)
Issue of shares through stock options exercised	4	37
<b>Total share capital</b>	<b>104</b>	<b>100</b>
<b>Other equity</b>		
Convertible senior notes	-	90
Convertible preferred shares	-	117
<b>Total share capital and other equity</b>	<b>104</b>	<b>307</b>
<b>Contributed surplus</b>		
Balance, beginning of year	163	504
Repurchase and cancellation of common shares	-	(329)
Repurchase and cancellation of ACE convertible senior notes and preferred shares	199	-
Deconsolidation of ACE's investment in Air Canada	(6)	-
Fair value of stock options recognized as compensation recovery	2	(5)
Fair value of exercised stock options to share capital	-	(7)
<b>Total contributed surplus</b>	<b>358</b>	<b>163</b>
<b>Retained earnings (deficit)</b>		
Balance, beginning of year	600	2,209
Repurchase and cancellation of common shares	-	(1,489)
Loss for the year	(692)	(120)
<b>Total retained earnings (deficit)</b>	<b>(92)</b>	<b>600</b>
<b>Accumulated other comprehensive income (loss)</b>		
Balance, beginning of year	(606)	54
Other comprehensive income (loss)	556	(660)
<b>Total accumulated other comprehensive loss</b>	<b>(50)</b>	<b>(606)</b>
<b>Total retained earnings (deficit) and accumulated other comprehensive loss</b>	<b>(142)</b>	<b>(6)</b>
<b>Total shareholders' equity</b>	<b>\$ 320</b>	<b>\$ 464</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

The accompanying notes are an integral part of these financial statements.

**Consolidated Statement of Comprehensive Income (Loss)**

For the year ended December 31 (Canadian dollars in millions)		2009 * Notes 1 & 3	2008
<b>Comprehensive income (loss)</b>			
Loss for the year		\$ (692)	\$ (120)
Other comprehensive income (loss), net of taxes:			
Net change in unrealized gain on Jazz Air Income Fund	Note 3	-	65
Reclassification of net realized gains on Jazz Air Income Fund to income	Note 3	-	(65)
Net change in unrealized gain on Aeroplan Income Fund	Note 3	-	331
Reclassification of net realized gains on Aeroplan Income Fund to income	Note 3	-	(331)
Unrealized gain on translation of self-sustaining operation		-	2
Net losses on fuel derivatives under hedge accounting		(1)	(605)
Reclassification of net realized losses (gains) on fuel derivatives to income		366	(57)
Deconsolidation of ACE's investment in Air Canada	Note 3	176	-
Proportionate share of Air Canada's other comprehensive income	Note 3	15	-
<b>Total comprehensive loss</b>		<b>\$ (136)</b>	<b>\$ (780)</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

The accompanying notes are an integral part of these financial statements.

**Consolidated Statement of Cash Flow**

For the year ended December 31 (Canadian dollars in millions)	2009 * Notes 1 & 3	2008
<b>Cash flows from (used for)</b>		
<b>Operating</b>		
Loss for the year	\$ (692)	\$ (120)
Adjustments to reconcile to net cash from operations		
Depreciation and amortization	545	686
Loss on ACE's investment in Air Canada	Note 3 630	-
Equity investment loss	7	69
Gain on sale of Aeroplan and Jazz units	Note 3 -	(997)
Loss on other assets	Note 5 70	51
Loss on repurchase of ACE convertible senior notes and preferred shares	Notes 7 & 12 44	-
Foreign exchange (gain) loss	(505)	822
Future income taxes	6	221
Excess of employee future benefit funding over expense	(334)	(316)
Provision for cargo investigations	-	125
Non-controlling interest	13	(238)
Fuel and other derivatives	20	(208)
Fuel hedge collateral deposits, net	228	(322)
Changes in non-cash working capital balances	(230)	120
Other	30	(3)
	<b>(168)</b>	<b>(110)</b>
<b>Financing</b>		
Issue of ACE common shares	-	30
Repurchase and cancellation of ACE common shares	Note 12 -	(1,998)
Repurchase of ACE convertible senior notes	Note 7 (297)	-
Repurchase of ACE convertible preferred shares	Note 12 (260)	-
Air Canada borrowings	776	871
Air Canada shares issued under public offering	Note 3 230	-
Air Canada warrants issued under the Air Canada public offering and Air Canada credit facility	Note 3 24	-
Reduction of long-term debt and capital lease obligations	(882)	(993)
Other	-	(5)
	<b>(409)</b>	<b>(2,095)</b>
<b>Investing</b>		
Short-term investments	338	334
Proceeds from sale of Aeroplan units	Note 3 -	692
Proceeds from sale of Jazz units	Note 3 -	182
Exercise of ACTS Aero put option	Note 3 -	(19)
Proceeds from escrow related to sale of ACTS	Note 3 -	40
Deconsolidation of Air Canada cash	Note 3 (1,277)	-
Additions to capital assets	(200)	(883)
Proceeds from contractual commitment	230	-
Proceeds from sale of assets	Note 4 96	38
Proceeds from sale-leaseback transactions	Note 4 172	708
Funding of Aveos letter of credit	-	59
Other	(18)	61
	<b>(659)</b>	<b>1,212</b>
<b>Decrease in cash and cash equivalents</b>	<b>(1,236)</b>	<b>(993)</b>
Cash and cash equivalents, beginning of year	1,307	2,300
<b>Cash and cash equivalents, end of year</b>	<b>\$ 71</b>	<b>\$ 1,307</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3). Cash and cash equivalents exclude Short-term investments of nil as at December 31, 2009 (\$506 as at December 31, 2008).

The accompanying notes are an integral part of these financial statements.

**For the years ended December 31, 2009 and 2008  
(currencies in millions – Canadian dollars)**

## **1. BASIS OF PRESENTATION**

ACE Aviation Holdings Inc. ("ACE") which was incorporated on June 29, 2004, is an investment holding company of aviation interests. Reference to the "Corporation" in the following notes to the financial statements 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. Refer to Note 3 for a description of ACE's investments.

ACE had two reportable segments: Air Canada and Corporate Items and Eliminations ("CIE") until October 27, 2009, after which time only one segment remains.

These financial statements have been prepared on a going concern basis of presentation. As described in Note 3, effective October 27, 2009, ACE no longer consolidates Air Canada's financial position, operating results and cash flows. ACE's investment in Air Canada has since been accounted for using the equity method whereby the Air Canada investment carrying value is adjusted to include the Corporation's pro rata share of post-dilution earnings. The result is as follows:

- The Consolidated statement of operations and related notes for the year ending December 31, 2009 reflect ten months of Air Canada consolidated operating results and two months of Air Canada equity loss.
- The Consolidated statement of financial position and related notes as at December 31, 2009 exclude the Air Canada consolidated financial position and instead reflect the Air Canada investment using the equity method.
- The Consolidated statement of comprehensive income (loss) and related notes for the year ending December 31, 2009 reflect ten months of Air Canada consolidated comprehensive income (loss) and two months of ACE's proportionate share of Air Canada comprehensive income (loss).
- The Consolidated statement of cash flow and related notes for the year ending December 31, 2009 reflect ten months of Air Canada consolidated cash flow and two months of ACE's unconsolidated cash flows.

These consolidated financial statements are expressed in millions of Canadian dollars and are prepared in accordance with generally accepted accounting principles in Canada ("GAAP").

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



## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### **A) PRINCIPLES OF CONSOLIDATION**

These consolidated financial statements include the accounts of the Corporation and its aviation interests, with adjustments for non-controlling interests. The consolidated financial statements of the Corporation also include the accounts of variable interest entities for which the Corporation is the primary beneficiary. All inter-company balances and transactions are eliminated.

Aeroplan Limited Partnership ("Aeroplan") was consolidated up to March 14, 2007, Jazz Air Limited Partnership ("Jazz") was consolidated up to May 24, 2007, ACTS Limited Partnership ("ACTS") was consolidated up to October 16, 2007 and Air Canada was consolidated up to October 27, 2009 (Refer to Note 3).

### **B) USE OF ESTIMATES**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Significant estimates made in the preparation of the consolidated financial statements include those used in accounting for employee future benefits (Note 9), accounting for income taxes (Note 8), the determination of passenger revenues, the determination of amortization period for long-lived assets, the impairment considerations on long-lived assets and the carrying value of financial instruments recorded at fair value.

### **C) CASH AND CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS**

Cash includes \$40 pertaining to investments with original maturities of three months or less at December 31, 2009 (2008 - \$1,215). Investments include bankers' acceptances and bankers' discount notes, which may be liquidated promptly and have original maturities of three months or less. The weighted average interest rate on investments as at December 31, 2009 is 0.22% (2008 - 1.74%).

Short-term investments, comprised of bankers' acceptances and bankers' discount notes, have original maturities over three months, but not more than one year. The weighted average interest rate on Short-term investments as at December 31, 2008 was 2.90%.

### **D) EQUITY INVESTMENTS**

Investments subject to significant influence are accounted for using the equity method which reflects the costs of the investment and the Corporation's proportionate share of the investee's profits or losses, other comprehensive income or losses, capital transactions and dividends received. The Corporation does not record the losses of investee's when the Corporation is unlikely to share in such losses unless the Corporation has guaranteed the obligations of the investee, has committed to provide further financial support to the investee or the investee seem assured of imminently returning to profitability. When there is a loss in value of an investment accounted for using the equity method that is other than a temporary decline, the investment is written down to its fair value with a loss recognized in the statement of operations. Such write-downs are not reversed if there is a subsequent increase in value. Refer to Notes 3 and 18.

### **E) LOAN RECEIVABLE**

The loan and related interest receivable from Air Canada are classified as loans and receivables and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.

Derivative instruments are recorded on the consolidated statement of financial position at fair value, including those derivatives that are embedded in financial or non-financial contracts. Changes in the fair values of derivative instruments are recognized in non-operating income (expense).

**F) RELATED PARTY TRANSACTIONS**

Related party transactions not in the normal course of operations are measured at the exchange amount when the change in ownership interest in the item transferred is substantive and the exchange amount is supported by independent evidence; otherwise it is recorded at the carrying amount. Related party transactions in the normal course of operations are measured at the exchange amount.

**G) INCOME TAXES**

The Corporation utilizes the asset and liability method of accounting for income taxes under which future income tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amount and the tax basis of assets and liabilities. Future income tax assets and liabilities are measured using substantively enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. Income taxes are recognized in the income statement except to the extent that it relates to items charged or credited to Shareholders' equity, in which case the taxes are netted with such items. The effect on future income tax assets and liabilities of a change in tax rates is recognized in earnings in the period when the change is substantively enacted. Future income tax assets are recognized to the extent that realization is considered more likely than not. The Corporation applied fresh start reporting on September 30, 2004 under which the assets and liabilities of the Corporation were comprehensively revalued, excluding goodwill ("fresh start"). The benefit of future income tax assets that existed at fresh start, and for which a valuation allowance is recorded, have been recognized first to reduce to nil any remaining intangible assets (on a pro-rata basis) that were recorded upon fresh start reporting with any remaining amount as a credit to Shareholders' equity, up to October 27, 2009 (Refer to Note 3). The benefit of future income tax assets that arise after fresh start will be recognized in the Consolidated Statement of Operations.

**H) IMPAIRMENT OF LONG-LIVED ASSETS**

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

Indefinite life intangible assets are subjected to impairment tests on an annual basis or when events or circumstances indicate a potential impairment. If the carrying value of such assets exceeds the fair values, the assets are written down to fair value.

**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES SPECIFIC TO AIR CANADA****I) PASSENGER AND CARGO REVENUES**

Airline passenger and cargo advance sales are deferred and included in Current liabilities. Advance sales also include the proceeds from the sale of flight tickets to Aeroplan, a corporation that provides loyalty program services to Air Canada and purchases seats from Air Canada pursuant to the Commercial Participation and Services Agreement between Aeroplan and Air Canada (the "CPSA"). Passenger and cargo revenues are recognized when the transportation is provided, except for revenue on unlimited flight passes which is recognized on a straight-line basis over the period during which the travel pass is valid. Air Canada has formed alliances with other airlines encompassing loyalty program participation, code sharing and coordination of services including reservations, baggage handling and flight schedules. Revenues are allocated based upon formulas specified in the agreements and are recognized as transportation is provided.

Air Canada performs regular evaluations on the deferred revenue liability which may result in adjustments being recognized as revenue. Due to the complex pricing structures; the complex nature of interline and other commercial agreements used throughout the industry; historical experience over a period of many years; and other factors including refunds, exchanges and unused tickets, certain relatively small amounts are recognized as revenue based on estimates. Events and circumstances may result in actual results that are different from estimates.

**J) CAPACITY PURCHASE AGREEMENTS – JAZZ AND TIER III CARRIERS**

Air Canada has capacity purchase agreements with Jazz and certain other regional carriers, which are referred to as Tier III carriers, operating aircraft of 18 seats or less. Under these agreements, Air Canada markets, tickets and enters into other commercial arrangements relating to these flights and records the revenue it earns under Passenger revenue. Operating expenses under capacity purchase agreements include the capacity purchase fees, which, under a capacity purchase agreement between Air Canada and Jazz (the “Jazz CPA”), include a variable component that is dependent on Jazz aircraft utilization, a fixed component and pass-through costs. Pass-through costs are non-marked-up costs charged to Air Canada and include fuel, airport and user fees and other costs. These expenses are recorded in the applicable category within Operating expenses.

The following table outlines expenses and pass through costs under the Jazz CPA for the last two years.

	2009 *	2008
Expenses from Jazz CPA	\$ 825	\$ 948
Pass through fuel expense from Jazz CPA	211	427
Pass through airport expense from Jazz CPA	165	201
Pass through other expense from Jazz CPA	27	38
	<b>\$ 1,228</b>	<b>\$ 1,614</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

Due to terms of the Jazz CPA, Jazz is deemed to be a variable interest entity. Notwithstanding that Air Canada is not the primary beneficiary of Jazz, Air Canada holds a significant variable interest in Jazz through the contractual arrangements with Jazz.

**K) AEROPLAN LOYALTY PROGRAM**

Air Canada is an Aeroplan partner providing certain of Air Canada's customers with Aeroplan Miles, which can be redeemed by customers for air travel or other rewards acquired by Aeroplan.

Under the CPSA, Aeroplan purchases passenger tickets from Air Canada to meet its obligation for the redemption of Aeroplan Miles for air travel. The proceeds from the sale of passenger tickets to Aeroplan are included in Advance ticket sales. Revenue related to these passenger tickets is recorded in passenger revenues when transportation is provided.

For Aeroplan Miles earned by Air Canada customers, Air Canada purchases Miles from Aeroplan in accordance with the terms of the CPSA. The cost of purchasing Aeroplan Miles from Aeroplan is accounted for as a sales incentive and charged against passenger revenues when the points are issued, which occurs upon the qualifying air travel being provided to the customer.

**L) OTHER REVENUES**

Other revenue includes revenues from the sale of the ground portion of vacation packages, ground handling services and other airline related services. Vacation package revenue is recognized as services are provided over the period of the vacation. Other airline related service revenues are recognized as the products are sold to passengers or the services are provided.

Other revenue also includes revenue related to the lease or sublease of aircraft to third parties. Lease or sublease revenues are recognized on a straight line basis over the term of the lease or sublease. Rental revenue from operating leases and subleases amounted to \$105 in 2009 (2008 - \$115).

In certain subleases of aircraft to Jazz, Air Canada reports the sublease revenues net against aircraft rent expense as the terms of the sublease match the terms of Air Canada's lease. Air Canada acts as lessee and sublessor in these matters.

Air Canada provides certain services to related parties, namely ACE and Aveos Fleet Performance Inc. (“Aveos”), and former related parties consisting principally of administrative services. Administrative service revenues are recognized as services are provided. Real estate rental revenues are recognized on a straight line basis over the term of the lease.

#### **M) EMPLOYEE FUTURE BENEFITS**

The cost of pensions, other post-retirement and post-employment benefits earned by employees is actuarially determined annually as at December 31. The cost is determined using the projected benefit method prorated on service, market interest rates, and management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees and health care costs.

A market-related valuation method is used to value plan assets for the purpose of calculating the expected return on plan assets. Under the selected method, the differences between investment returns during a given year and the expected investment returns are amortized on a straight line basis over four years.

Past service costs arising from plan amendments are amortized on a straight-line basis over the expected average remaining service period of employees active at the date of amendment. This period does not exceed the expected average remaining service period of such employees up to the full eligibility date. The expected average remaining service period of active employees (or expected average remaining life expectancy of retired members for a plan with no active members) is between 7 and 16 years for pension plans and between 10 and 11 years for post retirement and post employment benefit plans.

Cumulative unrecognized net actuarial gains and losses in excess of 10% of the greater of the projected benefit obligation or market-related value of plan assets at the beginning of the year are amortized over the expected remaining service life of active employees.

Certain Air Canada employees are contractually assigned to Aveos and are members of Air Canada-sponsored defined benefit pension plans and also participate in Air Canada-sponsored health, life and disability benefit plans. Other Air Canada employees were contractually assigned to Aeroplan until the date of transition to employment at Aeroplan and then ceased to accrue benefits under the Corporation-sponsored defined benefit pension plans and under the Corporation-sponsored health, life and disability benefit plans. These consolidated financial statements include all of the assets and liabilities of all sponsored plans of Air Canada. Pension and other employee benefits expenses are recorded net of costs recovered from these entities pertaining to employees contractually assigned by Air Canada to these entities based on an agreed upon formula. The cost recovery reduces Air Canada's benefit cost.

#### **N) EMPLOYEE PROFIT SHARING PLAN**

Air Canada has employee profit sharing plans. Expenses are calculated annually on full calendar year results and recorded throughout the year as a charge to salary and wage expense based on the estimated annual payment under the plan.

#### **O) STOCK-BASED COMPENSATION PLANS**

Certain employees of Air Canada participate in Air Canada's Long-Term Incentive Plan, which provide for the grant of stock options and Performance Share Units (“PSUs”).

The Corporation changed its accounting policy for awards of stock based compensation granted to Corporation employees with a graded vesting schedule. Prior to January 1, 2009, the fair value of stock options with a graded vesting schedule was recognized as compensation expense and a credit to Contributed surplus on a straight line basis over the applicable vesting period. Effective January 1, 2009, the fair value of stock options with a graded vesting schedule is determined based on different expected lives for the options that vest each year, as it would be if the award were viewed as several separate awards, each with a different vesting date, and it is accounted for on that basis. The new accounting policy provides more reliable and relevant information about the effects of the transactions. For a stock option award attributable to an employee who is eligible to retire at the grant date, the fair value of the stock option award is expensed on the grant date. For a stock option award attributable to an employee who will become eligible to retire during the vesting period, the fair value of the stock option award is recognized over the period from the grant date to the date the employee becomes eligible to retire. The amount of compensation cost recognized at any date at least equals the value of the vested options at that date.

The impact of the change in accounting policy for awards granted to Corporation employees with a graded vesting schedule was immaterial to any prior period and therefore no adjustments were made to such prior periods.

For grants of PSUs that are accounted for as equity settled instruments, Air Canada recognizes Compensation expense offset by Contributed surplus equal to the market value of an Air Canada common share at the date of grant on a straight line basis over the applicable vesting period. Compensation expense is adjusted for subsequent changes in management's estimate of the number of PSUs that are expected to vest. For grants of PSUs that are accounted for as cash settled instruments, Air Canada recognizes Compensation expense offset by Other long-term liabilities equal to the market value of an Air Canada common share at the date of grant on a straight line basis over the applicable vesting period. Compensation expense is adjusted for subsequent changes in the market value of Air Canada common shares and management's estimate of the number of PSUs that are expected to vest.

Air Canada also maintains an employee share purchase plan. Under this plan, contributions by Air Canada employees are matched to a specific percentage by Air Canada. Employees must remain with the Corporation until March 31 of the subsequent year for vesting of Air Canada's contributions. These contributions are included in Wages, salaries, and benefits expense as earned.

#### **P) MAINTENANCE AND REPAIRS**

Maintenance and repair costs for both leased and owned aircraft, including line maintenance, component overhaul and repair, and maintenance checks, are charged to Operating expenses as incurred, with the exception of maintenance and repair costs related to return conditions on short-term aircraft leases, which are accrued over the term of the lease. Line maintenance consists of routine daily and weekly scheduled maintenance inspections and checks, overhaul and repair involves the inspection or replacements of major parts, and maintenance checks consist of more complex inspections and servicing of the aircraft.

#### **Q) OTHER OPERATING EXPENSES**

Included in Other operating expenses are expenses related to building rent and maintenance, terminal handling, professional fees and services, crew meals and hotels, advertising and promotion, insurance costs, credit card fees, ground costs for Air Canada Vacations packages, and other expenses. Expenses are recognized as incurred.

#### **R) FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING**

Under the Corporation's risk management policy derivative financial instruments are used only for risk management purposes and not for generating trading profits.

Financial assets and financial liabilities, including derivatives, are recognized on the Consolidated Statement of Financial Position when the Corporation becomes a party to the contractual provisions of the financial instrument or non-financial derivative contract. All financial instruments are required to be measured at fair value on initial recognition except for certain related party transactions. Effective January 1, 2009, the Corporation adopted the recommendations of the Emerging Issues Committee of the CICA relating to Abstract EIC-173 Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. Under this Abstract, the Corporation's own credit risk and the credit risk of the counterparty are taken into consideration in determining the fair value of financial assets and financial liabilities, including derivative instruments. The adoption of this guidance had no significant impact on the Corporation's consolidated financial statements as collateral deposits with fuel derivative counterparties and master netting arrangements are considered in determining whether a credit risk adjustment is required on the valuation of the derivatives. Measurement in subsequent periods is dependent upon the classification of the financial instrument as held-for-trading, held-to-maturity, available-for-sale, loans and receivables, or other financial liabilities. The held-for-trading classification is applied when an entity is "trading" in an instrument or alternatively the standard permits that any financial instrument be irrevocably designated as held-for-trading. The held-to-maturity classification is applied only if the asset has specified characteristics and the entity has the ability and intent to hold the asset until maturity. For financial instruments classified as other than held-for-trading, transaction costs are added to the initial fair value of the related financial instrument.

Financial assets and financial liabilities classified as held-for-trading are measured at fair value with changes in those fair values recognized in Non-operating income (expense). Financial assets classified as held-to-maturity, loans and receivables, or other financial liabilities are measured at amortized cost using the effective interest method of amortization. Financial assets classified as available-for-sale are measured at fair value with unrealized gains and losses, including changes in foreign exchange rates, being recognized in Other Comprehensive Income ("OCI"), as described below. Investments in equity instruments classified as available-for-sale that do not have a quoted market price in an active market are measured at cost.

Air Canada enters into interest rate, foreign currency, and fuel derivatives to manage the associated risks. Derivative instruments are recorded on the Consolidated Statement of Financial Position at fair value, including those derivatives that are embedded in financial or non-financial contracts. Changes in the fair value of derivative instruments are recognized in Non-operating income (expense) with the exception of foreign exchange risk management contracts, which are recorded in Foreign exchange gain (loss), and fuel derivatives designated as effective cash flow hedges, as further described below. These contracts are included in the Consolidated Statement of Financial Position at fair value in Prepaid expenses and other current assets, Deposits and other assets, Accounts payable and accrued liabilities, or Other long-term liabilities based on the terms of the contractual agreements. All cash flows associated with purchasing and selling derivatives are classified as operating cash flows in the Consolidated Statement of Cash Flow.

For financial instruments measured at amortized cost, transaction costs or fees, premiums or discounts earned or incurred are recorded, at inception, net against the fair value of the financial instrument. Interest expense is recorded using the effective interest method. For any guarantee issued that meets the definition of a guarantee pursuant to Accounting Guideline 14, *Disclosure of Guarantees*, the inception fair value of the obligation relating to the guarantee is recognized and amortized over the term of the guarantee. It is the Corporation's policy to not re-measure the fair value of the financial guarantee unless it qualifies as a derivative.

The Corporation has implemented the following classifications:

- Cash and cash equivalents and Short-term investments are classified as held-for-trading and any period change in fair value is recorded through interest income.
- Restricted cash is classified as held-for-trading.
- Aircraft related and other deposits are classified as held-to-maturity investments and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.
- Accounts receivable are classified as loans and receivables and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.
- Accounts payable, credit facilities, bank loans and the financial liability component of convertible notes and convertible preferred shares are classified as other financial liabilities and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.

Effective January 1, 2009, the Corporation has adopted the enhanced disclosure requirements of amended CICA section 3862 *Financial Instruments – Disclosures*. Refer to Note 15 for a classification of fair value measurements recognized in the Consolidated Statement of Financial Position using a fair value hierarchy that reflects the significance of the inputs used in making the measurements.

#### Fuel Derivatives Under Hedge Accounting

Prior to Air Canada discontinuing hedge accounting for all fuel derivatives effective the third quarter of 2009 as described below, Air Canada had designated certain of its fuel derivatives as cash flow hedges. In a cash flow hedging relationship, the effective portion of the change in the fair value of the hedging derivative is recognized in Other comprehensive income ("OCI") while the ineffective portion is recognized in Non-operating income (expense). Upon maturity of the fuel derivatives, the effective gains and losses previously recognized in Accumulated OCI ("AOCI") are recorded in fuel expense.

Hedge accounting is discontinued prospectively when the derivative no longer qualifies as an effective hedge, or the derivative is terminated or sold, or upon the sale or early termination of the hedged item. The amounts previously recognized in AOCI are reclassified to fuel expense during the periods when the derivative matures.

After considering the costs and benefits specific to the application of cash flow hedge accounting, Air Canada elected to discontinue hedge accounting for all fuel derivatives effective the third quarter of 2009. The derivative instruments will continue to be recorded at fair value in each period with both realized and unrealized changes in fair value recognized immediately in earnings in non-operating income (expense). Amounts deferred to AOCI for derivatives previously designated under hedge accounting will be taken into fuel expense in the period in which the derivative was originally scheduled to mature.

#### **S) FOREIGN CURRENCY TRANSLATION**

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at rates of exchange in effect at the date of the Consolidated Statement of Financial Position. Non-monetary assets and liabilities, revenues and expenses arising from transactions denominated in foreign currencies, are translated at the historical exchange rate or the average exchange rate during the period, as applicable. Adjustments to the Canadian dollar equivalent of foreign denominated monetary assets and liabilities due to the impact of exchange rate changes are recognized in Foreign exchange gain (loss).

#### **T) RESTRICTED CASH**

As at December 31, 2008, Air Canada had recorded \$45 in Restricted cash, under Current assets, representing funds held in trust by Air Canada Vacations in accordance with regulatory requirements governing Advance ticket sales, recorded under Current liabilities, for certain travel related activities.

Restricted cash with maturities greater than one year from the balance sheet date is recorded in Deposits and other assets. This restricted cash relates to funds on deposit with various financial institutions as collateral for letters of credit and other items.

#### **U) AIRCRAFT FUEL INVENTORY AND SPARE PARTS INVENTORY**

Inventories of aircraft fuel and spare parts and supplies are measured at the lower of cost and net realizable value, with cost being determined using a weighted average formula.

Air Canada did not recognize any write-downs on inventories or reversals of any previous write-downs during the periods presented. Included in aircraft maintenance is \$69 related to spare parts and supplies consumed during the year.

#### **V) PROPERTY AND EQUIPMENT**

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

Property and equipment are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Property and equipment under capital leases and within variable interest entities are depreciated to estimated residual values over the life of the lease. Aircraft and flight equipment, including spare engines and related parts ("rotables") are depreciated over 20 to 25 years, with 10% to 20% estimated residual values. Aircraft reconfiguration costs are amortized over 3 to 5 years. Betterments to owned aircraft are capitalized and amortized over the remaining service life of the aircraft. Betterments to aircraft on operating leases are amortized over the term of the lease.

Buildings are depreciated over their useful lives not exceeding 50 years on a straight line basis. An exception to this is where the useful life of the building is greater than the term of the land lease. In these circumstances, the building is depreciated over the life of the lease. Leasehold improvements are amortized over the lesser of the lease term or 5 years. Ground and other equipment is depreciated over 3 to 25 years.

**W) INTEREST CAPITALIZED**

Interest on funds used to finance the acquisition of new flight equipment and other property and equipment is capitalized for periods preceding the dates that the assets are available for service. Capitalized interest related to the acquisition of new flight equipment and other property and equipment is included in purchase deposits within Property and equipment (Note 4) using the effective interest rate method. Capitalized interest also includes financing costs charged by the manufacturer on capital commitments.

**X) INTANGIBLE ASSETS**

Effective January 1, 2009 the Corporation adopted the new CICA accounting standard 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 Corporation's accounting policy for intangible assets is consistent with the new standard and as a result, no adjustment was recorded on transition.

As a result of the application of fresh start reporting, intangible assets were recorded at their estimated fair values at September 30, 2004. For periods subsequent to September 30, 2004, intangible assets are initially recorded at cost. Indefinite life assets are not amortized while assets with finite lives are amortized on a straight line basis to nil over their estimated useful lives.

	Estimated Useful Life
International routes and slots	Indefinite
Air Canada trade name	Indefinite
Other marketing based trade names	Indefinite
Star Alliance membership	25 years
Other contract and customer based intangible assets	10 to 15 years
Technology based intangible assets	1 to 5 years

**Y) AIRCRAFT LEASE PAYMENTS IN EXCESS OF OR LESS THAN RENT EXPENSE**

Total aircraft operating lease rentals over the lease term are amortized to operating expense on a straight-line basis. Included in Deposits and other assets and Other long-term liabilities are the differences between the straight line aircraft rent expense and the payments as stipulated under the lease agreement.

**Z) ASSET RETIREMENT OBLIGATIONS**

Air Canada records an asset and related liability for the costs associated with the retirement of long-lived tangible assets when a legal liability to retire such assets exists. The fair value of a liability for an asset retirement obligation is recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and then amortized over its estimated useful life. In subsequent periods, the asset retirement obligation is adjusted for the passage of time through charges to income and any changes in the amount of the underlying cash flows through increases or decreases to the asset retirement obligation and related asset. A gain or loss may be incurred upon settlement of the liability.

**AA) VARIABLE INTEREST ENTITIES**

Aircraft Leasing Transactions

Air Canada has aircraft leasing transactions with a number of special purpose entities that are variable interest entities (a "VIE") under Accounting Guideline 15 of the CICA Handbook, Variable Interest Entities ("AcG-15"). As a result of Air Canada being the primary beneficiary of these VIEs, Air Canada consolidates leasing entities covering 44 aircraft.



### Fuel Facilities Arrangements

Air Canada participates in fuel facilities arrangements operated through fuel facility corporations (the "Fuel Facility Corporations"), along with other airlines to contract for fuel services at various major Canadian airports. The Fuel Facility Corporations are organizations incorporated under federal or provincial business corporations acts in order to acquire, finance and lease assets used in connection with the fuelling of aircraft and ground support equipment. The Fuel Facilities Corporations operate on a cost recovery basis.

Under AcG-15, Air Canada is the primary beneficiary of three of the Fuel Facility Corporations in Canada. As at December 31, 2008, five of the Fuel Facility Corporations in which Air Canada participates in Canada that had not been consolidated have assets of approximately \$150 and debt of approximately \$127, which was Air Canada's maximum exposure to loss without taking into consideration any cost sharing and asset retirement obligations that would occur amongst the other contracting airlines. Air Canada considers this loss potential as remote.

### **FUTURE ACCOUNTING STANDARD CHANGES**

The following is an overview of accounting standard changes that the Corporation will be required to adopt in future years:

#### Business Combinations, Consolidated Financial Statements and Non-controlling Interests

The CICA issued three new accounting standards in January 2009: section 1582, *Business Combinations*, section 1601, *Consolidated Financial Statements*, and section 1602, *Non-controlling interests*. These new standards will be effective for fiscal years beginning on or after January 1, 2011. The Corporation is in the process of evaluating the requirements of these new standards.

Section 1582 replaces section 1581, and establishes standards for the accounting for a business combination. It provides the Canadian equivalent to International Financial Reporting Standard IFRS 3 – *Business Combinations*. The section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011.

Sections 1601 and 1602 together replace section 1600 – *Consolidated Financial Statements*. Section 1601, establishes standards for the preparation of consolidated financial statements. Section 1601 applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of International Financial Reporting Standard IAS 27 - *Consolidated and Separate Financial Statements* and applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011.

### 3. INVESTMENTS

As at December 31, 2009, ACE's principal investments are:

- a 27.0% (75 million Class B Voting Shares) ownership interest in Air Canada; and
- a secured loan of \$150 to Air Canada.

ACE also has a 28.4% interest in Aero Technical Support & Services Holdings sarl ("ACTS Aero"), which owns 100% of Aveos Fleet Performance Inc. ("Aveos"). As at December 31, 2009, the carrying value of the Corporation's investment in ACTS Aero is nil. Refer to Note 18.

These investments are more fully described below. During 2008, ACE completed the sales of its remaining investments in Aeroplan and Jazz.

#### **Air Canada**

##### Overview

Air Canada includes the passenger and cargo transportation services business operated by Air Canada and related ancillary services.

These services are provided through Air Canada, Air Canada Cargo Limited Partnership ("Air Canada Cargo") up to and including November 30, 2009, ACGHS Limited Partnership ("Air Canada Ground Handling Services" or "ACGHS") up to and including November 30, 2009 and Touram Limited Partnership ("Air Canada Vacations").

Effective December 1, 2009, the operations of Air Canada Cargo and Air Canada Ground Handling Services, previously operated by wholly-owned subsidiaries of Air Canada, were wound up into Air Canada and are now operated as divisions of Air Canada. These wind-ups had no impact on the consolidated financial statements.

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 as well as the international markets to and from Canada. Certain of the scheduled passenger services offered on domestic and Canada-US transborder routes are provided by Jazz Air LP through a capacity purchase agreement between Air Canada and Jazz. Through Air Canada's global route network, virtually every major market throughout the world is served either directly or through the Star Alliance network. In addition, Air Canada provides certain passenger charter services.

Air Canada offers air cargo services on domestic and US transborder routes using cargo capacity on aircraft operated by Air Canada and Jazz. (Prior to December 1, 2009, these services were provided by Air Canada Cargo). Air Canada offers international cargo services on routes between Canada and major markets in Europe, Asia, South America and Australia using cargo capacity on Boeing 777 and other wide body aircraft operated by Air Canada.

Up until December 1, 2009, Air Canada Ground Handling Services provided passenger handling services to Air Canada, Jazz and other airlines with a primary focus on Canadian stations. Services covered included passenger check-in, gate management, baggage and cargo handling and processing, cabin cleaning, de-icing as well as aircraft ramp services. Effective December 1, 2009 with the wind-up of ACGHS into Air Canada, Air Canada offers these services directly.

Air Canada Vacations is one of Canada's leading tour operators. Based in Montreal and Toronto, it operates its business in the outgoing leisure travel market (Caribbean, Mexico, USA, Europe, South America and Asia) by developing, marketing and distributing vacation travel packages and services through a network of independent travel agencies in Canada as well as through the Air Canada Vacations website, [aircanadavacations.com](http://aircanadavacations.com).

Summary of significant events

During 2009, Air Canada entered into the following significant transactions in an effort to mitigate liquidity risks:

- Completed a share and warrant public offering for net proceeds of \$249.
- Completed a secured term credit facility (the "Credit Facility") for financing proceeds of \$600, less fees of \$20. The Credit Facility is a five-year facility, with the first principal repayment due in August 2010, and currently bears interest at 12.75%. Under the Credit Facility, 10 million warrants were issued which entitle the debt holders to acquire up to 10 million shares in Air Canada. ACE provided financing of \$150 with respect to the Credit Facility, as further described below.
- Pension funding agreements with all of Air Canada's Canadian-based unions (the "Pension MOUs") and the adoption of the *Air Canada Pension Funding Regulations, 2009* (the "Air Canada 2009 Pension Regulations"). The Air Canada 2009 Pension Regulations relieve Air Canada from making any special (past service cost) payments for the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contributions shall equal the lesser of (i) \$150, \$175, and \$225 in respect of 2011, 2012, and 2013, respectively and (ii) the maximum past service contributions permitted under the Income Tax Act. Pursuant to the Pension MOUs, on October 26, 2009 Air Canada issued, to a trust, 17,647,059 Class B Voting Shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of the sale of such shares held by the trust are to be contributed to the pension plans.
- Total cash flows to Air Canada during the full year 2009 from borrowing, including the Credit Facility described above, amounted to \$926, proceeds from sale of assets amounted to \$103, proceeds from sale-leaseback transactions amounted to \$552 and proceeds from contractual commitments amounted to \$230.

At December 31, 2009, Air Canada had Cash and cash equivalents and Short-term investments of \$1,407 (\$1,005 as at December 31, 2008).

Guarantee of Air Canada obligation

On May 7, 2009, ACE intervened into the employment agreement between Air Canada and Mr. Calin Rovinescu, its President and Chief Executive Officer, to guarantee the payments required of Air Canada under the agreement.

In addition, ACE agreed to cause to be issued an irrevocable bank letter of credit to a maximum of \$5. At December 31, 2009, as agreed by the parties, the letter of credit had not been issued.

Loan receivable from Air Canada

On July 29, 2009, ACE participated in the \$600 Air Canada Credit Facility with a number of other lenders providing financing of \$150 which represented 25% of the Credit Facility.

Under the Credit Facility, ACE received 1,250,000 warrants on July 30, 2009 for the purchase of Air Canada Class B Voting Shares with an exercise price of \$1.51 per share, exercisable at any time, and expiring four years after the date of issuance. On October 19, 2009, ACE received an additional 1,250,000 warrants with an exercise price of \$1.44 per share, exercisable at any time, and expiring four years after the date of issuance.

The terms of the Credit Facility permit, on or before the first anniversary of the Air Canada Credit Facility and subject to satisfaction of certain conditions, Air Canada to request an increase to the facility by up to an additional \$100 by obtaining new commitments from either the existing or new lenders. ACE's pro-rata share of the Credit Facility is repayable in 16 consecutive quarterly installments commencing in August 2010 of \$7.5 with the final installment of \$30 due in July 2014. Any increase to the facility would increase, on a pro rata basis, the scheduled repayments, including the final payment.

The Credit Facility bears interest at a rate based upon the greater of the bankers' acceptance rate or 3.00% plus 9.75% (12.75% as at December 31, 2009). The Credit Facility can be repaid at any time, in whole or in part, with the payment of applicable fees, subject to a minimum repayment of \$10.

Air Canada's obligations under the Credit Facility are secured by a first priority security interest and hypothec over substantially all the present and after-acquired property of Air Canada and its subsidiaries, subject to certain exclusions and permitted liens. The Credit Facility contains customary representations and warranties and is subject to customary terms and conditions (including negative covenants, financial covenants and events of default). Financial covenants require Air Canada to maintain, as of the last business day of each month, a minimum liquidity level (as defined per the Credit Facility and generally based upon the balances as reported in Cash and cash equivalents and Short-term investments) of \$800 and a minimum EBITDAR (earnings before interest, income taxes, depreciation, amortization, aircraft rentals, certain non-operating income (expense) and special items) and an interest coverage ratio test determined as at the end of each fiscal quarter.

A requirement of the Credit Facility is that Air Canada maintain securities of \$800 in accounts subject to securities control agreements. The securities in such accounts would become restricted if Air Canada defaults on certain terms of the agreement.

#### Dilution of ACE's investment in Air Canada

##### *Air Canada Pension MOUs*

As described above, Air Canada entered into the Pension MOUs providing for Air Canada to issue 17,647,059 Class B Voting Shares representing a fully diluted 15% equity ownership of Air Canada, established as of the date of the Pension MOUs, to a trust (the "Trust") with all net proceeds of the eventual sale of the shares held by the trust to be contributed to the pension plans. As a result, on October 26, 2009, Air Canada issued 17,647,059 Class B Voting Shares to the Trust.

##### *Air Canada Share and Warrant Offering*

As described above, on October 27, 2009 Air Canada completed a previously announced bought deal public offering pursuant to which it sold to an underwriting syndicate 160,500,000 units (the "Units") of Air Canada at a price of \$1.62 per Unit for aggregate gross proceeds to Air Canada of \$260 (net proceeds of \$249 after expenses and underwriter fees).

Each Unit was comprised of one Class A variable voting share (the "Variable Voting Shares") or one Class B voting share (the "Voting Shares", and, together with the Variable Voting Shares, the "Shares") of Air Canada, and one-half of one share purchase warrant. Each whole share purchase warrant is defined as a "Warrant". Each Warrant will entitle the holder thereof to acquire one Variable Voting Share or one Voting Share (each, a "Warrant Share") at an exercise price of \$2.20 per Warrant Share, at any time prior to 36 months following October 27, 2009. In the event that, prior to the time of expiry of the Warrants, the 20-day volume weighted average trading price of the Variable Voting Shares on the Toronto Stock Exchange ("TSX") is equal to or greater than \$4.00 or the 20-day volume weighted average trading price of the Voting Shares on the TSX is equal to or greater than \$4.00 (each, an "Acceleration Event"), Air Canada shall have the right, at its option, within 10 business days after the Acceleration Event, to accelerate the time of expiry of the Warrants.

##### *Air Canada dilution and resulting loss of control*

As a result of the shares issued by Air Canada completed on October 26, 2009 and October 27, 2009, ACE's ownership interest in Air Canada was reduced from 75% to 27% such that ACE ceased to control Air Canada. As a result, ACE recorded a dilution loss of \$411.

As of October 27, 2009, ACE no longer consolidates Air Canada's financial position, operating results and cash flows. ACE's investment in Air Canada has since been accounted for using the equity method whereby the Air Canada investment carrying value is adjusted to include the Corporation's pro rata share of post-dilution earnings and other comprehensive income. An equity loss of \$7 was recorded representing ACE's pro rata share of post-dilution earnings through to December 31, 2009. The proportionate share of Air Canada other comprehensive income of \$15 was recorded representing ACE's pro rata share of post-dilution other comprehensive income through to December 31, 2009.

Carrying value of ACE's investment in Air Canada

In December 2009, ACE recorded a Provision for loss on Air Canada investment of \$219 as a result of adjusting the carrying value due to an other than temporary decline in the value of the Corporation's investment in Air Canada to \$99 based on Air Canada's closing market price as at December 31, 2009 (\$1.32 per Class B share) as quoted on the Toronto Stock Exchange.

Air Canada carrying value prior to the following:	\$ 721
Air Canada dilution loss	(411)
Air Canada carrying value as at October 27, 2009 subsequent to the dilution loss	310
Proportionate share of loss, subsequent to October 27, 2009	(7)
Proportionate share of other comprehensive income, subsequent to October 27, 2009	15
Provision for loss on Air Canada investment	(219)
<b>Air Canada carrying value as at December 31, 2009</b>	<b>\$ 99</b>
Air Canada total assets as at December 31, 2009	\$ 10,406
Air Canada total liabilities as at December 31, 2009	\$ 8,759
Air Canada loss for the year ended December 31, 2009	\$ (24)

The loss on ACE's investment in Air Canada of \$630, included in the Consolidated statement of operations, is comprised of the Air Canada dilution loss of \$411 and the Provision for loss on Air Canada investment of \$219.

**ACTS Aero**

ACTS LP was a full service aircraft maintenance, repair and overhaul organization competing on a global basis.

ACTS was consolidated up to October 16, 2007. Post-monetization described below, ACE's investment in ACTS Aero is accounted for using the equity method.

Monetization

On October 16, 2007, ACE sold substantially all the assets and liabilities of ACTS LP to ACTS Aero. As a result of the monetization of ACTS, the \$200 intercompany note payable by ACTS to ACE was settled through the issue of additional partnership units of ACTS LP to ACE. After settlement of certain obligations ACE received cash proceeds of \$723. Subsequent to December 31, 2007, ACE received an additional \$40 in cash proceeds from funds held in escrow that was conditional upon the completion of certain supplier contracts within specified terms. In addition, on closing Air Canada received cash proceeds of \$65, comprised of \$28 for the sale of a building, \$20 pursuant to the Repair Schemes and Non-compete agreement, and \$17 as repayment of a note.

ACE realized a gain of \$565 on the monetization in 2007, which includes the funds held in escrow received subsequent to closing. ACE continues to own 100% of ACTS LP, which is now a non-operating company, and ACTS Aero conducts the business previously operated by ACTS LP. Following the redemption of the exchangeable share issued to a party related to Grupo TACA as discussed below and the establishment of an initial ACTS Long Term Incentive Plan ("LTIP"), ACE held a 23% (28.4% as at December 31, 2009) equity interest in ACTS Aero. The consolidated statement of financial position does not include the financial position or results of operations of ACTS Aero, as ACTS Aero is equity accounted for subsequent to the monetization. As at October 16, 2007, ACE's net investment in ACTS Aero was \$76.

The Corporation has various related party transactions after removing ACTS from the consolidation of ACE.

These transactions are recorded at the exchange amount. Refer to Note 17 Related Party Transactions for a description of the transactions between the Corporation and ACTS Aero.

### Acquisition of Aeroman

On February 13, 2007, ACTS LP, through a wholly-owned subsidiary, acquired 80% of Aeromantenimiento, S.A. ("Aeroman"), the aircraft maintenance division of Grupo TACA Holdings Limited ("Grupo TACA") of El Salvador. Total consideration for this acquisition included cash as well as a right to acquire an equity stake in ACTS LP. The cash component of US\$45 consisted of cash of \$50 (US\$43) on closing and milestone payments of up to \$2 (US\$2) in the aggregate, funded by ACTS LP through ACE's available cash resources.

As part of the monetization process, an entity related to Grupo TACA exchanged its exchangeable share and received \$31 cash, a 5% equity stake in ACTS and a put option that allowed it to put its 5% equity interest back to ACE for US\$18 within 12 months. During 2008, the entity related to Grupo TACA exercised its put option and sold its 5% equity interest to ACE for \$19 (US\$18) increasing ACE's ownership interest in ACTS Aero from 22.8% to 27.8%. The liability related to this redemption obligation, initially recorded, was settled as part of the transaction.

### Provision for loss on ACTS Aero investment

In December 2008, the Corporation recorded a provision for loss of \$10 related to its equity investment in ACTS Aero. As at December 31, 2009, the carrying value of the Corporation's investment in ACTS Aero is nil (nil as at December 31, 2008). Refer to Note 18.

## **Aeroplan**

### Overview

Aeroplan provides its commercial partners, including Air Canada, with loyalty marketing services designed to stimulate demand for such partners' products and services.

ACE had an indirect ownership interest in Aeroplan Limited Partnership through its holdings in Aeroplan Income Fund ("AIF"). Aeroplan was consolidated until March 14, 2007, the date the Corporation made a special distribution of Aeroplan Income Fund units to the Corporation's shareholders. From March 14, 2007 to May 9, 2008, ACE's investment in Aeroplan was accounted for using the equity method. From May 10, 2008 to June 2, 2008, ACE's investment in Aeroplan was accounted for as an available for sale security. The classification of the investment in Aeroplan as available-for-sale resulted in the investment being carried at fair value. The adjustment to fair value recorded to OCI was \$331, net of income taxes of \$72.

### Summary of sales of units in 2008

On April 21, 2008, ACE sold a total of 20.4 million units of AIF at a price of \$17.50 per unit representing total net proceeds to ACE of \$343 and realized a gain on sale of \$413 (\$340 after tax).

On June 2, 2008, ACE sold its remaining units of AIF for total net proceeds to ACE of \$349, and realized a gain on sale of \$417 (\$344 after tax). Net realized gains of \$331, net of tax of \$72, were taken into income from OCI.

Since June 2, 2008, subsequent to the sale of all remaining AIF units, ACE has no ownership interest in Aeroplan.

## **Jazz**

### Overview

Jazz is the largest regional airline and second largest airline in Canada, after Air Canada, based on fleet size and number of routes operated. Jazz provides service to Air Canada's customers in lower density markets and in higher density markets at off-peak times throughout Canada and to certain destinations in the United States under a capacity purchase agreement between Air Canada and Jazz.

ACE had an indirect ownership interest in Jazz Air LP through its holdings in Jazz Air Income Fund ("JAIF"). Jazz was consolidated to May 24, 2007, the date the Corporation made a special distribution of Jazz Air Income Fund units to the Corporation's shareholders. From that date to January 24, 2008, ACE's investment in Jazz was accounted for using the equity method. Subsequent to the sale on January 24, 2008 to February 7, 2008, ACE's investment in Jazz was classified as an available-for-sale investment. The classification of the investment in Jazz as available-for-sale resulted in the investment being carried at fair value. The adjustment to fair value recorded to OCI was \$71, net of income taxes of (\$15).

#### Summary of sales of units in 2008

On January 24, 2008, ACE sold a total of 13 million units of JAIF at a price of \$7.45 per unit representing total net proceeds to ACE of \$97 and realized a gain on sale of \$89 (\$71 net of taxes).

On June 2, 2008, ACE sold its remaining units of JAIF for total net proceeds to ACE of \$85, and realized a gain on sale of \$78 (\$62 net of taxes). Net realized gains of \$65, net of tax of \$14, were taken into income from OCI.

Since June 2, 2008, subsequent to the completion of the sale of JAIF units, ACE has no ownership interest in Jazz.

**4. PROPERTY AND EQUIPMENT**

	2009 * Notes 1 & 3	2008
<b>Cost</b>		
Flight equipment, including spare engines (a)	\$ -	\$ 6,235
Assets under capital leases (b)	-	1,940
Buildings, including leasehold improvements	-	643
Ground and other equipment	-	160
	-	8,978
<b>Accumulated depreciation and amortization</b>		
Flight equipment, including spare engines (a)	-	1,101
Assets under capital leases (b)	-	562
Buildings, including leasehold improvements	-	148
Ground and other equipment	-	49
	-	1,860
Purchase deposits, including capitalized interest (c)	-	<b>7,118</b>
	-	351
<b>Property and equipment at net book value (d)</b>	<b>\$ -</b>	<b>\$ 7,469</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

- (a) Included in flight equipment as at December 31, 2008 are rotable parts, including spare engines with a cost of \$798 less accumulated depreciation of \$279 for a net book value of \$519. Also included in flight equipment as at December 31, 2008 are 30 aircraft and 1 engine which are leased to Jazz and third parties with a cost of \$942 less accumulated depreciation of \$289 for a net book value of \$653.
- (b) Included in capital leases as at December 31, 2008 are 41 aircraft with a cost of \$1,874 less accumulated depreciation of \$554 for a net book value of \$1,320 and facilities with a cost of \$66 less accumulated depreciation \$8 for a net book value of \$58.
- (c) As at December 31, 2008, included \$259 for Boeing B777/787 aircraft, \$58 for the aircraft interior refurbishment program and \$34 for equipment purchases and internal projects. Refer to Note 7(m) relating to the financing of Boeing pre-delivery payments.
- (d) As at December 31, 2008, net book value of Property and equipment included \$836 consolidated for aircraft leasing entities and \$150 consolidated for fuel facility corporations both of which are consolidated under AcG-15.

As at December 31, 2008, flight equipment included 21 aircraft that are retired from active service with a net carrying value of \$33.

Interest capitalized during 2009 amounted to \$4 at an interest rate of 7.38% (2008 - \$37 with \$10 at an interest rate of 1 month US LIBOR plus 1.14%, \$6 at an interest rate of 3 month US LIBOR plus 3.00%, \$17 at an interest rate of 7.72%, and \$4 of fees).

Depreciation of property and equipment in 2009 amounted to \$496 (2008 - \$646).



During 2009:

- Air Canada took delivery of one Boeing 777 aircraft. The aircraft was financed with guarantee support from the Export-Import Bank of the United States (“EXIM”).
- Air Canada entered into a sale lease-back transaction which closed during Quarter 1 2009 for a Boeing 777 aircraft, which was originally delivered in 2007 and debt financed. The proceeds from the transaction of \$172 were used to repay the outstanding loan of \$114. Air Canada recorded a charge of \$17 in interest expense for this transaction including a prepayment fee of \$14. The gain on sale of the aircraft of \$26 has been deferred and will be recognized in Depreciation and amortization over the term of the lease. The lease is accounted for as a capital lease with a 12 year term, with monthly lease payments.
- Air Canada sold two A340 aircraft for proceeds of \$91 with a book value of \$93, resulting in a loss on sale of \$2. Air Canada made a repayment of \$82 for the associated debt.

During 2008:

- Air Canada received delivery of eight Boeing 777 aircraft. Three aircraft were financed with guarantee support from EXIM (Note 7). Five of the aircraft were financed under sale leaseback transactions with proceeds of \$708. The resulting gain on sale of \$81 was deferred and is being recognized as a reduction to Aircraft rent expense over the term of the leases. The leases are accounted for as operating leases with 12 year terms, paid monthly.
- Air Canada recorded an impairment charge of \$38 on its fleet of B767-200 aircraft due to the revised retirement date of the aircraft.
- Air Canada sold six Dash-8 aircraft for proceeds of \$10 with a book value of \$8, resulting in a gain on sale of \$2.
- Air Canada sold an A319 aircraft for proceeds of \$23 with a book value of \$21, resulting in a gain on sale of \$2.

**5. INTANGIBLE ASSETS**

	2009 * Notes 1 & 3	2008
<b>Indefinite life assets</b>		
International route rights and slots	\$ -	\$ 192
Air Canada trade name	-	174
Other marketing based trade names	-	15
	-	<b>381</b>
<b>Finite life assets</b>		
Star Alliance membership	-	92
Other contract and customer based	-	153
Technology based	-	277
	-	522
<b>Accumulated depreciation and amortization</b>		
Star Alliance membership	-	(30)
Other contract and customer based	-	(93)
Technology based	-	(82)
	-	(205)
<b>Finite life assets, net</b>	-	<b>317</b>
	<b>\$ -</b>	<b>\$ 698</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

The amortization of intangible assets during 2009 amounted to \$44 (\$40 for the year ended December 31, 2008).

During 2009, Air Canada recorded an impairment charge of \$68 related to previously capitalized costs incurred pertaining to the development of a new reservation system, referred to as POLARIS, which was recorded in Technology based intangible assets. Air Canada is currently working towards the implementation of certain components of the solution such as web and fare technology but has suspended activity relating to the implementation of the reservation system.

**6. DEPOSITS AND OTHER ASSETS**

		2009 * Notes 1 & 3	2008
Aircraft related deposits (a)		\$ -	\$ 203
Restricted cash		-	65
Deposit related to the Pension and Benefits Agreement	Note 17	-	42
Asset backed commercial paper (b)		-	29
Aircraft lease payments in excess of rent expense	Note 2Y	-	49
Other deposits		-	78
Other		-	29
		\$ -	\$ 495

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

- (a) Represented the amount of deposits with lessors for the lease of aircraft and flight simulators.
- (b) As at December 31, 2008, Air Canada had \$37 (\$29 net of a fair value adjustment) in non-bank sponsored ABCP. The carrying value as at December 31, 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 adjustments to the carrying value were recorded during the year ended December 31, 2009.

**7. LONG-TERM DEBT AND CAPITAL LEASES**

	Base Currency	Final Maturity	Stated Interest Rate (%)	2009 * Notes 1 & 3	2008
ACE:					
Convertible Senior Notes (a)	CDN	2035	4.25	\$ -	\$ 289
Air Canada:					
Embraer aircraft financing (b)	USD	2017-2021	3.37-8.49	-	1,425
Boeing aircraft financing (c)	USD	2019 - 2020	1.50-5.69	-	871
Boeing aircraft financing (d)	JPY	2020	1.04-1.20	-	270
Conditional sales agreements (e)	USD	2019	4.37-6.44	-	175
Spare engine financing (f)	USD	2013	5.13	-	95
Spare parts financing (g)	USD	2014	6.97	-	97
Lufthansa cooperation agreement (h)	USD	2009	6.50	-	16
GE loan (i)	USD	2015	4.60	-	24
Revolving credit facility (j)	CDN			-	50
Canadian Regional Jet (k)	CDN	2012	4.38	-	25
Short-term loan due 2009 (l)	USD	2009	6.45	-	190
<b>Direct Corporation debt</b>				-	<b>3,527</b>
Air Canada:					
Boeing pre-delivery payments (m)	USD	2009-2013	1.61	-	81
Aircraft leasing entities - debt (n)				-	828
Fuel facility corporations – debt (o)				-	125
<b>Debt consolidated under AcG-15</b>				-	<b>1,034</b>
Air Canada:					
Capital lease obligations (p)				-	1,082
<b>Total debt and capital leases</b>				-	<b>5,643</b>
Current portion				-	(663)
<b>Long-term debt and capital leases</b>				<b>\$ -</b>	<b>\$ 4,980</b>

The Stated Interest Rate in the table above is the rate as of December 31, 2008

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

Amounts reported below are before any transaction costs or fees recorded net against the value of the debt.

- (a) During 2005 ACE issued \$330 of Convertible Senior Notes due 2035 (“Convertible Notes”) for net proceeds of \$319. For accounting purposes, the Convertible Notes were presented as a compound instrument. At the date of issuance, the value ascribed to the holders’ conversion option, which was presented as equity, was \$94 less allocated fees of \$2; the value ascribed to the financial liability was \$236. The financial liability was originally calculated by discounting the stream of future payments of interest and principal at the prevailing rate for a similar liability that did not have an associated conversion feature.

The Convertible Notes bore interest at a rate of 4.25% per annum payable semi-annually in arrears on June 1 and December 1 in each year commencing December 1, 2005. Holders had the right to convert their Convertible Notes into Class B Voting Shares (if the holder was Canadian) or into Class A Variable Voting Shares (if the holder was not a Canadian) prior to maturity based on an initial conversion rate of 20.8333 Shares per \$1,000.00 principal amount of Convertible Notes. Upon notice of conversion, ACE had the option to deliver cash, shares or a combination of cash and shares for the Convertible Notes surrendered. Holders converting their Notes would not have received any payment upon conversion representing accrued but unpaid interest on such Notes. The amount of cash to be delivered per Convertible Note, would have been determined by multiplying the conversion rate by the average closing price (defined as the weighted average, by volume, of the reported last sale price of each class of shares) of the shares on the Toronto Stock Exchange (“TSX”) for the ten consecutive trading days ending on the third trading day following the date fixed for redemption. By delivering the amount of cash and/or the number of Shares issuable on conversion, the Corporation would have been deemed to have satisfied its obligation to pay the principal amount of the

Convertible Notes and its obligation to pay accrued and unpaid interest, attributable to the period from the most recent interest payment date through the conversion date (which amount will be deemed paid in full rather than cancelled, extinguished or forfeited).

In connection with the share purchase and cancellation by ACE on June 18, 2008, described in Note 12, the conversion rate of ACE's 4.25% Convertible Senior Notes Due 2035 was adjusted from 39.0341 to 40.6917 (after it had been adjusted from 37.6879 to 39.0341 effective January 11, 2008) Class A variable voting shares or Class B voting shares per \$1,000 principal amount of Convertible Senior Notes and was effective June 19, 2008. Adjustments were determined in accordance with the terms of the indenture governing the Convertible Senior Notes.

During 2008, Convertible Senior Notes with a face value of \$1 were converted at the option of the holder and ACE settled for cash of \$1, reducing the liability and equity portions of the notes. The gain realized on conversion was negligible.

At any time on or after June 6, 2008, ACE had the right to redeem all or a portion of the Convertible Notes at a redemption price equal to 100% of the principal amount of the Convertible Notes, plus accrued interest. Holders had the right to require ACE to purchase all or a portion of the Convertible Notes on June 1, 2010; June 1, 2015; June 1, 2020; June 1, 2025 and June 1, 2030 at a purchase price equal to 100% of the principal amount of the Notes to be purchased, plus accrued and unpaid interest. Upon specified change of control events, holders of Convertible Notes would have had the option to require ACE to purchase all or any portion of the Convertible Notes at a price equal to 100% of the principal amount of the Convertible Notes to be purchased, plus accrued and unpaid interest.

ACE had the right, at its option and subject to certain conditions, to elect to satisfy its obligation to repay all or any portion of the principal amount of the Convertible Notes that were to be redeemed, purchased or that were to be repaid at maturity, by issuing and delivering Class A Variable Voting Shares (if the holder was not a Canadian) and Class B Voting Shares (if the holder was a Canadian). The number of Shares a holder would have received in respect of each Convertible Note would have been determined by dividing the principal amount of the Convertible Notes that were to be redeemed, purchased or repaid at maturity, as the case may be, and that were not paid in cash, by 95% of the average closing price (defined as the weighted average, by volume, of the reported last sale price of each class of shares) of the shares on the Toronto Stock Exchange ("TSX") for the ten consecutive trading days ending on the third trading day following the date fixed for redemption, purchase or maturity date, as the case may be.

In January 2009, ACE completed a substantial issuer bid to purchase for cancellation 80% of its Convertible senior notes outstanding as at December 31, 2008, at a purchase price of \$900 dollars in cash for each \$1,000 dollars principal amount of notes. The aggregate principal amount of the repurchased Convertible senior notes was \$259. On January 21, 2009, the Corporation paid an aggregate purchase price of \$233 for the notes tendered. The repurchase price of these instruments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$1 being recorded in 2009 within Non-operating expense. The residual equity components of the instruments amounting to \$72 have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity.

On December 14, 2009, the Corporation paid an aggregate purchase price of \$64 for the redemption of the remaining convertible senior notes. The repurchase price of these instruments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$1 being recorded in 2009 within Non-operating expense. The residual equity components of the instruments amounting to \$17 have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity.

- (b) Embraer aircraft financing amounted to US\$1,163 as at December 31, 2008. Principal and interest is repaid quarterly until maturity. The financing can be repaid at any time, in whole or in part, with the payment of applicable fees. The financing was secured by the 60 delivered Embraer aircraft, with a carrying value of \$1,665.

- (c) Boeing aircraft financing amounted to US\$711 as at December 31, 2008, which was financed under loan guarantee support provided by the EXIM. Principal and interest is repaid quarterly until maturity. The financing can be repaid at any time, in whole or in part, with the payment of applicable fees. The financing was secured by the 8 delivered aircraft with a carrying value of \$1,103.
- (d) Boeing aircraft financing amounted to JPY19,995 as at December 31, 2008, which was financed under loan guarantee support provided by the EXIM. Principal and interest is repaid quarterly until maturity. The financing can be repaid at any time, in whole or in part, with the payment of applicable fees. The financing was secured by the 2 delivered aircraft with a carrying value of \$244.
- (e) As at December 31, 2008, US\$142 principal outstanding on acquisitions of two A340-500 aircraft financed through conditional sales agreements. Principal and interest is paid quarterly until maturity in 2019. The purchase price installments bore interest at a three month LIBOR rate plus 2.9% (4.37% - 6.44% as at December 31, 2008). The financing can be repaid at any time, in whole or in part, with the payment of applicable fees. The carrying value of the two A340-500 aircraft provided as security under the conditional sales agreements was \$238 as at December 31, 2008.
- (f) As at December 31, 2008, US\$78 principal outstanding to mature in 2013, with quarterly repayments and a final payment at maturity of 50% of the original principal, at a floating interest rate equal to the three month LIBOR rate plus 3.40%. The financing can be repaid at any time, in whole, with the payment of applicable fees. The loan was secured by 10 spare engines with a carrying value of \$121.

The loan agreement contained a current market value test, beginning on the first anniversary of the facility, and annually thereafter until expiry. This test related to 10 engines and under the test, Air Canada may have been required to provide additional collateral or prepay certain facility amounts, based on engine current market values, as of the date of the test. Any amounts prepaid would be recorded as a reduction of the loan. The maximum amount payable on the first anniversary, assuming the engines are worth nil and no additional collateral had been provided, was \$86 (US\$71). This amount declines over time to fifty percent of the original principal upon the loan expiry. In January 2009 an additional \$46 (US\$37) principal and 22 engines were added under the original agreement with the same terms as described above. Financing fees totaling \$2 were recorded in 2009 for these additional borrowings.

- (g) As at December 31, 2008, US\$80 principal outstanding to mature in 2014, with quarterly repayments, at a floating interest rate equal to the three month LIBOR rate plus the lenders incremental cost of funds rate and a margin of 3.00%. The financing can be repaid subsequent to the 36th monthly anniversary of the initial funding date, in whole or in part, with the payment of applicable fees. The loan was secured by spare parts and other assets with a carrying value of \$295. The loan agreement contained a collateral value test, performed on a monthly basis. This test related to all inventory collateral and Air Canada may have been required to provide additional inventory collateral, cash collateral, letters of credit, prepay some of the loan or any combination of the above based on appraised values, as of the date of the test. Any amounts prepaid would be recorded as a reduction of the loan. This amount declines over time to nil upon the loan expiry. In January 2009 an additional \$92 (US\$75) principal was added under the original agreement with the same terms as described above. Financing fees totaling \$6 were recorded in 2009 for these additional borrowings.
- (h) As at December 31, 2008, US\$13 principal outstanding to mature in 2009, with semi-annual repayments, at a fixed interest rate of 4.50% plus an annual 2.0% guarantee fee.
- (i) As at December 31, 2008, US\$20 principal outstanding to mature in 2015, with quarterly repayments, at a floating interest rate equal to the six month LIBOR rate plus 2.75% pre-payable on any interest payment date after September 21, 2009, without the payment of applicable fees. The next interest payment date was March 20, 2009. The debt was secured by certain flight training equipment with a current carrying value of \$39.

- (j) As at December 31, 2008, the revolving credit facility was a \$100 senior secured revolving credit facility (the "Credit Facility"). The Credit Facility had a one year term that could be extended at Air Canada's request for additional one-year periods on each anniversary of the closing, subject to prior approval of the lenders. The Credit Facility replaced Air Canada's previous secured syndicated three year revolving credit facility, which was a \$400 facility as of December 31, 2007. The total amount available for borrowing under the Credit Facility was subject to a borrowing base restriction based on certain percentages of the values of eligible accounts receivable and eligible real property. As at December 31, 2008, the funds available under the Credit Facility were \$50. The Credit Facility was secured by a first priority security interest and hypothec over the present and after-acquired personal property of Air Canada, subject to certain exclusions and permitted liens, and by a first priority charge and hypothec over certain owned and leased real property of Air Canada. Air Canada's obligations were guaranteed by 1209265 Alberta Ltd., a subsidiary of Air Canada, which provided a first priority security interest over its present and after-acquired personal property, subject to certain exclusions and permitted liens, as security for its guarantee obligations. The Credit Facility contained customary representations and warranties and is subject to customary terms and conditions (including negative covenants, financial covenants and events of default). Financial covenants required Air Canada to maintain, as of the last business day of each month, a minimum liquidity level of \$900, which included the unused and available commitment under the facility, and an interest coverage ratio test determined as at the end of each fiscal quarter. The interest rate margin for drawn amounts was, at the option of Air Canada, prime plus 13.00% or bankers' acceptances plus 14.00%.
- (k) As at December 31, 2008, the principal outstanding is \$25 on four CRJ aircraft. Principal and interest are paid quarterly to maturity in 2012. The financing bore interest at a floating rate of the 3 month Canadian bankers' acceptance rate plus 1.7%. The financing can be repaid at any time, in whole or in part, with the payment of applicable fees. The loan was secured by the aircraft with a carrying value of \$26.
- (l) During 2008, Air Canada arranged for and received financing amounting to \$190 (US\$155). The first payment of US\$80 matured and was repaid in January 2009. The remainder of the financing had a term to December 15, 2009 and was repayable prior to then provided Air Canada had received certain additional alternate financing. The financing bore interest at one month LIBOR plus 5.98% (currently 6.45%) and was secured by a security interest and a movable hypothec in the principal amount of \$400. The financing could be repaid at any time prior to maturity, in whole or in part, without the payment of applicable fees.
- (m) On October 30, 2007, Air Canada entered into an agreement with a syndicate of banks for the financing of pre-delivery payments ("PDP") for 10 of the 16 Boeing B777 aircraft contemplated in the Boeing Purchase Agreement. The PDP financing was a series of loans that are aircraft specific with a maximum aggregate commitment of up to \$568 (US\$575). The PDP loans had a term of five years, but may have been prepaid upon the delivery of the aircraft without penalty. During 2008, Air Canada drew \$39 (US\$39). Air Canada prepaid \$516 (US\$501) towards 8 aircraft during 2008. In addition, Air Canada served notice to the PDP syndicate that it would be repaying the final PDP loan on delivery of the tenth aircraft that was expected to be delivered in February 2009. At year-end 2008, the balance outstanding on the PDP loans was \$81 (US\$66). The 2008 year to date capitalized interest relating to this financing was \$10 at an interest rate of 30 day LIBOR plus 1.14% (1.61% as at December 31, 2008).

- (n) As at December 31, 2008, Air Canada had entered into aircraft lease transactions with several special purpose entities that qualify as VIEs. The debt had a weighted average effective interest rate of approximately 8%. These aircraft had a carrying value of \$836 and were charged as collateral against the debt by the owners thereof. The creditors under these leasing arrangements had recourse to Air Canada, as lessee, in the event of default or early termination of the lease. Aircraft related debt amounted to US\$676 (\$828) was summarized as follows:

	Final Maturity	2009 * Notes 1 & 3	2008
Canadian Regional Jet	2010-2011	\$ -	\$ 257
Boeing 767-300	2011-2016	-	185
Airbus 319	2011-2014	-	242
Airbus 321	2017	-	144
<b>Total</b>		<b>\$ -</b>	<b>\$ 828</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

- (o) As at December 31, 2008, under AcG-15, Air Canada was the primary beneficiary of certain Fuel Facility Corporations in Canada. The debt was comprised of bankers' acceptances with bankers' acceptance plus 2%, bank loans at prime plus 0.25%, and bonds payable with an interest rate of 5.09%. \$107 of debt matures in 2032 with equal semi-annual payments of principal and interest. The remaining debt had varying maturities. The debt was secured by a general security agreement covering all assets of the Fuel Facility Corporations. The carrying value of the assets of the fuel facilities was \$150 as at December 31, 2008.
- (p) As at December 31, 2008, capital leases, related to computer equipment, facilities and 41 aircraft, totaled \$1,082 (\$84 and US\$815). The debt had a weighted average effective interest rate of approximately 8% and final maturities range from 2009 to 2027. During 2008, Air Canada recorded interest expense on capital lease obligations of \$78.

Certain aircraft lease agreements contained a fair value test, beginning in Quarter 3 2009, and annually thereafter until lease expiry. This test related to 26 aircraft under lease of which 23 are accounted for as capital leases and the remainder relates to leasing entities that are consolidated under AcG-15. Under the test, Air Canada may have been required to prepay certain lease amounts, based on aircraft fair values, as of the date of the test. Any amounts prepaid would be recorded as a reduction of the lease obligation. Air Canada contracts with certain third parties to provide residual value support for certain aircraft. If Air Canada was required under the loan to value test to prepay lease obligations, these amounts were recoverable from the third party residual value support provider upon lease expiry to the extent that the adjusted obligation taking into account prepayments is less than the residual value support. The maximum amount payable on July 1, 2009, assuming the related aircraft are worth nil, was \$896 (US\$731). The maximum payable amount declines over time to nil upon lease expiry. As Air Canada does not expect to have to prepay any significant amounts based upon expectations of aircraft fair values into the future, the amortized cost of these capital lease obligations reflects the scheduled payments over the term to final maturity.

Interest paid on Long-term debt and capital leases during 2009 by the Corporation was \$282 (\$307 for the year ended December 31, 2008).



**8. FUTURE INCOME TAXES**

The following income tax related amounts appear in the Corporation's Statement of financial position:

	2009 *	2008
<b>Asset</b>		
Future income tax asset recorded in current assets (a)	\$ -	\$ -
<b>Liability</b>		
Long-term tax payable (b)	\$ -	\$ (10)
Future income tax liability (b)	-	(50)
	<b>\$ -</b>	<b>\$ (60)</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

**a) FUTURE INCOME TAX ASSETS**

As at December 31, 2009, the Corporation had determined that it is more likely than not that future income tax assets of \$216 (2008 - \$1,239) are not recoverable and have been offset by a valuation allowance. However, the future tax deductions underlying the future tax assets remain available for use in the future to reduce taxable income. Subsequent to the deconsolidation of Air Canada, the benefit of future income tax assets that arise will be recognized in the Consolidated Statement of Operations.

**b) TAXES PAYABLE AND FUTURE INCOME TAX LIABILITY**

In 2007, Air Canada recorded a Current income tax expense of \$10 resulting from the Federal and Ontario harmonization of corporate taxes. Air Canada will have a cash tax payable of \$10 that will be payable over a five year period beginning in 2010. This amount was included in Other long-term liabilities.

At December 31, 2008, certain intangibles and other assets with nominal tax cost and a carrying value of approximately \$381, had indefinite lives and accordingly, the associated future income tax liability was not expected to reverse until the assets were disposed of or became amortizable, resulting in the reporting of a future income tax liability of \$50.

	2009	2008
<b>Future tax assets</b>		
Loss carry forwards	\$ 36	\$ 629
Investments at equity	164	-
Post-employment obligations	-	466
Accounting provisions not currently deductible for tax	-	261
Deferred gains	-	40
Other	16	121
<b>Total future tax assets</b>	<b>216</b>	<b>1,517</b>
<b>Future tax liabilities</b>		
Book basis of capital over tax basis	-	219
Intangible assets	-	72
Other	-	37
<b>Total future tax liabilities</b>	<b>-</b>	<b>328</b>
<b>Net future tax assets</b>	<b>216</b>	<b>1,189</b>
Less valuation allowance	(216)	(1,239)
<b>Net recorded future income tax asset (liability)</b>	<b>\$ -</b>	<b>\$ (50)</b>

The reconciliation of income tax attributable to continuing operations, computed at the statutory tax rates, to income tax expense is as follows:

	2009	2008
Provision (recovery) based on combined federal and provincial rates	\$ (213)	\$ 35
Non-taxable portion of capital (gains) losses	(90)	72
Non-deductible expenses	10	69
Dilution of ACE's investment in Air Canada	40	-
Non-taxable capital gain on distribution and disposal of investments	-	(155)
Non-controlling interest	-	(80)
Effect of tax rate changes on future income taxes	80	82
Other	8	15
	(165)	38
Valuation allowance	169	186
<b>Provision for income taxes</b>	<b>\$ 4</b>	<b>\$ 224</b>

Significant components of the provision for income taxes attributable to continuing operations are as follows:

	2009	2008
Current tax expense (recovery)	\$ (2)	\$ 3
Future income tax recovery relating to temporary differences	(243)	(47)
Future income tax expense from tax rate changes	80	82
Valuation allowance	169	186
<b>Provision for income taxes</b>	<b>\$ 4</b>	<b>\$ 224</b>

Income taxes recovered in 2009 by the Corporation were \$2 (2008 – payments of \$2).

The balances of tax attributes as at December 31, 2009, namely the balances of non-capital loss carry forwards, vary amongst different taxing jurisdictions. The following are the Federal tax loss expiry dates:

	Tax Losses
2014	\$ 27
2026	6
2028	37
2029	18
	<b>\$ 88</b>

There are \$47 (2008 - \$47) of net capital losses that have no expiry date.

In late 2009, the Canada Revenue Agency ("CRA") commenced an audit of ACE's income tax returns for the years 2005 to 2007. The CRA is currently in the information gathering stage as a means to establishing the scope of their audit.

## 9. PENSION AND OTHER BENEFIT LIABILITIES

Air Canada maintains several defined benefit and defined contribution plans providing pension, other post-retirement and post-employment benefits to its employees, including those employees of Air Canada who are contractually assigned to Aveos and were contractually assigned to Aeroplan.

Air Canada is the administrator and sponsoring employer of ten Domestic Registered Plans ("Domestic Registered Plans") under the Pension Benefits Standard Act, 1985 (Canada). The US plan, UK plan and Japan plan are international plans covering employees in those countries. In addition, Air Canada maintains a number of supplementary pension plans, which are not registered. The defined benefit pension plans provide benefits upon retirement, termination or death based on the member's years of service and final average earnings for a specified period.

The other employee benefits consist of health, life and disability. These benefits consist of both post-employment and post-retirement benefits. The post-employment benefits relate to disability benefits available to eligible active employees, while the post-retirement benefits are comprised of health care and life insurance benefits available to eligible retired employees.

Certain Air Canada employees are contractually assigned to Aveos and are members of Corporation-sponsored defined benefit pension plans and also participate in Corporation-sponsored health, life and disability benefit plans. Other Air Canada employees were contractually assigned to Aeroplan until the date of transition to employment at Aeroplan and then ceased to accrue benefits under the Corporation-sponsored defined benefit pension plans and under the Corporation-sponsored health, life and disability benefit plans. These consolidated financial statements include all of the assets and liabilities of all Corporation-sponsored plans. The employee benefit expense in these consolidated financial statements includes the expenses for all employees participating in the plans less a cost recovery which is charged to Aveos and Aeroplan for those employees contractually assigned. The cost recovery includes current service costs for pensions, past service cost to Aeroplan for pensions and a portion of post-employment and post-retirement benefits to Aveos, based on actuarial calculation for their specific employee group. This cost recovery amounted to \$27 for the year ended December 31, 2009 (year ended December 31, 2008 - \$39).

In May 2009, Air Canada and Aeroplan reached an agreement with the Canadian Auto Workers (CAW) Local 2002 providing for a process for the approximately 750 Air Canada employees then assigned to and working in the Aeroplan contact centres to choose to transition to employment at Aeroplan, effective June 1, 2009, or to remain employees of Air Canada. Employees at Air Canada work locations who became surplus to Air Canada's needs due to employees who were senior to them and then working at Aeroplan contact centres choosing to remain employees of Air Canada were given the option to transition to employment at Aeroplan. Effective October 4, 2009, all affected employees had completed the transition to Aeroplan. For those employees who transferred to Aeroplan, their service, which largely determines benefit levels under the Air Canada pension and other employee benefit plans, ceased to accrue as of the date of employment with Aeroplan. Air Canada and Aeroplan continue to discuss the terms surrounding the transfer of pension benefits and certain implications relating to same remain unresolved. Air Canada continues to retain plan assets and report liabilities for services accrued for the transferred Aeroplan employees as at December 31, 2009, pending final determination of this matter. Aeroplan is now contributing current service costs in their pension plan for service accruing with Aeroplan.

As described in Note 17, Air Canada and Aveos are parties to a Pension and Benefits Agreement covering the future transfer of certain pension and benefit assets and obligations to Aveos.

As described in Note 2, the accounting for pensions requires Air Canada management to make significant estimates including estimates as to the discount rate applicable to the benefit obligation and the expected rate of return on plan assets.

### **Pension Plan Cash Funding Obligations**

As at January 1, 2009, based on the actuarial valuations which were used to determine certain pension funding requirements in 2009, the aggregate solvency deficit, in the registered pension plans was \$2,835. Based on preliminary actuarial valuations as at January 1, 2010, the aggregate solvency deficit in the registered plans is estimated to be between \$2,500 and \$2,700. This preliminary estimated solvency deficit range includes the impact of the actual return on plan assets as shown below partially offset by a decrease in the discount rate used to value the benefit obligation which has the effect of increasing the benefit obligation. The final actuarial valuations for January 1, 2010 will be completed in the first half of 2010, but as described below, they will not impact the 2010 pension funding obligations.

In July 2009, the Government of Canada adopted the Air Canada 2009 Pension Regulations. The Air Canada 2009 Pension Regulations relieve Air Canada from making any past service contributions (i.e. special payments to amortize the plan deficits) to its ten domestic defined benefit registered pension plans in respect of the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contribution shall equal the lesser of (i) \$150, \$175, and \$225 in respect of 2011, 2012, and 2013, respectively, on an accrued basis, and (ii) the maximum past service contribution permitted under the Tax Act.

The Air Canada 2009 Pension Regulations were adopted in coordination with the Pension MOUs described in Note 3. Pursuant to the Pension MOUs, on October 26, 2009, Air Canada issued to a trust, 17,647,059 Class B Voting Shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of sale of such shares by the trust are to be contributed to the pension plans. On October 26, 2009, upon the issuance of the shares to the trust, Air Canada recorded a decrease to its Pension and other benefit liabilities in the amount of \$28 and an increase to Share capital in the amount of \$28. For so long as the trust continues to hold at least 2% of the issued and outstanding shares of Air Canada, the trustee will have the right to designate one nominee (who shall not be a member or officer of any of Air Canada's Canadian-based unions) to Air Canada's board of directors, subject to completion of Air Canada's usual governance process for selection and confirmation of director nominees. Current service contributions will continue to be made in the normal course while the Air Canada 2009 Pension Regulations are in effect.

After consideration of the effect of the Air Canada 2009 Pension Regulations as outlined above, employer pension funding contributions during 2009, representing the full year as published by Air Canada, amounted to \$389.

### **Discount Rate**

The discount rate used to determine the pension obligation was determined by reference to market interest rates on corporate bonds rated "AA" or better with cash flows that approximately match the timing and amount of expected benefit payments. An increase in the discount rate of 0.25% results in a decrease of \$346 to the pension obligation and \$28 to the pension expense. A decrease in the discount rate of 0.25% results in an increase of \$346 to the pension obligation and \$25 to the pension expense.

### **Expected Return on Assets Assumption**

The expected long-term rate of return on assets assumption is selected based on the facts and circumstances that exist as of the measurement date and the specific portfolio mix of plan assets. Air Canada's management, in conjunction with its actuaries, reviews anticipated future long-term performance of individual asset categories and considers the asset allocation strategy adopted by Air Canada, including the longer duration in its bond portfolio in comparison to other pension plans. These factors are used to determine the average rate of expected return on the funds invested to provide for the pension plan benefits. The determination of the long term rate considers recent fund performance, including the significant drop in the value of plan assets during 2008 and the partial recovery in 2009, and historical returns, to the extent that the past is indicative of the expected long-term, prospective rate. There can be no assurance that any of the plans will earn the expected rate of return.

**Benefit Obligation and Plan Assets**

The following table presents financial information related to the changes in the pension and other post-employment benefits plans for the year ended December 31, 2008:

	<b>Pension Benefits 2008</b>	<b>Other Employee Future Benefits 2008</b>
<b>Change in benefit obligation</b>		
Benefit obligation at beginning of year	\$ 12,150	\$ 899
Current service cost	203	62
Interest cost	706	52
Employees' contributions	83	-
Benefits paid	(677)	(57)
Plan amendments	2	-
Other termination benefits	-	-
Actuarial gain	(1,738)	(189)
Foreign exchange gain (loss)	-	23
	<b>10,729</b>	<b>790</b>
<b>Change in plan assets</b>		
Fair value of plan assets at beginning of year	11,747	-
Actual return (loss) on plan assets	(1,879)	-
Employer contributions	456	57
Employees' contributions	83	-
Benefits paid	(677)	(57)
Foreign exchange gain (loss)	(13)	-
	<b>9,717</b>	<b>-</b>
<b>Deficit at end of year</b>	<b>1,012</b>	<b>790</b>
Unrecognized past service costs	(2)	-
Unrecognized net actuarial gain (loss)	(479)	321
Valuation allowance against accrued benefit	9	-
<b>Net benefit obligation</b>	<b>\$ 540</b>	<b>\$ 1,111</b>
<b>Weighted average assumptions used to determine the accrued benefit liability</b>		
Discount rate	7.35%	6.25–7.35%
Rate of compensation increase (b)	2.50%	

- (a) Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).
- (b) As a result of pay awards, a rate of compensation increase of 1.75% was used for years 2007 and 2008 in determining the net benefit obligation for the pension plan and 2.50% for the remaining years.

Under the terms of the domestic registered and supplementary plans, there is no indexation provided after January 1, 2007.

The pension benefit deficit of only those plans that are not fully funded at the end of the 2008 year is as follows:

	2008
Domestic registered plans	\$ 383
US, UK, and Japan	83
Supplementary plans	606
	<b>\$ 1,072</b>

Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

The net deficit, on an accounting basis, at December 31, 2008 for pension benefits was \$1,012.

The net benefit obligation is recorded in the statement of financial position for the year ended December 31, 2008 is as follows:

	2008
Pension benefits	\$ 540
Other employee future benefits	1,111
<b>Net benefit obligation</b>	<b>1,651</b>
Current portion	(66)
<b>Pension and other benefit liabilities</b>	<b>\$ 1,585</b>

Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

The current portion of the net benefit obligation represents an estimate of other employee future benefits claims to be incurred during 2010. The current portion is included in Accounts payable and accrued liabilities.

**Pension and Other Employee Future Benefit Expense**

The Corporation has recorded net defined benefit pension and other employee future benefits expense for the year ended December 31, 2009 as follows:

	Pension Benefits		Other Employee Future Benefits	
	2009 <sup>(1)</sup> Notes 1 & 3	2008	2009 <sup>(1)</sup> Notes 1 & 3	2008
<b>Components of Net Periodic Pension Cost</b>				
Current service cost	\$ 103	\$ 203	\$ 42	\$ 62
Interest cost	633	706	45	52
Actual loss (return) on plan assets	(1,080)	1,879	-	-
Actuarial loss (gain)	846	(1,738)	28	(189)
Plan amendments	-	2	-	-
<b>Costs arising in the year</b>	<b>502</b>	<b>1,052</b>	<b>115</b>	<b>(75)</b>
<b>Differences between costs arising in the year and costs recognized in the year in respect of:</b>				
Loss (return) on plan assets	383	(2,711)	-	-
Actuarial loss (gain)	(890)	1,742	(52)	172
Plan amendments	-	(2)	-	-
Increase in valuation allowance provided against accrued benefit asset	5	8	-	-
<b>Net periodic benefit cost of plans</b>	<b>-</b>	<b>89</b>	<b>63</b>	<b>97</b>
Amount charged to Aveos and Aeroplan	(18)	(23)	(9)	(16)
<b>Net defined benefit pension and other employee benefits expense</b>	<b>\$ (18)</b>	<b>\$ 66</b>	<b>\$ 54</b>	<b>\$ 81</b>
<b>Weighted average assumptions used to determine the accrued benefit cost</b>				
Discount rate	7.35%	5.75%	6.25-7.35%	5.75-6.00%
Expected long-term rate of return on plan assets	7.15%	7.15%	n/a	n/a
Rate of compensation increase (2)	2.50%	2.50%		

(1) Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

(2) A rate of compensation increase of 0% plus merit in 2009 and in 2010 was used in determining the net benefit pension expense and 2.50% plus merit for the remaining years.

**Other Benefits — Sensitivity Analysis**

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. An 8.25% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2009 (2008 - 8.25%). The rate is assumed to decrease gradually to 5% by 2015. A one percentage point increase in assumed health care trend rates would have increased the service and interest costs by \$1 and the obligation by \$18. A one percentage point decrease in assumed health care trend rates would have decreased the service and interest costs by \$2 and the obligation by \$23.

**Composition of Pension Plan Assets**

The composition of the Domestic Registered Plan assets and the target allocation consist of the following:

	2009	2008	Target Allocation (1)
Non-matched assets (mainly equities)	55.9%	52.9%	54.4%
Matched assets (mainly Canadian bonds)	43.4%	43.5%	45.6%
Cash and temporary investments	0.7%	3.6%	0.0%
	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

- (1) Weighted average of the Master Trust Fund target allocation (99% of Domestic Registered Plan assets) and the Bond Fund target allocation. The Bond Fund serves the purpose of altering the asset mix of some of the participating plans. These plans exhibit characteristics that differ from the majority of the participating plans, which are solely invested in the Master Trust.

*Domestic Registered Plans*

For the Domestic Registered Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Master Trust Fund, as amended during 2009. The investment return objective is to achieve a total annualized rate of return that exceeds by a minimum of 1.0% before investment fees on average over the long term (i.e., 10 years) the total annualized return that could have been earned by passively managing the Liability Benchmark. The Liability Benchmark, which is referenced to widely used Canadian fixed income performance benchmarks (DEX), is composed of a mix of the DEX Universe Provincial Bond Index, DEX Long Term Provincial Bond Index and DEX Real Return Bond Index that closely matches the characteristics of the pension liabilities.

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

- Non-matched assets are mainly equities, and are required to be diversified among industries and economic sectors. Foreign equities can comprise 31% to 37% of the total market value of the Master Trust Fund. Limitations are placed on the overall allocation to any individual security at both cost and market value. Investments in non-publicly traded securities and in non-traditional asset classes are allowed up to 10% of the total market value of the Master Trust Fund.
- Matched assets are mainly Canadian bonds, oriented toward long term investment grade securities rated "BBB" or higher. With the exception of Government of Canada securities or a province thereof, in which the plan may invest the entire fixed income allocation, these investments are required to be diversified among individual securities and sectors.

Derivatives are permitted provided that they are used for hedging a particular risk (including interest rate risk related to pension liabilities) or to create exposures to given markets and currencies and that counterparties have a minimum credit rating of A. As of December 31, 2009, an additional 5% derivatives exposure to matched assets is in place to hedge interest rate risk related to pension liabilities.

**Defined Contribution Plans**

The Corporation's management, administrative and certain unionized employees may participate in defined contribution plans. Contributions range from 3% to 6% of annual pay for those employees in Canada and 3% to 7% of annual pay for those participants in the United Kingdom. The Corporation contributes an equal amount. The Corporation's expense for defined contribution plans amounted to \$1 for the year ended December 31, 2009 (\$1 for the year ended December 31, 2008).



**10. OTHER LONG-TERM LIABILITIES**

	2009 * Notes 1 & 3	2008
Aeroplane Miles obligations (a)	\$ -	\$ -
Unfavourable contract liability on aircraft leases (b)	-	37
Aircraft rent in excess of lease payments	-	56
Long-term employee liabilities (c)	-	35
Workplace safety and insurance board liabilities	-	37
Deferred gains on aircraft sale leasebacks	-	76
Other (d)	-	129
	<b>\$ -</b>	<b>\$ 370</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

- (a) Air Canada has a liability related to Aeroplane Miles which were issued by Air Canada prior to January 1, 2002. As of December 31, 2008 a liability for approximately \$35, remained in Air Canada, all of which was included in Advanced ticket sales.
- (b) The unfavourable contract liability on aircraft leases represents the net present value of lease payments in excess of estimated market rents related to lease arrangements that existed on fresh start reporting.
- (c) The following table outlines the changes to labour related provisions for the year ended December 31, 2008 which were included in long-term employee liabilities:

	2008
Beginning of year	\$ 66
Interest accretion	4
Charges recorded in wages, salaries, and benefits	21
Amounts disbursed	(37)
End of year	54
Current portion in Accounts payable and accrued liabilities	(19)
	<b>\$ 35</b>

The Corporation offers certain severance programs to certain employees from time to time. The cost of these programs is recorded within Operating expenses.

- (d) As at December 31, 2008, "Other" included asset retirement obligations of the Corporation. Under the terms of their respective land leases, each Fuel Facility Corporation has an obligation to restore the land to vacant condition at the end of the lease and to rectify any environmental damage for which it is responsible. If it were found that the Fuel Facility Corporations had to contribute to any remediation costs, each contracting airline would share pro rata, based on system usage, in the costs. For all asset retirement obligations including all Fuel Facility Corporations in Canada in which the Corporation participates, the Corporation had recorded an obligation of \$8 (\$50 undiscounted) as at December 31, 2008 representing the present value of the estimated decommissioning and remediation obligations at the end of the lease using an 8% discount rate, with lease term expiry dates ranging from 2032 to 2039. This estimate was based on numerous assumptions including the overall cost of decommissioning and remediation and the selection of alternative decommissioning and remediation approaches.

## 11. STOCK-BASED COMPENSATION

### ACE Stock Option Plan

Certain of the Corporation's employees participate in the ACE stock option plan. Plan participation is limited to employees holding positions that, in the ACE Board's view (or a committee selected by the Board), have a significant impact on ACE's long term results. The stock option plan provides that the options will have an exercise price of not less than 100% of the market price of the underlying shares at the time of grant. Under the terms of the stock option plan, fifty percent of all options vest over four years. The remaining options vest upon performance conditions that are based on net income targets established by the ACE Board over the same time period. All options expire after seven years. The terms of ACE's stock option plan specify that upon the retirement of the employee, options granted to that employee may be exercised as the options vest within three years of such retirement.

In compliance with the terms of the ACE stock option plan, in November 2007, the Board of ACE resolved to immediately vest all remaining unvested ACE stock options. This resulted in the immediate expense recognition of all deferred stock based compensation on outstanding ACE options granted, less amounts previously recognized as compensation expense. As a result of this immediate vesting of all ACE options granted, no further stock based compensation expense is expected to be recorded related to the ACE stock option plan.

In May 2009, the Chairman, President and Chief Executive Officer of ACE requested that the after-tax amount of severance and benefits of \$4.2 be paid to him in the form of shares of ACE. As a result, on May 22, 2009, the Chairman, President and Chief Executive Officer's after-tax amount was used to acquire and retain 784,350 Class B Voting Shares of ACE. Such subscription was effected through a grant of options that were exercised immediately upon the grant at an exercise price of \$5.34, which was equal to the market price determined under the terms of the Stock Option Plan.

In 2009, the amount credited to share capital for ACE stock options exercised was \$4 (2008 - \$37). For ACE stock options exercised, shares from treasury are issued by the Corporation.

A summary of the activity related to the Corporation employees participating in the ACE stock option plan is as follows:

	2009		2008	
	Options	Weighted Average Exercise Price/Share	Options	Weighted Average Exercise Price/Share
Beginning of year	61,230	\$ 14.11	1,682,206	\$ 18.09
Granted	784,350	5.34	-	-
Exercised	(784,350)	5.34	(1,611,930)	18.29
Forfeited	(13,418)	12.34	(9,046)	11.05
<b>Outstanding options, end of year</b>	<b>47,812</b>	<b>\$ 14.61</b>	<b>61,230</b>	<b>\$ 14.11</b>
<b>Options exercisable, end of year</b>	<b>47,812</b>	<b>\$ 14.61</b>	<b>61,230</b>	<b>\$ 14.11</b>

The total intrinsic value of options exercised under this plan during 2009 was nil (2008 - \$5).

Range of Exercise Prices	Expiry Dates	2009 Outstanding Options			2009 Exercisable Options	
		Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	Number of Exercisable Options	Weighted Average Exercise Price/Share
\$11.05	2011	27,010	2	\$ 11.05	27,010	\$ 11.05
\$19.23	2013	20,802	4	19.23	20,802	19.23
		<b>47,812</b>		<b>\$ 14.61</b>	<b>47,812</b>	<b>\$ 14.61</b>

Range of Exercise Prices	Expiry Dates	2008 Outstanding Options			2008 Exercisable Options	
		Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	Number of Exercisable Options	Weighted Average Exercise Price/Share
\$11.05	2011	38,319	3	\$ 11.05	38,319	\$ 11.05
\$19.23	2013	22,911	5	19.23	22,911	19.23
		<b>61,230</b>		<b>\$ 14.11</b>	<b>61,230</b>	<b>\$ 14.11</b>

The aggregate intrinsic value of the exercisable options outstanding at December 31, 2009 is nil (2008 - nil) and the weighted average remaining life is 2.3 years.

#### **Air Canada Long-Term Incentive Plan**

Certain of Air Canada's employees participate in the Air Canada Long-term Incentive Plan (the "Long-term Incentive Plan") administered by the Board of Directors of Air Canada. The Long-term Incentive Plan provides for the grant of options and performance share units to senior management and officers of Air Canada. Five million shares are authorized for issuance under the Long-term Incentive Plan in the form of stock options or performance share units.

The options to purchase shares granted under the Long-term Incentive Plan have a maximum term of 10 years and an exercise price based on the fair market value of the shares at the time of the grant of the options. Fifty percent of all options vest over four years. The remaining options will vest based upon performance conditions. The performance vesting conditions are based on operating margin (operating income over operating revenues) and net income targets established by the Air Canada Board over the same time period. The terms of the Long-term Incentive Plan specify that upon the retirement of the employee, options granted may be exercised as the rights to exercise accrue within three years from the retirement date.

The number of Air Canada stock options granted to employees, the related compensation expense recorded and the assumptions used to determine stock-based compensation expense, using the Black-Scholes option valuation model are as follows:

	2009 * Notes 1 & 3	2008
Compensation expense (recovery) (\$ millions)	\$ 2	\$ (3)
Number of stock options granted to Air Canada employees	2,330,000	11,000
Weighted average fair value per option granted (\$)	\$ 1.06	\$ 1.99
Aggregated fair value of options granted (\$ millions)	\$ 2	\$ -
Weighted average assumptions:		
Risk-free interest rate	1.73–3.14%	3.29%
Expected volatility	83.0 - 84.7%	34%
Dividend yield	0%	0%
Expected option life (years)	4.50	4.50

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

During 2008, previously recorded stock-based compensation expense, related to stock options, of \$3 was reversed as management had determined that the performance vesting criteria would not be met.

A summary of the Long-term Incentive Plan option activity is as follows:

	2008	
	Options	Weighted Average Exercise Price/Share
Beginning of year	1,720,092	\$ 19.24
Granted	11,000	8.51
Forfeited	(29,645)	21.00
<b>Outstanding options, end of year</b>	<b>1,701,447</b>	<b>\$ 19.14</b>
<b>Options exercisable end of year</b>	<b>362,253</b>	<b>\$ 19.96</b>

Range of Exercise Prices	Expiry Dates	2008 Outstanding Options			2008 Exercisable Options	
		Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	Number of Exercisable Options	Weighted Average Exercise Price/Share
\$21.00	2013	1,207,577	5	\$ 21.00	301,894	\$ 21.00
\$11.08 - \$18.60	2014	482,870	6	14.74	60,359	14.74
\$8.51	2015	11,000	7	8.51	-	-
		<b>1,701,447</b>		<b>\$ 19.14</b>	<b>362,253</b>	<b>\$ 19.96</b>

Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

**Performance Share Units**

The Long-term Incentive Plan also includes Performance Share Units (“PSUs”). The vesting term of PSUs is three years, generally commencing on January 1 of the year following granting, and incorporate performance vesting features based upon achieving earnings targets established over the vesting period. Subject to vesting and other conditions, each PSU entitles the employee to receive a payment in the form of one common share, cash in the amount equal to market value of one common share, or a combination thereof, at the discretion of the Board of Directors. The terms of the plan specify that upon the retirement of an employee, the number of PSUs that vest are prorated based on the total number of completed months of active service during the PSU vesting term. Certain PSUs previously granted may only be redeemed for Air Canada shares purchased on the secondary market and/or equivalent cash. As outlined above, the remaining PSUs may be redeemed for Air Canada shares issued from treasury or purchased on the secondary market and/or equivalent cash at the discretion of the Corporation.

The compensation expense related to PSUs in 2009 was less than \$1. In 2008, previously recorded stock based compensation expense, related to PSUs, of \$2 was reversed as management had determined that the performance vesting criteria would not be met.

A summary of the Long-term Incentive Plan performance share unit activity is as follows:

	<b>Number of PSUs</b>
	<b>2008</b>
Beginning of year	551,251
Granted	1,125,092
Forfeited	(5,275)
<b>Outstanding options, end of year (1)</b>	<b>1,671,068</b>

- (1) During 2008, 1,111,183 of the 1,125,092 number of PSUs granted will entitle the employee to receive, at the discretion of the Corporation, Air Canada shares purchased on the secondary market and/or equivalent cash.
- (2) Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

**Employee Share Purchase Plan**

Eligible employees can participate in the employee share purchase plan under which employees can invest up to 6% of their base salary for the purchase of shares on the secondary market. Air Canada will match 33.3% of the investments made by the employee. During 2009, the Corporation recorded compensation expense of less than \$1 (2008 - \$1).

**12. SHAREHOLDERS' EQUITY**

The issued and outstanding common shares of ACE, along with potential common shares, are set out below.

Outstanding shares ('000s)		2009	2008
<b>Issued and Outstanding</b>			
Class A variable voting shares		25,643	25,614
Class B voting shares		10,048	9,293
<b>Total issued and outstanding</b>	Note 18	<b>35,691</b>	<b>34,907</b>
<b>Potential common shares</b>			
Convertible preferred shares		-	11,863
Convertible senior notes		-	13,133
Stock options		48	61
<b>Total potential common shares</b>		<b>48</b>	<b>25,057</b>

	2009	2008
<b>Share Capital and Other equity</b>		
Common shares (a)	\$ 104	\$ 100
Total Share Capital	104	100
Convertible preferred shares (b)	-	117
Convertible senior notes (c)	-	90
<b>Total Share Capital and Other equity</b>	<b>\$ 104</b>	<b>\$ 307</b>

During 2009, the Corporation issued 784,350 (2008 – 1,611,930) common shares on the exercise of stock options for consideration of \$4 (2008 – cash consideration of \$30), \$4 (2008 - \$37) including the fair value of exercised stock options was transferred to share capital from contributed surplus. Refer to Note 11.

Share capital and other equity are comprised of:

**(a) Common shares**
**Class A Variable Voting Shares**

The Class A Variable Voting Shares may be held only by persons who are not Canadians and are entitled to one vote per Class A Variable Voting Share unless (i) the number of Class A Variable Voting Shares outstanding (including the Convertible Preferred Shares, on an as-converted basis), as a percentage of the total number of votes attaching to voting shares outstanding exceeds 25% or (ii) the total number of votes cast by or on behalf of holders of Class A Variable Voting Shares (including the Convertible Preferred Shares on an as-converted basis) at any meeting exceeds 25% of the total number of votes that may be cast at such meeting. If either of the above noted thresholds would otherwise be surpassed at any time, the vote attached to each Class A Variable Voting Share will decrease proportionately such that (i) the Class A Variable Voting Shares as a class (including the Convertible Preferred Shares on an as-converted basis) do not carry more than 25% of the aggregate votes attached to all issued and outstanding voting shares of ACE and (ii) the total number of votes cast by or on behalf of holders of Class A Variable Voting Shares (including the Convertible Preferred Shares on an as-converted basis) at any meeting do not exceed 25% of the votes that may be cast at such meeting.

**Class B Voting Shares**

The Class B Voting Shares may be held only by persons who are Canadians. Each Class B Voting Share shall confer the right to one (1) vote in person or by proxy at all meetings of shareholders of the ACE.

**(b) Convertible Preferred Shares**

As at September 30, 2004, 12,500,000 Convertible Preferred Shares were issued for consideration of \$250 before fees of \$12. These Convertible Preferred Shares were convertible into 11,863,464 common shares, based on the conversion ratio applicable as at December 31, 2008.

For accounting purposes, the Convertible Preferred Shares are presented as a compound instrument. At the date of issuance, the value ascribed to the holders' conversion option, which is presented as equity, was \$123 less allocated fees of \$6; the value ascribed to the financial liability was \$127. The Convertible Preferred Shares increased by 5% per annum, compounded semi-annually from the date of issuance ("Fully Accreted Value") resulting in an accretion on the financial liability at an effective interest rate of 12%. The financial liability amounted to \$206 at December 31, 2008.

The holders of Convertible Preferred Shares were entitled to vote on an as converted basis with the Variable Voting Shares and the Voting Shares and to the extent that they were held by persons who were not Canadians they were subject to the same proportionate reduction in voting percentage as if, for voting purposes only, the Convertible Preferred Shares had been converted into Variable Voting Shares.

The holders of Convertible Preferred Shares were entitled to participate on an as converted basis with the Variable Voting Shares and the Voting Shares with respect to all dividends, distributions, and similar transactions. The Convertible Preferred Shares are convertible at the option of the holders thereof at any time into Variable Voting Shares, if held by a non-Canadian, or into Voting Shares, if held by a Canadian, at a conversion rate equal to the Fully Accreted Value per Convertible Preferred Share (as of the conversion date) divided by the Conversion Price. For the purposes of the terms of the Convertible Preferred Shares, "Conversion Price" was equal to \$26 or 130% of the initial per share value attributed to the Variable Voting Shares and Voting Shares on September 30, 2004 of \$20. The Conversion Price of the Convertible Preferred Shares was subject to certain adjustments, including customary public company anti-dilution protection for stock splits, stock dividends, subdivisions, combinations and similar transactions, split-off, subscription rights or other offers or rights made available to holders of Variable Voting Shares and Voting Shares and any other similar transactions.

**Mandatory Conversion**

The holders of the Convertible Preferred Shares would have been required to convert the Convertible Preferred Shares into fully paid and non-assessable common shares at the conversion ratio applicable upon the date of conversion, if the closing price of the ACE shares on the principal market for each of thirty consecutive trading days exceeded 175% of the conversion price.

The Convertible Preferred Shares were also subject to mandatory conversion into fully paid and non-assessable common shares within ten days of each mandatory conversion date, at the conversion ratio applicable upon the date of conversion, upon the following terms and conditions:

- if the closing price of the ACE shares on the principal market exceeded the Fully Accreted Value of a preferred share on at least thirty of the one hundred trading days immediately prior to a particular mandatory conversion date; or
- if the closing price of the ACE shares on the principal market did not exceed the Fully Accreted Value of a preferred share on at least thirty of the one hundred trading days immediately prior to a particular mandatory conversion date, (i) the holders of the Convertible Preferred Shares would not have been required to convert their Convertible Preferred Shares into ACE shares and (ii) as of such mandatory conversion date, the then applicable conversion price would have been automatically reduced by 3.75%; and

- if the closing price of the ACE shares on the principal market did not exceed the Fully Accreted Value of a preferred share on at least thirty of the one hundred trading days immediately prior to the final maturity date, then holders of Convertible Preferred Shares would have been entitled, upon written notice to ACE given within ten days following the final maturity date, to require ACE to redeem each of the Convertible Preferred Shares in cash at a redemption price equal to the Fully Accreted Value as of the final maturity date.

The first mandatory conversion date would have been seven years from the date of issuance.

Subject to the rights, privileges, restrictions and conditions attaching to the shares of ACE ranking prior to the Convertible Preferred Shares, upon the liquidation, dissolution or winding-up or distribution of the assets of ACE, the holders of the Convertible Preferred Shares were entitled to receive, prior to and in preference to the holders of ACE shares, an amount equal to the Fully Accreted Value of the Convertible Preferred Shares as of the date of the liquidation, dissolution, winding-up or distribution.

The holders of Convertible Preferred Shares participated on an as-converted basis with respect to all dividends, distributions, spin-off, split-off, subscription rights or other offers made to holders of Class A Variable Voting Shares and Class B Voting Shares and any other similar transactions.

In January 2009 and March 2009, the Corporation completed two substantial issuer bids to purchase for cancellation 9.3 million of its convertible preferred shares at a purchase price of \$20 dollars per preferred share. The Corporation paid an aggregate purchase price of \$186 for the shares tendered. The repurchase price of these instruments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$32 being recorded in 2009 within Non-operating expense. The residual equity components of the instruments amounting to \$87 have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity.

In September 2009, the Corporation entered into an agreement with Morgan Stanley Canada Limited pursuant to which the Corporation indirectly acquired for cancellation all of its remaining 3.2 million convertible preferred shares at a price of \$23 dollars per preferred share. The Corporation paid an aggregate purchase price of \$74. The repurchase price of these instruments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$10 being recorded in 2009 within Non-operating expense. The residual equity components of the instruments amounting to \$23 have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity.

### **(c) Convertible Senior Notes**

During 2005, the Corporation issued \$330 of Convertible senior notes due 2035 ("Convertible Notes") for net proceeds of \$319. For accounting purposes, the Convertible Notes are presented as a compound instrument with the conversion option reflected in other equity above. Refer to Note 7 for additional information. In 2008, Convertible senior notes with a face value of \$1 (2007 - \$6) were converted at the option of the holder.

In January 2009, ACE completed a substantial issuer bid to purchase for cancellation 80% of its Convertible senior notes outstanding as at December 31, 2008, at a purchase price of \$900 dollars in cash for each \$1,000 dollars principal amount of notes. The aggregate principal amount of the repurchased Convertible senior notes was \$259. On January 21, 2009, the Corporation paid an aggregate purchase price of \$233 for the notes tendered. The repurchase price of these instruments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$1 being recorded in 2009 within Non-operating expense. The residual equity components of the instruments amounting to \$72 have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity.



On December 14, 2009, the Corporation paid an aggregate purchase price of \$64 for the redemption of the remaining convertible senior notes. The repurchase price of these instruments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$1 being recorded in 2009 within Non-operating expense. The residual equity components of the instruments amounting to \$17 have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity.

**(d) 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 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.

Upon purchase and cancellation by ACE of the Class A variable voting shares and Class B voting shares, Share capital decreased by \$115, Contributed surplus decreased by \$228, and Retained earnings decreased by \$1,155.

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.

**(e) 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 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.

Upon purchase and cancellation by ACE of the Class A variable voting Shares and Class B voting shares, Share capital decreased by \$65, Contributed surplus decreased by \$101, and Retained earnings decreased by \$334.

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.

**(f) Substantial Issuer Bid – January 2010**

On January 6, 2010, ACE accepted for purchase and cancellation a total of 1,401,094 Class A Variable Voting Shares and 1,824,711 Class B Voting Shares at \$6.20 per share for an aggregate purchase price of \$20 in accordance with the terms of a substantial issuer bid.

**Accumulated Other Comprehensive Income (Loss)**

The following table outlines the components of Accumulated other comprehensive income (loss) as at December 31:

<b>As at December 31 (Canadian dollars in millions)</b>	<b>2009</b>	<b>2008</b>
<b>Accumulated other comprehensive income (loss)</b>		
Unrealized change in fair value of derivatives (net of tax of \$6 for 2008)	\$ -	\$ (606)
Proportionate share of Air Canada's other comprehensive loss representing unrealized change in fair value of derivatives	(50)	-
<b>Total Accumulated other comprehensive loss</b>	<b>\$ (50)</b>	<b>\$ (606)</b>

**13. EARNINGS PER SHARE**

The following table outlines the calculation of basic and diluted loss per share:

(in millions, except per share amounts)	2009	2008
<b>Numerator:</b>		
<b>Numerator for basic loss per share:</b>		
Net loss for the year	\$ (692)	\$ (120)
Effect of potential dilutive securities:		
Stock options	-	-
Convertible preferred shares	-	-
Convertible notes	-	-
<b>Adjusted numerator for diluted loss per share</b>	<b>\$ (692)</b>	<b>\$ (120)</b>
<b>Denominator:</b>		
<b>Denominator for basic loss per share:</b>		
<b>Weighted-average shares</b>	35	46
Effect of potential dilutive securities:		
Stock options	-	-
Convertible preferred shares	-	-
Convertible notes	-	-
<b>Adjusted denominator for diluted loss per share</b>	<b>35</b>	<b>46</b>
<b>Basic loss per share</b>	<b>\$ (19.56)</b>	<b>\$ (2.59)</b>
<b>Diluted loss per share</b>	<b>\$ (19.56)</b>	<b>\$ (2.59)</b>

*The calculation of earnings per share is based on whole dollars and not on rounded millions.*

*As a result, the above amounts may not be recalculated to the per share amount disclosed above.*

The dilutive effect of outstanding stock options on earnings per share is based on the application of the treasury stock method. Under this method, the proceeds from the exercise of such securities are assumed to be used to purchase Class B Voting Shares.

Excluded from the calculation of diluted earnings per share in 2009 were 47,812 (2008 – 61,230) outstanding options where the options' exercise prices were greater than the average market price of the common shares for the year.

All Convertible senior notes and Convertible preferred shares are anti-dilutive for the years ended December 31, 2009 and December 31, 2008 and were excluded from the calculation. In addition, as described in Notes 7 and 12, as at December 31, 2009 the ACE balance of Convertible senior notes and Convertible preferred shares is nil.

**14. SUPPLEMENTARY AND GEOGRAPHIC INFORMATION****Composition of Business Segments**

ACE had two reportable segments: Air Canada and Corporate Items and Eliminations ("CIE") until October 27, 2009, after which time only one segment remains.

ACE's investment in Air Canada was changed on October 27, 2009 from the consolidation to the equity method of accounting reported under the CIE segment.

Prior to October 27, 2009, CIE included the corporate, financing and investing activities of ACE. ACE's investments in Aeroplan, Jazz and ACTS were changed in 2007 from the consolidation to the equity method of accounting reported under the CIE segment. As of May 9, 2008 and February 7, 2008, ACE no longer equity accounted for Aeroplan (Note 3) and Jazz (Note 3), respectively, but distributions from Aeroplan and Jazz were recorded in the CIE segment until June 2008 at which time ACE no longer held an ownership interest in Aeroplan and Jazz.

Future income taxes were recorded within the applicable taxable entities and were not allocated to non-taxable entities.

The under-noted reconciliation provides supplementary information to separate CIE from Air Canada results included in the consolidated financial statements.

	2009 Notes 1 & 3			2008		
	Air Canada *	CIE	Total ACE	Air Canada	CIE	Total ACE
Passenger revenue	\$ 7,196	\$ -	\$ 7,196	\$ 9,713	\$ -	\$ 9,713
Cargo revenue	282	-	282	515	-	515
Other revenue	728	-	728	851	1	852
External revenue	8,206	-	8,206	11,079	1	11,080
Inter-segment revenue	1	(1)	-	3	(3)	-
<b>Total revenues</b>	<b>8,207</b>	<b>(1)</b>	<b>8,206</b>	<b>11,082</b>	<b>(2)</b>	<b>11,080</b>
Aircraft fuel	2,056	-	2,056	3,419	-	3,419
Wages, salaries and benefits	1,468	4	1,472	1,877	31	1,908
Airport and navigation fees	822	-	822	1,001	-	1,001
Capacity purchase with Jazz	825	-	825	948	-	948
Depreciation and amortization	550	(5)	545	694	(8)	686
Aircraft maintenance	625	-	625	659	-	659
Food, beverages and supplies	248	-	248	314	-	314
Communications and information technology	255	-	255	286	-	286
Aircraft rent	276	-	276	279	-	279
Commissions	156	-	156	194	-	194
Other	1,162	8	1,170	1,450	10	1,460
<b>Total operating expenses</b>	<b>8,443</b>	<b>7</b>	<b>8,450</b>	<b>11,121</b>	<b>33</b>	<b>11,154</b>
<b>Operating loss before under noted item</b>	<b>(236)</b>	<b>(8)</b>	<b>(244)</b>	<b>(39)</b>	<b>(35)</b>	<b>(74)</b>
Provision for cargo investigations	-	-	-	(125)	-	(125)
<b>Operating loss</b>	<b>(236)</b>	<b>(8)</b>	<b>(244)</b>	<b>(164)</b>	<b>(35)</b>	<b>(199)</b>
Interest income	12	5	17	57	27	84
Interest expense	(316)	(5)	(321)	(319)	(54)	(373)
Interest capitalized	4	-	4	37	-	37
Loss on ACE's investment in Air Canada	-	(630)	(630)	-	-	-
Gain on sale of Aeroplan and Jazz units	-	-	-	-	997	997
Gain (loss) on other assets	(70)	-	(70)	(34)	(17)	(51)
Loss on repurchase of ACE convertible senior notes and preferred shares	-	(44)	(44)	-	-	-
Gain on financial instruments recorded at fair value	94	-	94	92	-	92
Equity and other investment loss	-	(7)	(7)	-	(64)	(64)
Other non-operating income (expense)	(5)	-	(5)	(3)	1	(2)
Non-controlling interest	(12)	(1)	(13)	(12)	250	238
Foreign exchange gain (loss)	531	-	531	(655)	-	(655)
Provision for income taxes	(1)	(3)	(4)	(24)	(200)	(224)
<b>Segment net income (loss)</b>	<b>\$ 1</b>	<b>\$ (693)</b>	<b>\$ (692)</b>	<b>\$ (1,025)</b>	<b>\$ 905</b>	<b>\$ (120)</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3). Aeroplan and Jazz equity investment income is recorded up to May 9, 2008 and February 7, 2008 respectively. Subsequent to these effective dates, distribution income from Aeroplan and Jazz is recorded within CIE through to June 2008. For the year ending December 31, 2009, equity loss of \$7 (2008 – equity loss of \$69) relating to ACE's equity investments is included in Equity and other investment loss.

**Geographic Information**

	<b>2009 *</b> <b>Notes 1 &amp; 3</b>	<b>2008</b>
<b>Passenger revenues</b>		
Canada	\$ 3,026	\$ 4,108
US Transborder	1,376	1,876
Atlantic	1,494	1,883
Pacific	703	995
Other	597	851
	<b>\$ 7,196</b>	<b>\$ 9,713</b>

	<b>2009 *</b> <b>Notes 1 &amp; 3</b>	<b>2008</b>
<b>Cargo revenues</b>		
Canada	\$ 53	\$ 97
US Transborder	11	18
Atlantic	101	212
Pacific	86	142
Other	31	46
	<b>\$ 282</b>	<b>\$ 515</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

Passenger and cargo revenues are based on the actual flown revenue for flights with an origin and destination in a specific country or region. Atlantic refers to flights that cross the Atlantic Ocean with origin and destinations principally in Europe. Pacific refers to flights that cross the Pacific Ocean with origin and destinations principally in Asia. Other revenues are principally derived from customers located in Canada.

**15. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT**
**Summary of Financial Instruments**

	Carrying Amounts					December 31, 2008
	December 31, 2009 (1)					
	Financial instruments classification					
	Held for trading	Held to maturity	Loans and receivables	Liabilities at amortized cost	Total	
<b>Financial Assets</b>						
Cash and cash equivalents (3)	\$ 71	\$ -	\$ -	\$ -	\$ 71	\$ 1,307
Short-term investments	-	-	-	-	-	506
Restricted cash	-	-	-	-	-	45
Accounts receivable	-	-	3	-	3	700
Collateral deposits for fuel derivatives	-	-	-	-	-	328
Loan receivable from Air Canada	-	-	150	-	150	-
Deposits and other assets						
Restricted cash	-	-	-	-	-	65
Asset backed commercial paper	-	-	-	-	-	29
Aircraft related and other deposits	-	-	-	-	-	323
Derivative instruments						
Foreign exchange derivatives	-	-	-	-	-	64
Interest rate swaps	-	-	-	-	-	21
	\$ 71	\$ -	\$ 153	\$ -	\$ 224	\$ 3,388
<b>Financial Liabilities</b>						
Accounts payable	\$ -	\$ -	\$ -	\$ 3	\$ 3	\$ 1,466
Current portion of long-term debt and capital leases	-	-	-	-	-	663
Long-term debt and capital leases	-	-	-	-	-	4,980
Convertible preferred shares	-	-	-	-	-	206
Derivative instruments						
Fuel derivatives (2)	-	-	-	-	-	15
	\$ -	\$ -	\$ -	\$ 3	\$ 3	\$ 7,330

- (1) Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).
- (2) The fuel derivatives above relate to fuel derivatives not designated under fuel hedge accounting. As at December 31, 2008, fuel derivatives under hedge accounting had a fair value of \$405 in favour of the counterparties.
- (3) As at December 31, 2009, Cash and cash equivalents includes \$40 pertaining to investments with original maturities of three months or less which have been valued using significant other observable inputs.

There have been no changes in classification of financial instruments since December 31, 2008.

**Summary of Gain on Financial Instruments Recorded at Fair Value**

	2009 *	2008
Ineffective portion of fuel hedges	\$ -	\$ 83
Fuel derivatives not under hedge accounting	98	(9)
Cross currency interest rate swaps	-	4
Other	(4)	14
<b>Gain on financial instruments recorded at fair value</b>	<b>\$ 94</b>	<b>\$ 92</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3)

**Risk Management**

As described in Notes 1 and 3, effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE.

As a result, as at December 31, 2009, ACE's financial instruments are limited to cash and cash equivalents in the amount of \$71, a secured loan of \$150 to Air Canada, interest receivable of \$3 from Air Canada and accounts payable of \$3. The risk exposure related to these holdings is described below.

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 is exposed to interest rate risk from its holding in cash and cash equivalents of \$71 in addition to its secured loan receivable and related interest receivable from Air Canada of \$150 and \$3, respectively. The loan receivable from Air Canada bears interest at a rate based upon the greater of the bankers' acceptance rate or 3.00% plus 9.75% (12.75% as at December 31, 2009), which mitigates risk to nil.

The weighted average interest rate on ACE's cash and cash equivalents at December 31, 2009, is 0.22%, which results in limited downside risk.

Liquidity risk

Liquidity risk is the risk that the Corporation will encounter difficulty in meeting obligations associated with its financial liabilities. This risk is mitigated by the fact that as at December 31, 2009, the Corporation had Cash and cash equivalents of \$71 and current financial liabilities of \$3.

Credit Risk

Credit risk is the risk of loss due to a counterparty's inability to meet its obligations. The Corporation is exposed to credit risk from its cash and cash equivalents and its secured loan receivable from Air Canada and related interest receivable from Air Canada. The maximum exposure of which is represented by the carrying amounts reported on the balance sheet.

This risk is mitigated by the fact that:

- Cash and cash equivalents are held by credit worthy institutions only. The Corporation's target is that no one financial institution hold more than 25% of the total cash balance;
- Air Canada's obligations under the Credit Facility are secured by a first priority security interest and hypothec over substantially all the present and after-acquired property of Air Canada and its subsidiaries, subject to certain exclusions and permitted liens. The Credit Facility contains customary representations and warranties and is subject to customary terms and conditions (including negative covenants, financial covenants and events of default).

## 16. CAPITAL DISCLOSURES

ACE is an investment holding company of aviation interests which include, as at December 31, 2009, a non-controlling interest in Air Canada, and a non-controlling interest in ACTS Aero. During the time that ACE had a controlling interest in Air Canada, ACE managed its capital at the parent company level separately from the capital of Air Canada. Each of the ACE and Air Canada Boards of Directors approved the ACE or Air Canada objectives and policies for managing capital as the case may be.

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 is used by management and may not be comparable to measures presented by other public companies. Capital managed by ACE, summarized from the consolidated statement of financial position, follows:

	2009	2008
Convertible senior notes*	\$ -	\$ 289
Convertible preferred shares*	-	206
Non-controlling interest	-	512
Shareholders' equity*	320	464
<b>Capital</b>	<b>\$ 320</b>	<b>\$ 1,471</b>

\* For accounting purposes, the convertible senior notes and convertible preferred shares were presented as compound instruments.

The carrying values ascribed to the holders' conversion options within the convertible senior notes and preferred shares, included in shareholders' equity as at December 31, 2008, amounted to \$90 and \$117, respectively.

As at December 31, 2009, ACE's capital amounted to \$320, a decline of \$1,151 during 2009. As at December 31, 2009, ACE unconsolidated cash and cash equivalents amounted to \$71 (\$808 as at December 31, 2008).

ACE's business strategy, to surface shareholder value and to return capital to its shareholders, has influenced its capital management objectives. Consistent with those objectives, during 2008 and 2009, the ACE Board of Directors authorized the return of capital to its shareholders and the redemption of its convertible senior notes and convertible preferred shares, as further described below. Going forward, the Board will continue to review alternatives to maximize the return to its shareholders.

### Investments

Consistent with ACE's strategy to surface shareholder value, in the year ended December 31, 2008, ACE sold the remaining 40.3 million trust units of Aeroplan Income Fund for net proceeds of \$692, and realized a gain on disposal of \$830 (\$684 after tax). ACE also sold the remaining 24.7 million trust units of Jazz Air Income Fund for net proceeds of \$182 and realized a gain on disposal of \$167 (\$133 after tax). As at December 31, 2009, ACE has retained ownership interests in Air Canada (27.0%) and ACTS Aero (28.4%). ACE no longer has any ownership interest in Aeroplan or Jazz.

### Common shares

During 2008, ACE returned capital to its shareholders by way of two substantial issuer bids, wherein ACE completed the purchase and cancellation of 72.6 million common shares for an aggregate purchase price of \$1,998.

On January 6, 2010, ACE accepted for purchase and cancellation a total of 1,401,094 Class A Variable Voting Shares and 1,824,711 Class B Voting Shares at \$6.20 per share for an aggregate purchase price of \$20 in accordance with the terms of a substantial issuer bid.



**Convertible senior notes**

In January 2009, ACE completed a substantial issuer bid to purchase for cancellation 80% of its Convertible senior notes outstanding as at December 31, 2008, at a purchase price of \$900 dollars in cash for each \$1,000 dollars principal amount of notes. The aggregate principal amount of the repurchased Convertible senior notes was \$259. On January 21, 2009, the Corporation paid an aggregate purchase price of \$233 for the notes tendered. The repurchase price of these instruments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$1 being recorded in 2009 within Non-operating expense. The residual equity components of the instruments amounting to \$72 have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity.

On December 14, 2009, the Corporation paid an aggregate purchase price of \$64 for the redemption of the remaining convertible senior notes. The repurchase price of these instruments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$1 being recorded in 2009 within Non-operating expense. The residual equity components of the instruments amounting to \$17 have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity.

**Convertible preferred shares**

In January 2009 and March 2009, the Corporation completed two substantial issuer bids to purchase for cancellation 9.3 million of its convertible preferred shares at a purchase price of \$20 dollars per preferred share. The Corporation paid an aggregate purchase price of \$186 for the shares tendered. The repurchase price of these instruments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$32 being recorded in 2009 within Non-operating expense. The residual equity components of the instruments amounting to \$87 have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity.

In September 2009, the Corporation entered into an agreement with Morgan Stanley Canada Limited pursuant to which the Corporation indirectly acquired for cancellation all of its remaining 3.2 million convertible preferred shares at a price of \$23 dollars per preferred share. The Corporation paid an aggregate purchase price of \$74. The repurchase price of these instruments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$10 being recorded in 2009 within Non-operating expense. The residual equity components of the instruments amounting to \$23 have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity.

**Non-controlling interest**

As described in Note 3, effective October 27, 2009, ACE no longer consolidates Air Canada's financial position, operating results and cash flows. As a result, as at December 31, 2009 ACE's Non-controlling interest included in its Consolidated statement of financial position is nil.

**17. RELATED PARTY TRANSACTIONS**

At December 31, 2009 ACE holds a 27% ownership interest in Air Canada. On October 16, 2007, ACTS LP sold substantially all its assets, liabilities and business to ACTS Aero, a new entity established to purchase the assets of ACTS LP. ACTS Aero owns 100% of Aveos (Aveos Fleet Performance Inc.) which changed its legal name on September 23, 2008 from its previous name of ACTS Aero Technical Support and Services Inc. As at December 31, 2009 ACE has a 28.4% interest in ACTS Aero.

Air Canada has various related party transactions with Aveos.

Related party trade balances, as outlined below, mainly arise from the provision of services, including the allocation of employee related costs, as further described in Note 9. Trade balances between the related parties have trade terms which generally require payment 30 days after receipt of invoice.

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

	2009	2008
<b>Accounts receivable</b>		
Air Canada	\$ 3	\$ -
Aveos (Air Canada)	-	120
	<b>\$ 3</b>	<b>\$ 120</b>
<b>Prepaid Maintenance</b>		
Aveos (Air Canada)	\$ -	\$ 5
	<b>\$ -</b>	<b>\$ 5</b>
<b>Loan receivable</b>		
Air Canada	\$ 150	\$ -
	<b>\$ 150</b>	<b>\$ -</b>
<b>Accounts payable and accrued liabilities</b>		
Aveos (Air Canada)	\$ -	\$ 99
	<b>\$ -</b>	<b>\$ 99</b>

Revenues and expenses with related parties are summarized as follows:

	2009 *	2008
<b>Revenues</b>		
Property rental revenues from Aveos	\$ 26	\$ 29
Revenues from information technology services to Aveos	5	15
Revenues from corporate services and other to Aveos	7	12
Interest revenue for ACE's participation in the Credit Facility	3	-
	<b>\$ 41</b>	<b>\$ 56</b>
<b>Expenses</b>		
Maintenance expense for services from Aveos	\$ 423	\$ 478
Recovery of wages, salary and benefit expense for employees assigned to Aveos	(190)	(249)
Other expenses	-	1
	<b>\$ 233</b>	<b>\$ 230</b>

\* Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE (Refer to Notes 1 & 3).

**Summary of significant related party agreements***The Relationship between Air Canada and Aveos**Pension and Benefits Agreement*

Air Canada, ACTS and ACTS Aero entered into a Pension and Benefits Agreement effective as of October 16, 2007, as amended (“Pension and Benefits Agreement”), relating to pension and benefits arrangements pertaining to (i) the non-unionized employees of Air Canada who were previously assigned to the ACTS operation became employees of Aveos on October 16, 2007 and (ii) unionized employees of Air Canada who were assigned to ACTS Aero operation pursuant to general services agreements between Air Canada and ACTS for the assignment of unionized employees from Air Canada to ACTS (these agreements were assigned to ACTS Aero upon the closing of the monetization). Aveos is required to establish new defined benefit and defined contribution pension plans as well as other employee and retiree benefit arrangements (including health, life and disability) are being established by ACTS Aero (the “ACTS Benefit Arrangements”).

Upon receipt of regulatory approval where required and based upon valuations of the relevant pension and benefit arrangements of Air Canada (the “Air Canada Benefit Arrangements”) as at October 16, 2007, the assets and obligations under the Air Canada Benefit Arrangements pertaining to the transferring non-unionized employees will be transferred to ACTS Aero or the ACTS Benefit Arrangements, as applicable. Amounts with a present value equal to the solvency deficiency in the defined benefit pension plans as at October 16, 2007 related to transferring non-unionized employees will be paid by Air Canada through quarterly payments to Aveos until 2014. Amounts with a present value equal to the accounting liability as at October 16, 2007 in respect of retiree and disability benefits related to transferring non-unionized employees will be paid by Air Canada through quarterly payments to Aveos until 2012. The present value of these quarterly payments is also referred to as the compensation amount. Until such future time as the assets and obligations under the Air Canada Benefit Arrangements pertaining to non-unionized employees are to be transferred to Aveos, the current service pension cost and the current service and interest costs for other employee benefits are expensed by Air Canada with a full offset recorded as an amount charged to affiliates (Aveos).

In addition, the Pension and Benefits Agreement contemplates similar asset and liability transfer and compensation arrangements in respect of unionized employees, which arrangements would take effect at such future time as those unionized employees may commence employment with Aveos pursuant to the Transition Memorandum of Agreement (“the Transition MOA”), as further described below. However, the solvency deficiencies in respect of transferring unionized employees for which the future quarterly compensation payments would be made are determined as at October 16, 2007, subject to certain adjustments, and the discount rate used to compute the accounting liability for the unionized employees’ retiree and disability benefits is fixed as at October 16, 2007. The compensation payments in respect of these solvency deficiencies and accounting liabilities would be made quarterly during the five years beginning after the unionized employees are transferred to Aveos, but only if such a transfer occurs. Until such future time as the assets and obligations under the Air Canada Benefit Arrangement pertaining to unionized employees may be transferred to Aveos, the current service pension cost and the current service and interest costs for other employee benefits in respect of Air Canada employees providing services to Aveos are charged to Aveos.

The Pension and Benefits Agreement also required that Air Canada provide letters of credit to Aveos on October 16, 2007, to secure the above-described payment obligations in respect of the solvency deficiencies of the defined benefit pension plans and accounting liabilities for other retiree and disability benefit arrangements. The letters of credit initially total \$101, subject to adjustment once the exact amounts of the relevant solvency deficiencies and accounting liabilities as at October 16, 2007 are determined by actuarial valuations. The face amount of the letter of credit in respect of the unionized solvency deficiency is also adjusted annually to recognize past service costs paid by Air Canada to the plan in respect of unionized employees assigned to ACTS Aero. The face amount of the letters of credit decreases as the related quarterly funding payments described above are made. During 2008, as described below under “Agreement with Aveos on Revised Payment Terms”, Air Canada and Aveos agreed to temporarily cancel certain letters of credit in the amount of \$40. Aveos may call the letters of credit in whole or in part, in the event of a default as defined in the Pension and Benefits Agreement. Collateral equal to the amount of the letters of credit was paid in cash with the asset recorded in Deposits and other assets.

During 2008, Air Canada, Aveos, and the union representing the employees assigned to Aveos continued discussions regarding the options under which certain unionized employees would commence employment directly with Aveos and the creation of a separate bargaining unit for those employees at Aveos. On January 8, 2009, these same parties entered into the Transition MOA in order to resolve certain remaining issues and in order to (i) facilitate the orderly transition of certain Air Canada employees to Aveos and (ii) to establish terms and conditions of employment that will apply to those Air Canada employees who elect to become employees of Aveos. In relation to the Transition MOA, Air Canada and Aveos also entered into certain ancillary agreements (the "Ancillary Transition Agreements") to address commercial issues relating to the transition of employees contemplated by the Transition MOA. On March 5, 2009, Air Canada received the decision of the arbitrator seized with resolving five issues which remained outstanding following the execution of the Transition MOA. Air Canada and the IAMAW subsequently amended the Transition MOA, by establishing timelines for the steps for the transition and by providing for a date on which the employees who will transition to Aveos will become employees of Aveos, namely, April 1, 2011.

#### Repair Schemes and Non-Compete Transfer Agreement

Aveos and Air Canada are parties to a non-compete and repair schemes transfer agreement, effective as of October 16, 2007 (the "Repair Schemes and Non-Compete Agreement"). Generally described, repair schemes are processes and methods which may be used in the maintenance and repair of aircraft and related equipment. The Repair Schemes and Non-Compete Agreement confirmed an arrangement and provides for the sale from Air Canada to ACTS Aero (as successor to ACTS LP) of an undivided joint ownership interest in repair schemes owned by Air Canada or approved under Air Canada's airworthiness engineering organization as well as the sale from Aveos to Air Canada of an undivided joint ownership interest in the repair schemes owned or developed by Aveos and applicable to airframe heavy maintenance services provided by ACTS to Air Canada under the parties' airframe heavy maintenance services agreement. However, in September 2004 as part of the implementation of the Corporation's plan of arrangement under the Companies' Creditors Arrangement Act, the Corporation had already granted ACTS full and exclusive right to these schemes on a royalty free basis.

The Repair Schemes and Non-Compete Agreement also restricts Air Canada's ability to own any equity interest in an entity (other than entities in which Air Canada previously held interests), or to carry on a business activity, related to the following commercial maintenance, repair and overhaul services in the airline industry, namely, airframe heavy maintenance and paint services, engine and auxiliary power unit ("APU") overhaul maintenance services, and component maintenance services. The applicable non-compete periods are as follows:

- With respect to airframe heavy maintenance services and paint services, the non-compete period ends one year after the current heavy maintenance services agreement is terminated or expires (the current term of the heavy maintenance services agreement expires October 1, 2011);
- With respect to engine and APU overhaul maintenance services, the non-compete period ends on October 1, 2015; and
- With respect to component maintenance services, the non-compete period ends on October 1, 2016;

The Repair Schemes and Non-Compete Agreement does not restrict Air Canada from holding interests in any entities in which it held interests at the time of concluding the agreement nor does it limit Air Canada's line maintenance activities which it continues to operate.

#### Agreement with Aveos on Revised Payment Terms

Air Canada and Aveos entered into an agreement dated October 28, 2008 pursuant to which Air Canada has agreed to temporarily extend payment terms to Aveos under certain related party agreements. In exchange for the extended payment terms, certain letters of credit related to the Pension and Benefits Agreement, as described above, were cancelled. The cancellation of the letters of credit provided cash to Air Canada of approximately \$40 and was offset by the impact of extended payment terms to Aveos of \$22, for a net cash flow benefit of \$18 to Air Canada. The extended payment terms to Aveos were originally scheduled to begin reducing in May 2009 with a corresponding return of the letters of credit to Aveos.

As a result of amendments, the payment terms were extended. The extended payment terms will be reduced starting in February 2010 with the expiration of the extended payment terms to be completed over the following six months. By July 2010, following expiration of the extended payment terms, the letters of credit would be reinstated to the levels then required under the Pension and Benefits Agreement between the two parties.

#### Maintenance Agreements

Aveos and Air Canada are parties to a general terms and related services agreements effective October 1, 2006, pursuant to which Aveos provides technical services to Air Canada including engine and auxiliary power unit maintenance services, aircraft heavy maintenance services (excluding line and cabin maintenance services which are provided by Air Canada) and component maintenance. Aveos serves as Air Canada's exclusive repair agency in respect of aircraft heavy maintenance, engine maintenance, auxiliary power unit maintenance services as well as for maintenance services relating to certain components. The services agreement relating to aircraft heavy maintenance services which expires in October 2011, will be extended to June 2013 conditional upon the issuance of an order of the Canada Industrial Relations Board establishing that Aveos is a distinct employer, bound by separate collective agreements and providing for the transition of employees from Air Canada to Aveos which are fully within the scope of the Transition MOA and the Ancillary Transition Agreements mentioned above. The services agreement relating to engine maintenance expires in October 2013, except in respect of certain engine types, for which the parties have agreed to extend the term to December 31, 2018. Each of the other maintenance agreements referred to above expire in October 2013.

#### Master Services Agreement (MSA)

Aveos and Air Canada are parties to an amended and restated master services agreement (the "Aveos MSA"), effective January 1, 2007, pursuant to which Air Canada provides Aveos with services including infrastructure support and services which are mostly administrative in nature, including information technology, human resources, finance and accounting services in return for fees paid by Aveos to Air Canada. Aveos may elect to terminate any services under the Aveos MSA or the entire Aveos MSA upon six months' prior written notice, with the exception of services relating to information technology which Aveos cannot terminate prior to the expiry of the Aveos MSA. Air Canada may elect to terminate any services under the Aveos MSA or the entire Aveos MSA upon 18 months' prior written notice. These amounts are recorded in the above table summarizing related party revenues and expenses under Revenues from corporate services and other.

#### General Services Agreements

Aveos and Air Canada are parties to an amended and restated general services agreement (the "Aveos GSA"), effective as of June 22, 2007, pursuant to which Air Canada provides Aveos with the services of a group of unionized employees for which Air Canada is reimbursed by Aveos for all costs, including salary and benefits, on a fully allocated basis. The Aveos GSA may be terminated by either party at any time upon a 30 days' prior written notice.

#### Real Estate Agreements

Aveos and Air Canada are parties to a master lease agreement, effective as of October 1, 2006, pursuant to which Aveos leases space from Air Canada at the Vancouver, Winnipeg, Toronto and Montreal airports.

### *The Relationship between Air Canada and ACE*

#### Credit Facility

ACE is a participant lender in the Credit Facility as described in Note 3. ACE's participation in the Credit Facility represents \$150 of the outstanding loan of \$600 as at December 31, 2009. The participant lenders participate on a pro-rata basis with respect to any warrants and principal and interest payments. ACE's pro-rata share of interest expense reported during the year amounts to \$8 and its prorata share of the warrants as reported in Air Canada's Contributed surplus is approximately \$2.

#### Master Services Agreement

Air Canada provides certain accounting and administrative services to ACE in return for a fee. ACE terminated the majority of these service agreements in 2009.

Guarantee of Air Canada obligation

On May 7, 2009, ACE intervened into the employment agreement between Air Canada and Mr. Calin Rovinescu, its President and Chief Executive Officer, to guarantee the payments required of Air Canada under the agreement.

In addition, ACE agreed to cause to be issued an irrevocable bank letter of credit to a maximum of \$5. At December 31, 2009, as agreed by the parties, the letter of credit had not been issued.

**18. SUBSEQUENT EVENTS****Substantial issuer bid**

On January 6, 2010, ACE accepted for purchase and cancellation a total of 1,401,094 Class A Variable Voting Shares and 1,824,711 Class B Voting Shares at \$6.20 per share for an aggregate purchase price of \$20 in accordance with the terms of a substantial issuer bid.

**Aveos restructuring and lockup agreement**

On January 22, 2010 ACE entered into a Restructuring and Lockup Agreement with Aveos, ACTS Aero, lenders and other shareholders. Under the terms of the restructuring, which is planned to be completed in Quarter 1, 2010, ACE has agreed on closing to transfer its shares in ACTS Aero to a newly formed company, in which ACE will have no interest, for nil consideration.



**2009**

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

**February 11, 2010**

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**1. Preface**

ACE Aviation Holdings Inc. ("ACE"), which was incorporated on June 29, 2004, is an investment holding company of aviation interests. 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.

On December 14, 2009, ACE redeemed the remaining convertible senior notes for an aggregate purchase price of \$64 million. In addition, on January 6, 2010, ACE completed a substantial issuer bid and purchased \$20 million of its shares at a purchase price of \$6.20 per share. Going forward, the Board will continue to review alternatives to maximize the return to shareholders, including alternatives for its debt and equity interests in Air Canada.

ACE's financial statements have been prepared on a going concern basis of presentation. The going concern basis of presentation assumes continuity of operations, realization of assets and satisfaction of liabilities in the ordinary course of business. Effective October 27, 2009, ACE no longer consolidates Air Canada's financial position, operating results and cash flows. ACE's investment in Air Canada has since been accounted for using the equity method whereby the Air Canada investment carrying value is adjusted to include the Corporation's pro rata share of post-dilution earnings.

This MD&A should be read in conjunction with ACE's audited consolidated financial statements and notes for 2009. 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 as otherwise noted, all monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 18 "Glossary of Terms". Except as otherwise noted, this MD&A is current as of February 11, 2010. Certain comparative figures have been reclassified to conform to the financial statement presentation adopted in the current period.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" in section 2 of this MD&A for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of the risks relating to ACE, see section 15 "Risk Factors" of this MD&A.

The ACE Audit, Finance & Risk Committee has reviewed this MD&A and the 2009 audited 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](http://www.sedar.com), or ACE's website at [www.aceaviation.com](http://www.aceaviation.com).

**2. Caution Regarding Forward-Looking Information**

ACE's public communications may include written or oral forward-looking statements within the meaning of applicable securities laws. Such statements are included in this MD&A and may be included in other filings with regulatory authorities and securities regulators. Forward-looking statements relate to analyses and other information that are based on forecasts of future results and estimates of amounts not yet determinable. These statements may involve, but are not limited to, comments relating to strategies, expectations, planned operations or future actions. 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.

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. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, industry, market, credit and economic conditions, the ability to reduce operating costs and secure financing, pension issues, energy prices, currency exchange and interest rates, employee and labour relations, competition, war, terrorist acts, epidemic diseases, insurance issues and costs, changes in demand due to the seasonal nature of the business, supply issues, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties as well as the factors identified throughout this MD&A and, in particular, those identified in section 15 "Risk Factors" of this MD&A. The forward-looking statements contained in this MD&A 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. ACE's Assets, Obligations and Net Assets at Fair Value**

The following table presents the assets and liabilities of ACE at fair value as at January 31, 2010 and December 31, 2009. The objective of this information is to present information on the assets and liabilities of ACE as certain of ACE's shareholders use this information to assess ACE's financial position. This non-GAAP information including net assets at fair value is not prepared in accordance with standards prescribed by Canadian generally accepted accounting principles ("GAAP") and may not be comparable to other similar information provided by other companies. This is not presented as a substitute for the balance sheet of ACE which has been prepared in accordance with Canadian GAAP and has been prepared on a going concern basis. Further, this presentation is not intended to reflect ACE's net asset value on a liquidation basis and does not purport to represent the fair value of ACE as a whole or per share.

(Canadian dollars in millions)	January 31 2010	December 31 2009
Cash and cash equivalents <sup>(2)</sup>	\$ 50	\$ 71
Interest receivable on Air Canada loan	5	3
Air Canada shares <sup>(1)</sup>	100	99
Air Canada secured loan <sup>(1)</sup>	150	150
	305	323
Current obligations	(3)	(3)
Contingencies <sup>(3)</sup>	-	-
	(3)	(3)
<b>Net assets at fair value <sup>(2)</sup></b>	<b>\$ 302</b>	<b>\$ 320</b>
<b>Net assets at fair value per share – Basic <sup>(2)</sup></b>	<b>\$ 9.30</b>	<b>\$ 8.97</b>

- (1) As at January 31, 2010, ACE's held a 27.0% ownership interest in Air Canada consisting of 75 million Class B Voting Shares and held a secured loan of \$150 million to Air Canada as part of the Air Canada Credit Facility. Under the Credit Facility, ACE received 1,250,000 warrants on July 30, 2009, for the purchase of Air Canada Class B Voting Shares with an exercise price of \$1.51 per share, exercisable at any time, and expiring four years after the date of issuance. An additional 1,250,000 warrants were issued to ACE on October 19, 2009 with an exercise price of \$1.44 per share, exercisable at any time, and expiring four years after the date of issuance. The Air Canada shares of \$100 million as at January 31, 2010 and \$99 million as at December 31, 2009 are based on the market prices of \$1.33 per Air Canada Class B share as at January 31, 2010 and \$1.32 per Air Canada Class B share as at December 31, 2009, as quoted on the TSX. The Air Canada secured loan is included in the table above at its principal amount of \$150 million.
- (2) As detailed in section 9.5 of this MD&A, on January 6, 2010 ACE completed a substantial issuer bid and purchased \$20 million of its shares at a purchase price of \$6.20 per share. As at January 31, 2010, there were 32,465,484 issued and outstanding common shares (December 31, 2009, 35,691,289)
- (3) ACE is subject to ongoing audits by Canadian tax authorities for the years 2005 to 2009 and no liabilities that may arise have been included above. See Section 12 for Off-balance sheet arrangements. Should ACE proceed to a liquidation in the future, additional costs and other liabilities may arise.

**4. Significant Events**

The following significant events occurred during the period January 1, 2009 to February 11, 2010:

On January 19, 2009, ACE announced that \$259 million principal amount of 4.25% convertible senior notes due 2035 were deposited and taken up under a substantial issuer bid, at a purchase price of \$900 for each \$1,000 principal amount of notes, for an aggregate purchase price of \$233 million. ACE also announced on January 19, 2009 that 8.3 million convertible preferred shares, at a purchase price of \$20.00 per preferred share, were deposited and taken up under a substantial issuer bid, for an aggregate purchase price of \$166 million.

On March 19, 2009, ACE announced that it had taken up and accepted for purchase and cancellation 1.0 million of its convertible preferred shares, at a purchase price of \$20.00 per preferred share, for an aggregate purchase price of \$20 million in accordance with the terms of the substantial issuer bid.

On July 29, 2009, ACE announced that its participation in the Air Canada credit facility of \$600 million, amounted to \$150 million. ACE's \$150 million loan participation is repayable in equal consecutive quarterly installments of \$7.5 million starting August 1, 2010, with a final payment of \$30 million due by the fifth anniversary of the initial drawdown. Under the Credit Facility, ACE received 1,250,000 warrants on July 30, 2009 for the purchase of Air Canada's Class B Voting Shares with an exercise price of \$1.51 per share, exercisable at any time, and expiring four years after the date of issuance. An additional 1,250,000 million warrants were issued to ACE under the credit facility on October 19, 2009 and have an exercise price of \$1.44 per share, exercisable at any time, and expiring four years after the date of issuance.

On September 21, 2009, ACE announced it had entered into an agreement with Morgan Stanley Canada Limited pursuant to which ACE indirectly acquired for cancellation all of its remaining 3.2 million preferred shares at a price of \$23.00 per preferred share for an aggregate purchase price of \$74 million.

On October 27, 2009, Air Canada completed an offering of 160,500,000 units with each unit comprised of one share and one-half of a warrant. On October 26, 2009, Air Canada issued 17.6 million shares under the pension funding agreements, announced in July 2009. As a result of these share issuances by Air Canada, ACE's ownership in Air Canada was reduced from 75% to 27%. As at January 31, 2010, there were 90.25 million warrants outstanding to acquire Air Canada shares at exercise prices between \$1.44 and \$2.20.

Effective October 27, 2009, ACE no longer consolidates Air Canada's financial position, operating results and cash flows. ACE's investment in Air Canada has since been accounted for using the equity method whereby the Air Canada investment carrying value is adjusted to include the Corporation's pro rata share of post-dilution earnings and other comprehensive income.

On December 14, 2009, ACE paid an aggregate purchase price of \$64 million for the redemption of its remaining convertible senior notes.

On January 6, 2010, ACE announced that it had accepted for purchase and cancellation a total of 1,401,094 Class A Variable Voting Shares and 1,824,711 Class B Voting Shares at \$6.20 per share for an aggregate purchase price of \$20 million in accordance with the terms of the substantial issuer bid.

## 5. Investments

As at December 31, 2009, ACE's principal investments are:

- a 27.0% (75 million Class B Voting Shares) ownership interest in Air Canada; and
- a secured loan of \$150 million to Air Canada.

ACE also has a 28.4% interest in Aero Technical Support & Services Holdings sarl ("ACTS Aero"), which owns 100% of Aveos Fleet Performance Inc. ("Aveos"). As at December 31, 2009, the carrying value of ACE's investment in ACTS Aero is nil.

These investments are more fully described below. During 2008, ACE completed the sales of its remaining investments in Aeroplan and Jazz.

### Air Canada

#### Overview

Air Canada includes the passenger and cargo transportation services business operated by Air Canada and related ancillary services.

These services are provided through Air Canada, Air Canada Cargo Limited Partnership ("Air Canada Cargo") up to and including November 30, 2009, ACGHS Limited Partnership ("Air Canada Ground Handling Services" or "ACGHS") up to and including November 30, 2009 and Touram Limited Partnership ("Air Canada Vacations").

Effective December 1, 2009, the operations of Air Canada Cargo and Air Canada Ground Handling Services, previously operated by wholly-owned subsidiaries of Air Canada, were wound up into Air Canada and are now operated as divisions of Air Canada. These wind-ups had no impact on the consolidated financial statements.

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 as well as the international markets to and from Canada. Certain of the scheduled passenger services offered on domestic and Canada-US transborder routes are provided by Jazz Air LP through a capacity purchase agreement between Air Canada and Jazz. Through Air Canada's global route network, virtually every major market throughout the world is served either directly or through the Star Alliance network. In addition, Air Canada provides certain passenger charter services.

Air Canada offers air cargo services on domestic and US transborder routes using cargo capacity on aircraft operated by Air Canada and Jazz. (Prior to December 1, 2009, these services were provided by Air Canada Cargo). Air Canada offers international cargo services on routes between Canada and major markets in Europe, Asia, South America and Australia using cargo capacity on Boeing 777 and other wide body aircraft operated by Air Canada.

Up until December 1, 2009, Air Canada Ground Handling Services provided passenger handling services to Air Canada, Jazz and other airlines with a primary focus on Canadian stations. Services covered included passenger check-in, gate management, baggage and cargo handling and processing, cabin cleaning, de-icing as well as aircraft ramp services. Effective December 1, 2009 with the wind-up of ACGHS into Air Canada, Air Canada offers these services directly.

Air Canada Vacations is one of Canada's leading tour operators. Based in Montreal and Toronto, it operates its business in the outgoing leisure travel market (Caribbean, Mexico, USA, Europe, South America and Asia) by developing, marketing and distributing vacation travel packages and services through a network of independent travel agencies in Canada as well as through the Air Canada Vacations website, [aircanadavacations.com](http://aircanadavacations.com).

Summary of significant events

During 2009, Air Canada entered into the following significant transactions in an effort to mitigate liquidity risks:

- Completed a share and warrant public offering for net proceeds of \$249 million.
- Completed a secured term credit facility (the "Credit Facility") for financing proceeds of \$600 million, less fees of \$20 million. The Credit Facility is a five-year facility, with the first principal repayment due in August 2010, and currently bears interest at 12.75%. Under the Credit Facility, 10 million warrants were also issued which entitle the debt holders to acquire up to 10 million shares in Air Canada. ACE provided financing of \$150 million with respect to the Credit Facility, as further described below.
- Pension funding agreements with all of Air Canada's Canadian-based unions (the "Pension MOUs") and the adoption of the Air Canada Pension Funding Regulations, 2009 (the "Air Canada 2009 Pension Regulations"). The Air Canada 2009 Pension Regulations relieve Air Canada from making any special (past service cost) payments for the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contributions shall equal the lesser of (i) \$150 million, \$175 million, and \$225 million in respect of 2011, 2012, and 2013, respectively and (ii) the maximum past service contributions permitted under the Income Tax Act. Pursuant to the Pension MOUs, on October 26, 2009 Air Canada issued, to a trust, 17,647,059 Class B Voting Shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of the sale of such shares held by the trust are to be contributed to the pension plans.
- Total cash flows to Air Canada during the full year 2009 from borrowing, including the Credit Facility described above, amounted to \$926 million, proceeds from sale of assets amounted to \$103 million, proceeds from sale-leaseback transactions amounted to \$552 million and proceeds from contractual commitments amounted to \$230 million. Reductions of long-term debt during 2009, which include repayments as a result of certain of the above financings and sale-leasebacks, amounted to \$1,237 million.

At December 31, 2009, Air Canada had Cash and cash equivalents and Short-term investments of \$1,407 million (\$1,005 million as at December 31, 2008).

Guarantee of Air Canada obligation

On May 7, 2009, ACE intervened into the employment agreement between Air Canada and Mr. Calin Rovinescu, its President and Chief Executive Officer, to guarantee the payments required of Air Canada under the agreement.

In addition, ACE agreed to cause to be issued an irrevocable bank letter of credit to a maximum of \$5 million. At December 31, 2009, as agreed by the parties, the letter of credit had not been issued.

Loan receivable from Air Canada

On July 29, 2009, ACE participated in the \$600 million Air Canada Credit Facility with several other lenders providing financing of \$150 million which represented 25% of the Credit Facility.

Under the Credit Facility, ACE received 1,250,000 warrants on July 30, 2009 for the purchase of Air Canada Class B Voting Shares with an exercise price of \$1.51 per share, exercisable at any time, and expiring four years after the date of issuance. On October 19, 2009, ACE received an additional 1,250,000 warrants with an exercise price of \$1.44 per share, exercisable at any time, and expiring four years after the date of issuance.

The terms of the Credit Facility permit, on or before the first anniversary of the Air Canada Credit Facility and subject to satisfaction of certain conditions, Air Canada to request an increase to the facility by up to an

additional \$100 million by obtaining new commitments from either the existing or new lenders. ACE's pro-rata share of the Credit Facility is repayable in 16 consecutive quarterly installments commencing in August 2010 of \$7.5 million with the final installment of \$30 million due in July 2014.

The Credit Facility bears interest at a rate based upon the greater of the bankers' acceptance rate or 3.00% plus 9.75% (12.75% as at December 31, 2009). The Credit Facility can be repaid at any time, in whole or in part, with the payments of applicable fees, subject to a minimum repayment of \$10 million.

Air Canada's obligations under the Credit Facility are secured by a first priority security interest and hypothec over substantially all the present and after-acquired property of Air Canada and its subsidiaries, subject to certain exclusions and permitted liens. The Credit Facility contains customary representations and warranties and is subject to customary terms and conditions (including negative covenants, financial covenants and events of default). Financial covenants require Air Canada to maintain, as of the last business day of each month, a minimum liquidity level (as defined per the Credit Facility and generally based upon the balances as reported in Cash and cash equivalents and Short-term investments) of \$800 million and a minimum EBITDAR (earnings before interest, income taxes, depreciation, amortization, aircraft rentals, certain non-operating income (expense) and special items) and an interest coverage ratio test determined as at the end of each fiscal quarter.

A requirement of the Credit Facility is that Air Canada maintain securities of \$800 million in accounts subject to securities control agreements. The securities in such accounts would become restricted if Air Canada defaults on certain terms of the agreement.

#### *Dilution of ACE's investment in Air Canada*

##### *Air Canada Pension MOUs*

As described above, Air Canada entered into the Pension MOUs providing for Air Canada to issue 17,647,059 Class B Voting Shares representing a fully diluted 15% equity ownership of Air Canada, established as of the date of the Pension MOUs, to a trust (the "Trust") with all net proceeds of the eventual sale of the shares held by the trust to be contributed to the pension plans. As a result, on October 26, 2009, Air Canada issued 17,647,059 Class B Voting Shares to the Trust.

##### *Air Canada Share and Warrant Offering*

As described above, on October 27, 2009 Air Canada completed a previously announced bought deal public offering pursuant to which it sold to an underwriting syndicate 160,500,000 units (the "Units") of Air Canada at a price of \$1.62 per Unit for aggregate gross proceeds to Air Canada of \$260 million (net proceeds of \$249 million after expenses and underwriter fees).

Each Unit was comprised of one Class A variable voting share (the "Variable Voting Shares") or one Class B voting share (the "Voting Shares", and, together with the Variable Voting Shares, the "Shares") of Air Canada, and one-half of one share purchase warrant. Each whole share purchase warrant is defined as a "Warrant". Each Warrant will entitle the holder thereof to acquire one Variable Voting Share or one Voting Share (each, a "Warrant Share") at an exercise price of \$2.20 per Warrant Share, at any time prior to 36 months following October 27, 2009. In the event that, prior to the time of expiry of the Warrants, the 20-day volume weighted average trading price of the Variable Voting Shares on the TSX is equal to or greater than \$4.00 or the 20-day volume weighted average trading price of the Voting Shares on the TSX is equal to or greater than \$4.00 (each, an "Acceleration Event"), Air Canada shall have the right, at its option, within 10 business days after the Acceleration Event, to accelerate the time of expiry of the Warrants.

##### *Air Canada dilution and resulting loss of control*

As a result of the share issuances by Air Canada completed on October 26, 2009 and October 27, 2009, ACE's ownership interest in Air Canada was reduced from 75% to 27% such that ACE ceased to control Air Canada. As a result, ACE recorded a dilution loss of \$411 million.

As of October 27, 2009, ACE no longer consolidates Air Canada's financial position, operating results and cash flows. ACE's investment in Air Canada has since been accounted for using the equity method whereby the Air Canada investment carrying value is adjusted to include the Corporation's pro rata share of post-dilution earnings and other comprehensive income. An equity loss of \$7 million was recorded representing ACE's pro rata share of post-dilution earnings through to December 31, 2009. The proportionate share of Air Canada other comprehensive income of \$15 million was recorded representing ACE's pro rata share of post-dilution other comprehensive income through to December 31, 2009.

Carrying value of ACE's investment in Air Canada

In December 2009, ACE recorded a Provision for loss on Air Canada investment of \$219 million as a result of adjusting the carrying value due to an other than temporary decline in the value of the Corporation's investment in Air Canada to \$99 million based on Air Canada's closing market price as at December 31, 2009 (\$1.32 per Class B share) as quoted on the TSX.

Air Canada carrying value prior to the following:	\$ 721
Air Canada dilution loss	(411)
Air Canada carrying value as at October 27, 2009 subsequent to the dilution loss	310
Proportionate share of loss, subsequent to October 27, 2009	(7)
Proportionate share of other comprehensive income, subsequent to October 27, 2009	15
Provision for loss on Air Canada investment	(219)
<b>Air Canada carrying value as at December 31, 2009</b>	<b>\$ 99</b>
Air Canada total assets as at December 31, 2009	\$ 10,406
Air Canada total liabilities as at December 31, 2009	\$ 8,759
Air Canada loss for the year ended December 31, 2009	\$ (24)

The loss on ACE's investment in Air Canada of \$630, included in the consolidated statement of operations, is comprised of the Air Canada dilution loss of \$411 and the Provision for loss on Air Canada investment of \$219.

**ACTS Aero**

ACTS LP was a full service aircraft maintenance, repair and overhaul organization competing on a global basis.

ACTS was consolidated up to October 16, 2007. Post-monetization described below, ACE's investment in ACTS Aero is accounted for using the equity method.

Monetization

On October 16, 2007, ACTS LP sold substantially all its assets, liabilities and business to ACTS Aero, a new entity established to purchase the assets of ACTS LP. ACTS Aero owns 100% of Aveos (Aveos Fleet Performance Inc.) which changed its legal name on September 23, 2008 from its previous name of ACTS Aero Technical Support and Services Inc. As a result of the monetization of ACTS, the \$200 million intercompany note payable by ACTS to ACE was settled through the issue of additional partnership units of ACTS LP to ACE. After settlement of certain obligations ACE received cash proceeds of \$723 million. Subsequent to December 31, 2007, ACE received an additional \$40 million in cash proceeds from funds held in escrow that was conditional upon the completion of certain supplier contracts within specified terms. In addition, on closing Air Canada received cash proceeds of \$65 million, comprised of \$28 million for the sale of a building, \$20 million pursuant to the Repair Schemes and Non-compete agreement, and \$17 million as repayment of a note.

ACE realized a gain of \$565 million on the monetization in 2007, which includes the funds held in escrow received subsequent to closing. ACE continues to own 100% of ACTS LP, which is now a non-operating



company, and ACTS Aero conducts the business previously operated by ACTS LP. Following the redemption of the exchangeable share issued to a party related to Grupo TACA as discussed below and the establishment of an initial ACTS Long Term Incentive Plan ("LTIP"), ACE held a 23% (28.4% as at December 31, 2009) equity interest in ACTS Aero. The consolidated statement of financial position does not include the financial position or results of operations of ACTS Aero, as ACTS Aero is equity accounted for subsequent to the monetization. As at October 16, 2007, ACE's net investment in ACTS Aero was \$76 million.

The Corporation has various related party transactions after removing ACTS from the consolidation of ACE.

These transactions are recorded at the exchange amount. Refer to section 13 Related Party Transactions for a description of the transactions between the Corporation and ACTS Aero.

#### Acquisition of Aeroman

On February 13, 2007, ACTS LP, through a wholly-owned subsidiary, acquired 80% of Aeromantenimiento, S.A. ("Aeroman"), the aircraft maintenance division of Grupo TACA Holdings Limited ("Grupo TACA") of El Salvador. Total consideration for this acquisition included cash as well as a right to acquire an equity stake in ACTS LP. The cash component of US\$45 million consisted of cash of \$50 million (US\$43 million) on closing and milestone payments of up to \$2 million (US\$2 million) in the aggregate, funded by ACTS LP through ACE's available cash resources.

As part of the monetization process, an entity related to Grupo TACA exchanged its exchangeable share and received \$31 million cash, a 5% equity stake in ACTS and a put option that allowed it to put its 5% equity interest back to ACE for US\$18 million within 12 months. During 2008, the entity related to Grupo TACA exercised its put option and sold its 5% equity interest to ACE for \$19 million (US\$18 million) increasing ACE's ownership interest in ACTS Aero from 22.8% to 27.8%. The liability related to this redemption obligation, initially recorded, was settled as part of the transaction.

#### Loss on ACTS Aero investment

In December 2008, the Corporation recorded a loss of \$10 million related to its equity investment in ACTS Aero. As at December 31, 2009, the carrying value of the Corporation's investment in ACTS Aero is nil (nil as at December 31, 2008).

On January 22, 2010, ACE entered into a Restructuring and Lockup Agreement with Aveos, ACTS Aero, lenders and other shareholders. Under the terms of the restructuring, which is planned to be completed in Quarter 1, 2010, ACE has agreed on closing to transfer its shares in ACTS Aero to a newly formed company, in which ACE will have no interest, for nil consideration.

## **Aeroplan**

### Overview

Aeroplan provides its commercial partners, including Air Canada, with loyalty marketing services designed to stimulate demand for such partners' products and services.

ACE had an indirect ownership interest in Aeroplan Limited Partnership through its holdings in Aeroplan Income Fund ("AIF"). Aeroplan was consolidated until March 14, 2007, the date the Corporation made a special distribution of Aeroplan Income Fund units to the Corporation's shareholders. From March 14, 2007 to May 9, 2008, ACE's investment in Aeroplan was accounted for using the equity method. From May 10, 2008 to June 2, 2008, ACE's investment in Aeroplan was accounted for as an available-for-sale security. The classification of the investment in Aeroplan as available-for-sale resulted in the investment being carried at fair value. The adjustment to fair value recorded to OCI was \$331 million, net of income taxes of \$72 million.

Summary of sales of units in 2008

On April 21, 2008, ACE sold a total of 20.4 million units of AIF at a price of \$17.50 per unit representing total net proceeds to ACE of \$343 million and realized a gain on sale of \$413 million (\$340 million after tax).

On June 2, 2008, ACE sold its remaining units of AIF for total net proceeds to ACE of \$349 million, and realized a gain on sale of \$417 million (\$344 million after tax). Net realized gains of \$331 million, net of tax of \$72 million, were taken into income from OCI.

Since June 2, 2008, subsequent to the sale of all remaining AIF units, ACE has no ownership interest in Aeroplan.

**Jazz**Overview

Jazz is the largest regional airline and second largest airline in Canada, after Air Canada, based on fleet size and number of routes operated. Jazz provides service to Air Canada's customers in lower density markets and in higher density markets at off-peak times throughout Canada and to certain destinations in the United States under a capacity purchase agreement between Air Canada and Jazz.

ACE had an indirect ownership interest in Jazz Air LP through its holdings in Jazz Air Income Fund ("JAIF"). Jazz was consolidated to May 24, 2007, the date the Corporation made a special distribution of Jazz Air Income Fund units to the Corporation's shareholders. From that date to January 24, 2008, ACE's investment in Jazz was accounted for using the equity method. Subsequent to the sale on January 24, 2008 to February 7, 2008, ACE's investment in Jazz was classified as an available-for-sale investment. The classification of the investment in Jazz as available-for-sale resulted in the investment being carried at fair value. The adjustment to fair value recorded to OCI was \$71 million, net of income taxes of (\$15) million.

Summary of sales of units in 2008

On January 24, 2008, ACE sold a total of 13 million units of JAIF at a price of \$7.45 per unit representing total net proceeds to ACE of \$97 million and realized a gain on sale of \$89 million (\$71 million net of taxes).

On June 2, 2008, ACE sold its remaining units of JAIF for total net proceeds to ACE of \$85 million, and realized a gain on sale of \$78 million (\$62 million net of taxes). Net realized gains of \$65 million, net of tax of \$14 million, were taken into income from OCI.

Since June 2, 2008, subsequent to the completion of the sale of JAIF units, ACE has no ownership interest in Jazz.

**Disposition of Aviation Interests**

The table below details the Loss on ACE's investment in Air Canada, Gain on sale of Aeroplan and Jazz units, and Gain (loss) on other assets realized in 2009, 2008, and 2007 as a result of disposition by way of sales of various aviation interests and impairment of investments and assets were as follows:

(Canadian dollars in millions)	2009 <sup>(1)</sup>	2008	2007
Air Canada dilution loss	\$ (411)	\$ -	\$ -
Provision for loss on Air Canada investment	(219)	-	-
<b>Loss on ACE's investment in Air Canada</b>	<b>\$ (630)</b>	<b>\$ -</b>	<b>\$ -</b>
Sale of Aeroplan Income Fund units	\$ -	\$ 830	\$ 539
Sale of Jazz Air Income Fund units	-	167	233
<b>Gain on sale of Aeroplan and Jazz units</b>	<b>\$ -</b>	<b>\$ 997</b>	<b>\$ 772</b>
<b>Gain on ACTS monetization</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 565</b>
US Airways	\$ -	\$ -	\$ 8
POLARIS impairment provision	(68)	-	-
Boeing 767 impairment provision	-	(38)	-
Provision for loss on ACTS Aero investment	-	(10)	-
Other	(2)	(3)	21
<b>Gain (loss) on other assets</b>	<b>\$ (70)</b>	<b>\$ (51)</b>	<b>\$ 29</b>
	<b>\$ (700)</b>	<b>\$ 946</b>	<b>\$ 1,366</b>

(1) Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE. Refer to Section 5 "Investments" in this MD&A.

## 6. Accounting Policies

This MD&A should be read in conjunction with ACE's audited consolidated financial statements and notes for 2009. ACE prepares its financial statements, on a going concern basis of presentation, in accordance with Canadian Generally Accepted Accounting Principles ("GAAP").

ACE's results reflect the consolidation of Air Canada only up to October 27, 2009. After that ACE's investment in Air Canada is accounted for using the equity method. Consequently, ACE's results of operations for 2009 are not directly comparable to its operating results for 2008.

Significant accounting policies and methods used in preparation of ACE's 2009 audited financial statements are described in Note 2 to ACE's 2009 audited consolidated financial statements.

The preparation of ACE's 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 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. Refer to section 14 of this MD&A for a discussion of ACE's critical accounting estimates.

### 6.1 Future Accounting Standard Changes

#### *Business combinations, consolidated financial statements and non-controlling interests*

The CICA issued three new accounting standards in January 2009: section 1582, *Business Combinations*, section 1601, *Consolidated Financial Statements*, and section 1602, *Non-controlling Interests*. These new standards will be effective for fiscal years beginning on or after January 1, 2011. The Corporation is in the process of evaluating the requirements of the new standards.

Section 1582 replaces section 1581, and establishes standards for the accounting for a business combination. It provides the Canadian equivalent to International Financial Reporting Standard IFRS 3 – *Business Combinations*. The section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011.

Sections 1601 and 1602 together replace section 1600 – *Consolidated Financial Statements*. Section 1601, establishes standards for the preparation of consolidated financial statements. Section 1601 applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of International Financial Reporting Standard IAS 27 - *Consolidated and Separate Financial Statements* and applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011.

## **6.2 International Financial Reporting Standards**

The Canadian Accounting Standards Board has 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 developed a plan to convert its consolidated financial statements to IFRS. The plan addresses the impact of IFRS on the Corporation and is progressing as planned.

ACE's Consolidated statement of financial position now reflects the following significant assets as at December 31, 2009:

- Cash and cash equivalents;
- a 27.0% (75 million Class B Voting Shares) ownership interest in Air Canada and
- a secured loan of \$150 million to Air Canada.

Although the review has not been finalized, the Corporation does not expect to identify differences between its current accounting policies and those required or expected to apply in preparing IFRS financial statements. The Corporation will continue to monitor any developments with respect to any new standards.

**7. Results of Operations – Quarter 4 2009**

The under-noted reconciliation provides supplementary information to separate CIE from Air Canada results included in the consolidated financial statements for Quarter 4 2009.

(Canadian dollars in millions)	Quarter 4 2009		
	Air Canada <sup>(1)</sup>	CIE	ACE Total
<b>Operating revenue</b>			
Passenger revenue	\$ 727	\$ -	\$ 727
Cargo revenue	34	-	34
Other revenue	54	-	54
	815	-	815
<b>Operating expenses</b>			
Aircraft fuel	209	-	209
Wages, salaries and benefits	135	-	135
Airport and navigation fees	79	-	79
Capacity purchase with Jazz	79	-	79
Depreciation and amortization	55	-	55
Aircraft maintenance	68	-	68
Food, beverages and supplies	26	-	26
Communications and information technology	26	-	26
Aircraft rent	26	-	26
Commissions	16	-	16
Other operating expenses	100	1	101
	819	1	820
<b>Operating loss</b>	<b>(4)</b>	<b>(1)</b>	<b>(5)</b>
<b>Non-operating income (expense)</b>			
Interest income	-	3	3
Interest expense	(29)	-	(29)
Interest capitalized	-	-	-
Loss on ACE's investment in Air Canada	-	(630)	(630)
Loss on repurchase of ACE convertible senior notes	-	(1)	(1)
Gain on financial instruments recorded at fair value	21	-	21
Equity and other investment loss	-	(7)	(7)
	(8)	(635)	(643)
<b>Loss before the following items</b>	<b>(12)</b>	<b>(636)</b>	<b>(648)</b>
Non-controlling interest	(1)	8	7
Foreign exchange loss	(18)	-	(18)
Recovery of income taxes	-	3	3
<b>Loss for the period</b>	<b>\$ (31)</b>	<b>\$ (625)</b>	<b>\$ (656)</b>

(1) Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE. Refer to Section 5 "Investments" in this MD&A.

The under-noted reconciliation provides supplementary information to separate CIE from Air Canada results included in the consolidated financial statements for Quarter 4 2008.

(Canadian dollars in millions)	Quarter 4 2008		
	Air Canada	CIE	ACE Total
<b>Operating revenue</b>			
Passenger revenue	\$ 2,182	\$ -	\$ 2,182
Cargo revenue	113	-	113
Other revenue	203	(2)	201
	2,498	(2)	2,496
<b>Operating expenses</b>			
Aircraft fuel	792	-	792
Wages, salaries and benefits	444	2	446
Airport and navigation fees	230	-	230
Capacity purchase with Jazz	237	-	237
Depreciation and amortization	174	(2)	172
Aircraft maintenance	157	-	157
Food, beverages and supplies	70	-	70
Communications and information technology	72	-	72
Aircraft rent	80	-	80
Commissions	40	-	40
Other operating expenses	348	2	350
	2,644	2	2,646
<b>Operating loss</b>	<b>(146)</b>	<b>(4)</b>	<b>(150)</b>
<b>Non-operating income (expense)</b>			
Interest income	11	6	17
Interest expense	(88)	(15)	(103)
Interest capitalized	6	-	6
Loss on other assets	(5)	(10)	(15)
Gain on financial instruments recorded at fair value	32	-	32
Equity and other investment loss	-	(62)	(62)
	(44)	(81)	(125)
<b>Loss before the following items</b>	<b>(190)</b>	<b>(85)</b>	<b>(275)</b>
Non-controlling interest	(4)	180	176
Foreign exchange loss	(527)	-	(527)
Provision for income taxes	(6)	(1)	(7)
<b>Net income (loss) for the period</b>	<b>\$ (727)</b>	<b>\$ 94</b>	<b>\$ (633)</b>

**ACE's results from operations include the consolidation of Air Canada's operations up to October 27, 2009 within the Air Canada column. After that date, Air Canada is accounted for using the equity method. Consequently, ACE's results of operations for Quarter 4 2009 are not directly comparable to its operating results for Quarter 4 2008.**

ACE recorded operating loss of \$5 million in Quarter 4 2009 compared to the operating loss of \$150 million in Quarter 4 2008. ACE's consolidated results for Quarter 4 2008 included an operating loss from Air Canada of \$146 million.

ACE recorded operating revenues of \$815 million and operating expenses of \$820 million in Quarter 4 2009. In the same period in 2008, ACE recorded operating revenues of \$2,496 million and operating expenses of \$2,646 million. As a result of the deconsolidation of Air Canada, ACE's Quarter 4 2009 operating revenues and expenses are not directly comparable to Quarter 4 2008.

Non-operating expense amounted to \$643 million in Quarter 4 2009 compared to non-operating expense of \$125 million in Quarter 4 2008. Included in Quarter 4 2009 non-operating expense was a loss on ACE's investment in Air Canada of \$630 million which is comprised of the Air Canada dilution loss of \$411 million and the Provision for loss on Air Canada investment of \$219 million. In Quarter 4 2008, a provision for loss on the investment in ACTS Aero was recorded in the amount of \$10 million. Quarter 4 2009 also included an equity loss of \$7 million related to the investment in Air Canada, subsequent to October 27, 2009, compared to an equity loss of \$62 million in Quarter 4 2008, related to the investment in ACTS Aero.

In Quarter 4 2009, \$7 million of the net loss was allocated to non-controlling interest compared to \$176 million of the net loss being allocated to non-controlling interest in Quarter 4 2008.

Losses on foreign exchange amounted to \$18 million in Quarter 4 of 2009 compared to losses of \$527 million in Quarter 4 2008.

The loss in Quarter 4 2009 amounted to \$656 million or \$(18.38) per diluted share. In Quarter 4 2008, ACE recorded a loss of \$633 million or \$(18.12) per diluted share.

## **7.1 Air Canada**

The following discussion is based upon Air Canada's Quarter 4 2009 published results.

Air Canada recorded a net loss of \$56 million or \$(0.25) per diluted share in the fourth quarter of 2009 compared to a net loss of \$727 million or \$(7.27) per diluted share in the fourth quarter of 2008. The net loss recorded in the fourth quarter of 2009 included foreign exchange gains of \$108 million. The foreign exchange gains were primarily attributable to a stronger Canadian dollar at December 31, 2009 versus September 30, 2009. The December 31, 2009 noon day exchange rate was US\$1 = C\$1.0466 while the September 30, 2009 noon day exchange rate was US \$1 = C\$1.0722. The fourth quarter 2008 included a foreign exchange loss of \$527 million.

In the fourth quarter of 2009, operating revenues of \$2,348 million decreased \$150 million or 6% from the operating revenues of \$2,498 million recorded in the fourth quarter of 2008. The decrease in operating revenues was mainly due to a passenger revenue decline of \$152 million or 7% over the same period in 2008. The passenger revenue decline was due to reduced yields. Yield declined 7.3% from the fourth quarter of 2008. Traffic increased 0.4% on a capacity increase of 2.0%, resulting in a passenger load factor decline of 1.3 percentage point. RASM decreased 8.8% over the same period in 2008, which was due to both the yield decline and the decrease in the passenger load factor.

In the fourth quarter of 2009, operating expenses of \$2,431 million decreased \$213 million or 8% from the operating expenses of \$2,644 million recorded the fourth quarter of 2008. Reduced fuel expense of \$191 million versus the same period in 2008 was the main factor in the decrease in operating expenses.

In the fourth quarter of 2009, CASM decreased 9.8% from the fourth quarter of 2008. Excluding fuel expense, CASM decreased 3.2% mainly due to the favourable impact of a stronger Canadian dollar versus the U.S. dollar,



and lower wages, salaries, and benefits expense. Partly offsetting these decreases to CASM (excluding fuel expense) was a year-over-year increase in aircraft maintenance expense.

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

CIE includes the corporate, financing and investing activities of ACE. As previously discussed, ACE's investment in Air Canada was changed during Quarter 4 2009 from consolidation to the equity method of accounting reported under the CIE column.

CIE recorded a non-operating expense of \$635 million in Quarter 4 2009 compared to a non-operating expense of \$81 million in Quarter 4 2008.

Factors contributing to the year-over-year change in Quarter 4 2009 included:

- In Quarter 4 2009, ACE recorded a dilution loss of \$411 million as a result of the shares issued by Air Canada which reduced ACE's ownership interest in Air Canada from 75% to 27%. In December 2009 ACE also recorded a Provision for loss on Air Canada investment of \$219 as a result of adjusting the carrying value due to an other than temporary decline in the value of the Corporation's investment in Air Canada to \$99 million based on Air Canada's closing market price as at December 31, 2009, (\$1.32 per Class B share) as quoted on the TSX.
- In Quarter 4 2008, ACE recorded a provision for loss on disposal of \$10 million related to its equity investment in ACTS Aero. As at December 31, 2008, and December 31, 2009, ACE's investment in ACTS Aero has a carrying value of nil.
- A reduction in interest expense of \$15 million as a result of the purchase for cancellation in January, 2009, of 80% of ACE's convertible senior notes outstanding as at December 31, 2008, the purchase of ACE's convertible preferred shares and the redemption of the remaining convertible senior notes in December 2009.
- ACE's consolidated statement of operations for Quarter 4 2009 reflected \$7 million of equity loss from ACE's investment in Air Canada versus Quarter 4 2008 \$62 million of equity loss from ACE's investment in ACTS Aero.

In Quarter 4 2009, \$8 million of the net loss was allocated to non-controlling interest compared to \$180 million of the net loss being allocated to non-controlling interest in Quarter 4 2008. This change is mainly attributed to the change to the equity method of accounting for ACE's investment in Air Canada.

**8. Results of Operations – 2009**

The under-noted reconciliation provides supplementary information to separate CIE from Air Canada results included in the consolidated financial statements for the year ended December 31, 2009.

(Canadian dollars in millions)	2009		
	Air Canada <sup>(1)</sup>	CIE	ACE Total
<b>Operating revenue</b>			
Passenger revenue	\$ 7,196	\$ -	\$ 7,196
Cargo revenue	282	-	282
Other revenue	728	-	728
External revenue	8,206	-	8,206
Inter-segment revenue	1	(1)	-
	8,207	(1)	8,206
<b>Operating expenses</b>			
Aircraft fuel	2,056	-	2,056
Wages, salaries and benefits	1,468	4	1,472
Airport and navigation fees	822	-	822
Capacity purchase with Jazz	825	-	825
Depreciation and amortization	550	(5)	545
Aircraft maintenance	625	-	625
Food, beverages and supplies	248	-	248
Communications and information technology	255	-	255
Aircraft rent	276	-	276
Commissions	156	-	156
Other operating expenses	1,162	8	1,170
	8,443	7	8,450
<b>Operating loss</b>	<b>(236)</b>	<b>(8)</b>	<b>(244)</b>
<b>Non-operating income (expense)</b>			
Interest income	12	5	17
Interest expense	(316)	(5)	(321)
Interest capitalized	4	-	4
Loss on ACE's investment in Air Canada	-	(630)	(630)
Loss on other assets	(70)	-	(70)
Loss on repurchase of ACE convertible senior notes and preferred shares	-	(44)	(44)
Gain on financial instruments recorded at fair value	94	-	94
Equity and other investment loss	-	(7)	(7)
Other	(5)	-	(5)
	(281)	(681)	(962)
<b>Loss before the following items</b>	<b>(517)</b>	<b>(689)</b>	<b>(1,206)</b>
Non-controlling interest	(12)	(1)	(13)
Foreign exchange gain	531	-	531
Provision for income taxes	(1)	(3)	(4)
<b>Net income (loss) for the year</b>	<b>\$ 1</b>	<b>\$ (693)</b>	<b>\$ (692)</b>

(1) Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE. Refer to Section 5 "Investments" in this MD&A.

The under-noted reconciliation provides supplementary information to separate CIE from Air Canada results included in the consolidated financial statements for the year ended December 31, 2008

(Canadian dollars in millions)	2008		
	Air Canada	CIE	ACE Total
<b>Operating revenue</b>			
Passenger revenue	\$ 9,713	\$ -	\$ 9,713
Cargo revenue	515	-	515
Other revenue	851	1	852
External revenue	11,079	1	11,080
Inter-segment revenue	3	(3)	-
	11,082	(2)	11,080
<b>Operating expenses</b>			
Aircraft fuel	3,419	-	3,419
Wages, salaries and benefits	1,877	31	1,908
Airport and navigation fees	1,001	-	1,001
Capacity purchase with Jazz	948	-	948
Depreciation and amortization	694	(8)	686
Aircraft maintenance	659	-	659
Food, beverages and supplies	314	-	314
Communications and information technology	286	-	286
Aircraft rent	279	-	279
Commissions	194	-	194
Other operating expenses	1,450	10	1,460
	11,121	33	11,154
<b>Operating income (loss) before under-noted item</b>	<b>(39)</b>	<b>(35)</b>	<b>(74)</b>
Provision for cargo investigations	(125)	-	(125)
<b>Operating loss</b>	<b>(164)</b>	<b>(35)</b>	<b>(199)</b>
<b>Non-operating income (expense)</b>			
Interest income	57	27	84
Interest expense	(319)	(54)	(373)
Interest capitalized	37	-	37
Gain on sale of Aeroplan and Jazz units	-	997	997
Loss on other assets	(34)	(17)	(51)
Gain on financial instruments recorded at fair value	92	-	92
Equity and other investment loss	-	(64)	(64)
Other	(3)	1	(2)
	(170)	890	720
<b>Income (loss) before the following items</b>	<b>(334)</b>	<b>855</b>	<b>521</b>
Non-controlling interest	(12)	250	238
Foreign exchange loss	(655)	-	(655)
Provision for income taxes	(24)	(200)	(224)
<b>Net income (loss) for the year</b>	<b>\$ (1,025)</b>	<b>\$ 905</b>	<b>\$ (120)</b>

**ACE's results from operations include the consolidation of Air Canada's operations up to October 27, 2009 within the Air Canada column. After that date, Air Canada is accounted for using the equity method. Consequently, ACE's results of operations for 2009 are not directly comparable to its operating results for 2008.**

ACE recorded an operating loss of \$244 million in 2009 compared to the operating loss of \$74 million, before the provision for cargo investigations, in 2008. In 2008, Air Canada recorded a provision for cargo investigations of \$125 million relating to alleged anti-competitive cargo pricing activities.

ACE recorded operating revenues of \$8,206 million and operating expenses of \$8,450 million in 2009. In the same period in 2008, ACE recorded operating revenues of \$11,080 million and operating expenses of \$11,154 million. As a result of the deconsolidation of Air Canada, ACE's 2009 operating revenues and operating expenses are not directly comparable to 2008.

Non-operating expense amounted to \$962 million in 2009 compared to non-operating income of \$720 million in 2008. In 2009, ACE recorded a loss on its investment in Air Canada in the amount of \$630 million. ACE recorded a loss on repurchase of the convertible senior notes and preferred shares within Non-operating expense in the amount of \$44 million. The repurchase prices of these investments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$44 million being recorded. The residual equity components of the instruments amounting to \$199 million have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity. Refer to section 9.5 of this MD&A for additional information. Included in 2008 were gains totalling \$997 million on ACE's sale of Aeroplan Income Fund units and Jazz Air Income Fund units.

In 2009, \$13 million of net income was allocated to non-controlling interest compared to \$238 million of the net loss being allocated to non-controlling interest in 2008.

Gains on foreign exchange amounted to \$531 million in 2009 compared to losses of \$655 million in 2008.

The net loss in 2009 amounted to \$692 million or \$(19.56) per diluted share. The net loss in 2008 amounted to \$120 million or \$(2.59) per diluted share. The net income in 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 and foreign exchange losses of \$655 million recorded by Air Canada. The net loss in 2009 included the loss on ACE's investment in Air Canada of \$630 million, partly offset the benefit of foreign exchange gains of \$531 million.

## **8.1 Air Canada**

The following discussion is based upon Air Canada's 2009 published results.

Air Canada recorded a loss of \$24 million or \$(0.18) per diluted share in 2009 compared to a loss of \$1,025 million or \$(10.25) per diluted share in 2008.

The net income recorded in 2009 included foreign exchange gains of \$657 million compared to foreign exchange losses of \$655 million in 2008. The gains in 2009 were attributable to a stronger Canadian dollar at December 31, 2009 compared to December 31, 2008. The December 31, 2009 noon day exchange rate was US\$1 = C\$1.0466 while the December 31, 2008 noon day exchange rate was US\$1 = C\$1.2246.

In 2009, operating revenues of \$9,739 million decreased \$1,343 million or 12% from the operating revenues of \$11,082 million recorded in 2008. The decrease in operating revenues was mainly due to a passenger revenue decline of \$1,214 million or 12% over 2008. The passenger revenue decline was due to lower yield and traffic. Yield declined 7.6% from 2008. Traffic decreased 5.2% on a capacity reduction of 4.4%, resulting in a passenger load factor decrease of 0.7 percentage point. RASM decreased 8.4% over 2008, which was mainly due to the yield decline, but also to the decrease in passenger load factor. A weaker Canadian dollar in 2009 versus 2008 had a positive impact on foreign currency denominated passenger revenues of \$184 million.

In 2009, operating expenses of \$10,055 million decreased \$1,066 million or 10% from the operating expenses of \$11,121 million recorded in 2008. Reduced fuel expense of \$971 million versus the same period in 2008 was the main factor in the decrease in operating expenses.

In 2009, CASM decreased 5.4% from 2008. Excluding fuel expense, CASM increased 3.3% from 2008. The unfavourable impact of a weaker Canadian dollar versus the US dollar accounted for approximately 44% of the CASM growth (excluding fuel expense) in 2009. In addition to the impact of foreign exchange, other factors included: growth in aircraft maintenance expense, increased Jazz CPA rates, higher unit cost of ownership and the impact of the capacity reduction which disproportionately impacts CASM as Air Canada's cost structure is such that its fixed costs do not fluctuate proportionately with changes in capacity in the short term.

Air Canada's non-operating expense amounted to \$355 million in 2009 compared to non-operating expense of \$170 million in 2008. Factors contributing to the year-over-year change in non-operating expense included:

- Net interest expense increased \$130 million from 2008 due to:
  - A \$43 million decrease in interest income which was due to both lower rates of interest and lower cash balances;
  - A \$54 million increase in interest expense which was mainly due to the impact of new financing transactions completed in 2009, and the unfavourable impact of foreign exchange on interest expense. These increases were partly offset by the impact of lower average interest rates year-over-year. In addition, in 2009, Air Canada recorded charges amounting to \$25 million related to the sale and leaseback transaction of four Boeing 777 aircraft and a charge of \$9 million related to the termination of the capital leases of two Airbus A340 aircraft and the subsequent sale of these aircraft. These increases were partly offset by a reduction of interest expense on aircraft pre-delivery payments related to Boeing 777 aircraft versus the same period in 2008;
  - A lower amount of capitalized interest of \$33 million compared to 2008.
- In 2009, Air Canada recorded an impairment charge of \$68 million related to previously capitalized costs incurred pertaining to the development of a new reservation system, referred to as Polaris. Air Canada is currently working towards the implementation of certain components of the solution such as web and fare technology but has suspended activity relating to the implementation of the reservation system. In addition, Air Canada recorded a loss on assets of \$24 million pertaining to the sale and leaseback of three Boeing 777 aircraft.
- In 2008, Air Canada recorded an impairment charge of \$38 million relating to the retirement of its fleet of Boeing 767-200 aircraft and gains amounting to \$7 million pertaining to the sale of aircraft-related inventory.
- Gains related to fair value adjustments on derivative instruments amounted to \$95 million in 2009 versus gains of \$92 million in 2008. The mark-to-market gains on financial instruments recorded in 2009 were mainly related to the change in the fair value of fuel derivatives.

## **8.2 Corporate Items and Eliminations ("CIE")**

CIE includes the corporate, financing and investing activities of ACE.

CIE recorded a non-operating expense of \$681 million in 2009 compared to non-operating income of \$890 million in 2008.

Factors contributing to the year-over-year change in 2009 included:

- In Quarter 4 2009, ACE recorded a dilution loss of \$411 million as a result of the shares issued by Air Canada which reduced ACE's ownership interest in Air Canada from 75% to 27%. In December 2009 ACE also recorded a Provision for loss on Air Canada investment of \$219 as a result of adjusting the carrying value due to an other than temporary decline in the value of the Corporation's investment in Air Canada to \$99 million based on Air Canada's closing market price as at December 31, 2009, (\$1.32 per Class B share) as quoted on the TSX.
- In 2009, ACE recorded a Loss on repurchase of the convertible senior notes and preferred shares within Non-operating expense in the amount of \$44 million. The repurchase prices of these investments, allocated to the liability components of these compound instruments, exceeded the respective carrying values resulting in a loss of \$44 million being recorded. The residual equity components of the instruments amounting to \$199 million have been transferred directly to Contributed surplus in the consolidated statement of changes in shareholders' equity. Refer to section 9.5 of this MD&A for additional information.
- In 2008, gains totalling \$997 million were recorded in CIE as a result of ACE's sale of Aeroplan Income Fund units and Jazz Air Income Fund units.
- A reduction in interest expense of \$49 million as a result of the purchase for cancellation in January, 2009, of 80% of ACE's convertible senior notes outstanding as at December 31, 2008, the purchase of ACE's convertible preferred shares and the redemption of the remaining convertible senior notes in December 2009.

In 2009, \$1 million of the net income was allocated to non-controlling interest compared to \$250 million of a net loss being allocated to non-controlling interest in 2008.

## 9. Financial and Capital Management

Effective October 27, 2009, the results, financial position and cash flows of Air Canada are not consolidated with ACE. Refer to Section 5 "Investments" in this MD&A.

The following table summarizes ACE's consolidated statement of financial position as at December 31, 2009 and as at December 31, 2008.

Condensed Consolidated Statement of Financial Position (Canadian dollars in millions)	December 31, 2009	December 31, 2008
<b>Assets</b>		
Cash, cash equivalents and short-term investments	\$ 71	\$ 1,813
Current Assets	3	1,396
Equity investment in Air Canada	99	-
Loan Receivable from Air Canada	150	-
Property and equipment	-	7,469
Intangible assets	-	698
Deposits and other assets	-	495
	<b>\$ 323</b>	<b>\$ 11,871</b>
<b>Liabilities</b>		
Current liabilities	\$ 3	\$ 3,704
Long-term debt and capital leases	-	4,980
Convertible preferred shares	-	206
Pension and other benefits liabilities	-	1,585
Other long-term liabilities	-	420
	<b>3</b>	<b>10,895</b>
<b>Non-controlling interest</b>	-	<b>512</b>
<b>Shareholders' equity</b>	<b>320</b>	<b>464</b>
	<b>\$ 323</b>	<b>\$ 11,871</b>

\* Refer to Section 12 for Off-balance sheet arrangements.

### 9.1 Analysis of Financial Position

The following discussion is based upon ACE's statement of financial position as at December 31, 2009 versus ACE's unconsolidated statement of financial position as at December 31, 2008.

#### *Cash and cash equivalents*

As at December 31, 2009, ACE's cash and cash equivalents amounted to \$71 million. As at December 31, 2008 ACE's unconsolidated cash and cash equivalents was \$808 million. Refer to section 9.2 of this MD&A for a discussion of the change in Cash, and cash equivalents.

#### *Investment in Air Canada*

On July 29, 2009, ACE participated in the \$600 million Air Canada Credit Facility with several other lenders providing financing of \$150 million which represented 25% of the Credit Facility. Since October 27, 2009, ACE no longer consolidates Air Canada's financial position. ACE's investment in Air Canada has since been accounted for using the equity method. In Quarter 4 2009, ACE recorded a dilution loss of \$411 million as a result of the shares issued by Air Canada which reduced ACE's ownership interest in Air Canada from 75% to 27%. In December 2009 ACE also recorded a Provision for loss on Air Canada investment of \$219 as a result of adjusting the carrying value due to an other than temporary decline in the value of the Corporation's

investment in Air Canada to \$99 million based on Air Canada's closing market price as at December 31, 2009, (\$1.32 per Class B share) as quoted on the TSX.

#### *Convertible senior notes*

In January 2009, ACE completed a substantial issuer bid resulting in the purchase for cancellation of 80% of ACE's convertible senior notes outstanding as at December 31, 2008, at a purchase price of \$900 in cash for each \$1,000 principal amount of notes. The aggregate principal amount of the repurchased convertible senior notes was \$259 million. On January 21, 2009, the Corporation paid an aggregate purchase price of \$233 million for the notes tendered. On December 14, 2009, the Corporation paid an aggregate purchase price of \$64 million for the redemption of the remaining convertible senior notes.

#### *Convertible preferred shares*

In January 2009 and March 2009, ACE completed substantial issuer bids resulting in the purchase for cancellation of 9.3 million of ACE's convertible preferred shares at a purchase price of \$20.00 per preferred share. In September 2009, ACE purchased for cancellation the remaining 3.2 million convertible preferred shares at a purchase price of \$23.00 per share. In Quarter 1 2009, the Corporation paid an aggregate purchase price of \$186 million for the shares tendered. In Quarter 3 2009, the Corporation paid an aggregate purchase price of \$74 million for the remaining shares.

#### *Shareholders' equity*

As at December 31, 2009, ACE's shareholders' equity amounted to \$320 million, a decline of \$144 million during 2009 mainly as a result of the loss of \$692 million offset by other comprehensive income of \$556 million.

## **9.2 Consolidated Cash Flows**

**Effective October 27, 2009, the results, financial position and also cash flows of Air Canada are not consolidated with ACE. Refer to Section 5 "Investments" in this MD&A.**

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

(Canadian dollars in millions)	Quarter 4			2009	2008	\$ Change
	2009	2008	\$ Change			
Cash from (used for) operating activities	\$ 19	\$ (291)	\$ 310	\$ (168)	\$ (110)	\$ (58)
Cash from (used for) financing activities	160	269	(109)	(409)	(2,095)	1,686
Cash from (used for) investing activities	(1,284)	8	(1,292)	(659)	1,212	(1,871)
<b>Net change in cash and cash equivalents during the period</b>	<b>(1,105)</b>	<b>(14)</b>	<b>(1,091)</b>	<b>(1,236)</b>	<b>(993)</b>	<b>(243)</b>
<b>Cash and cash equivalents - Beginning of period</b>	<b>1,176</b>	<b>1,321</b>	<b>(145)</b>	<b>1,307</b>	<b>2,300</b>	<b>(993)</b>
<b>Cash and cash equivalents - End of period</b>	<b>\$ 71</b>	<b>\$ 1,307</b>	<b>\$ (1,236)</b>	<b>\$ 71</b>	<b>\$ 1,307</b>	<b>\$ (1,236)</b>

\* Cash and cash equivalents exclude Short-term investments of \$506 million as at December 31, 2008.



**ACE**

The following summarizes significant transactions or factors which impacted ACE's non-consolidated cash and cash equivalents in 2009:

- In January 2009, ACE completed a substantial issuer bid to purchase for cancellation 80% of its convertible senior notes outstanding as at December 31, 2008, at a purchase price of \$900 in cash for each \$1,000 principal amount of notes. The aggregate principal amount of the repurchased convertible senior notes was \$259 million. On January 21, 2009, the Corporation paid an aggregate purchase price of \$233 million for the notes tendered.
- In January 2009, ACE completed a substantial issuer bid to purchase for cancellation 8.3 million of its convertible preferred shares at a purchase price of \$20.00 per preferred share. On January 21, 2009, the Corporation paid an aggregate purchase price of \$166 million for the shares tendered.
- In March 2009, ACE completed a substantial issuer bid to purchase for cancellation 1.0 million of its convertible preferred shares at a purchase price of \$20.00 per preferred share. On March 23, 2009, the Corporation paid an aggregate purchase price of \$20 million for the shares tendered.
- In July 2009, ACE participated in the Air Canada credit facility providing financing of \$150 million, which represents 25% of the \$600 million Credit Facility. The Credit Facility is a five-year facility repayable in sixteen (16) consecutive quarterly installments commencing in August 2010 with the final balloon installment due in July 2014. The Credit Facility bears interest at a rate based upon the greater of the bankers' acceptance rate or 3.00% plus 9.75% (12.75% at December 31, 2009).
- In September 2009, ACE entered into an agreement with Morgan Stanley Canada Limited pursuant to which ACE indirectly purchased for cancellation all of its remaining 3.2 million preferred shares at a price of \$23.00 per share for an aggregate purchase price of \$74 million.
- In December 2009, ACE redeemed the remaining convertible senior notes for an aggregate purchase price of \$64 million.

The following summarizes significant transactions or factors which impacted ACE's unconsolidated cash and cash equivalents in 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.
- ACE received 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.
- ACE received net proceeds of \$97 million related to the sale of Jazz Air Income Fund units on January 24, 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.

### **Air Canada**

The following discussion is based upon Air Canada's 2009 published results.

During 2009, Air Canada entered into the following significant transactions in an effort to mitigate liquidity risks:

- Completed a share and warrant public offering for net proceeds of \$249 million.
- Completed a secured term credit facility (the "Credit Facility") for financing proceeds of \$600 million, less fees of \$20 million. The Credit Facility is a five-year facility, with the first principal repayment due in August 2010, and currently bears interest at 12.75%. Under the Credit Facility, 10 million warrants were also issued which entitle the debt holders to acquire up to 10 million shares in Air Canada. ACE provided financing of \$150 million with respect to the Credit Facility, as further described below.
- Pension funding agreements with all of Air Canada's Canadian-based unions (the "Pension MOUs") and the adoption of the Air Canada Pension Funding Regulations, 2009 (the "Air Canada 2009 Pension Regulations"). The Air Canada 2009 Pension Regulations relieve Air Canada from making any special (past service cost) payments for the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contributions shall equal the lesser of (i) \$150 million, \$175 million, and \$225 million in respect of 2011, 2012, and 2013, respectively and (ii) the maximum past service contributions permitted under the Income Tax Act. Pursuant to the Pension MOUs, on October 26, 2009 Air Canada issued, to a trust, 17,647,059 Class B Voting Shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of the sale of such shares held by the trust are to be contributed to the pension plans.
- Total cash flows to Air Canada during the full year 2009 from borrowing, including the Credit Facility described above, amounted to \$926 million, proceeds from sale of assets amounted to \$103 million, proceeds from sale-leaseback transactions amounted to \$552 million and proceeds from contractual commitments amounted to \$230 million. Reductions of long-term debt during 2009, which include repayments as a result of certain of the above financings and sale-leasebacks, amounted to \$1,237 million.

At December 31, 2009, Air Canada had Cash and cash equivalents and Short-term investments of \$1,407 million (\$1,005 million as at December 31, 2008).

### **9.3 Contractual Obligations**

On November 5, 2009, the Board of Directors authorized the redemption for cash of ACE's senior convertible notes. The notes were redeemed on December 14, 2009 for an aggregate purchase price of \$64 million.

## 9.4 Capital Management

ACE views capital as the sum of parent company capital 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:

<b>(Canadian dollars in millions)</b>	<b>2009</b>	<b>2008</b>
Convertible senior notes	\$ -	\$ 289
Convertible preferred shares	-	206
Non-controlling interest	-	512
Shareholders' equity	320	464
<b>Capital</b>	<b>\$ 320</b>	<b>\$ 1,471</b>

As at December 31, 2009, ACE's capital amounted to \$320 million, a decline of \$1,151 million during 2009. As at December 31, 2009, ACE cash and cash equivalents amounted to \$71 million (\$808 million as at December 31, 2008).

ACE's business strategy, to surface shareholder value and to return capital to its shareholders, has influenced its capital management objectives. Consistent with those objectives, during 2008 and 2009, the ACE Board of Directors authorized the return of capital to its shareholders and the redemption of its convertible senior notes and convertible preferred shares, as further described below. Going forward, the Board will continue to review alternatives to maximize the return to its shareholders.

### *Convertible Senior Notes*

In January 2009, the Corporation completed a substantial issuer bid to purchase for cancellation 80% of its convertible senior notes outstanding as at December 31, 2008, at a purchase price of \$900 in cash for each \$1,000 principal amount of notes. The aggregate principal amount of the repurchased convertible senior notes was \$259 million. On January 21, 2009, the Corporation paid an aggregate purchase price of \$233 million for the convertible senior notes tendered. On December 14, 2009, the Corporation redeemed the remaining convertible senior notes for an aggregate purchase price of \$64 million.

### *Convertible Preferred Shares*

In January 2009 and March 2009, the Corporation completed two substantial issuer bids to purchase for cancellation 9.3 million of its convertible preferred shares at a purchase price of \$20.00 per preferred share. In Quarter 1 2009, the Corporation paid an aggregate purchase price of \$186 million for the shares tendered. In September 2009, the Corporation entered into an agreement with Morgan Stanley Canada Limited pursuant to which ACE indirectly acquired for cancellation all of its remaining 3.2 million preferred shares at a price of \$23.00 per share for an aggregate purchase price of \$74 million.

### *Non-controlling Interest*

Effective October 27, 2009, ACE no longer consolidates Air Canada's financial position, operating results and cash flows. As a result, as at December 31, 2009 ACE's Non-controlling interest is nil.

### *Shareholders' equity*

As at December 31, 2009, ACE's shareholders' equity amounted to \$320 million, a decline of \$144 million during 2009.

## 9.5 Share Information

At January 31, 2010, 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)	January 31, 2010	December 31, 2009
<b>Issued and outstanding common shares</b>		
Class A variable voting shares	24,223	25,643
Class B voting shares	8,242	10,048
<b>Total issued and outstanding common shares <sup>(1)</sup></b>	<b>32,465</b>	<b>35,691</b>
<b>Common shares potentially issuable</b>		
Convertible preferred shares <sup>(2)</sup>	-	-
Convertible senior notes <sup>(3)</sup>	-	-
Stock options <sup>(4)</sup>	48	48
<b>Total common shares potentially issuable</b>	<b>48</b>	<b>48</b>
<b>Total outstanding and potentially issuable common shares</b>	<b>32,513</b>	<b>35,739</b>

- (1) In May 2009, the Chairman, President and Chief Executive Officer of ACE requested that the after-tax amount of severance and benefits of \$4.2 million be paid to him in the form of shares of ACE. As a result, on May 22, 2009, the Chairman, President and Chief Executive Officer's after-tax amount was used to acquire and retain 784,350 Class B voting shares of ACE. Such subscription was effected through a grant of options that were exercised immediately upon the grant at an exercise price of \$5.34, which is equal to the market price determined under the terms of the Stock Option Plan.

In January 2010, the Corporation completed a substantial issuer bid to purchase for cancellation a total of 1,401,094 Class A Variable Voting Shares and 1,824,711 Class B Voting shares at \$6.20 per share for an aggregate purchase price of \$20 million.

- (2) In January 2009 and March 2009, the Corporation completed two substantial issuer bids to purchase for cancellation 9.3 million of its convertible preferred shares at a purchase price of \$20.00 per preferred share. In Quarter 1 2009, the Corporation paid an aggregate purchase price of \$186 million for the shares tendered. In September 2009, the Corporation entered into an agreement with Morgan Stanley Canada Limited pursuant to which ACE indirectly acquired for cancellation all of its remaining 3.2 million preferred shares at a price of \$23.00 per share for an aggregate purchase price of \$74 million.
- (3) In January 2009, the Corporation completed a substantial issuer bid to purchase for cancellation 80% of its convertible senior notes outstanding as at December 31, 2008, at a purchase price of \$900 in cash for each \$1,000 principal amount of notes. The aggregate principal amount of the repurchased convertible senior notes was \$259 million. On January 21, 2009, the Corporation paid an aggregate purchase price of \$233 million for the notes tendered. In November 2009, the Board of Directors authorized the redemption for cash of ACE's remaining senior convertible notes. On December 14, 2009, the Corporation redeemed the remaining convertible senior notes for an aggregate purchase price of \$64 million.
- (4) The Corporation's stock option plan is described in Note 13 to the 2008 annual consolidated financial statements. At January 31, 2010, a total of 47,812 stock options with a weighted exercise of \$14.61 were outstanding (61,230 stock options with a weighted exercise of \$14.11 outstanding as at December 31, 2008). The decrease of 13,418 stock options since December 31, 2008 is due to forfeitures experienced throughout 2009.

**10. Quarterly Financial Information**

The quarterly information presented below is not directly comparable as a result of ACE's investment in Air Canada being changed on October 27, 2009 from consolidation to the equity method of accounting.

(\$ millions, except per share amounts)	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 <sup>(1)</sup> 2009
Operating revenues	\$ 2,726	\$ 2,783	\$ 3,075	\$ 2,496	\$ 2,391	\$ 2,330	\$2,670	\$815
Operating expenses	(2,753)	(2,785)	(2,970)	(2,646)	(2,583)	(2,445)	(2,602)	820
<b>Operating income (loss) before under-noted item</b>	<b>(27)</b>	<b>(2)</b>	<b>105</b>	<b>(150)</b>	<b>(192)</b>	<b>(115)</b>	<b>68</b>	<b>(5)</b>
Provision for cargo investigations <sup>(2)</sup>	(125)	-	-	-	-	-	-	-
<b>Operating income (loss)</b>	<b>(152)</b>	<b>(2)</b>	<b>105</b>	<b>(150)</b>	<b>(192)</b>	<b>(115)</b>	<b>68</b>	<b>(5)</b>
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax <sup>(3)</sup>	(30)	832	(240)	(483)	(152)	225	130	(651)
<b>Net income (loss)</b>	<b>\$ (182)</b>	<b>\$ 830</b>	<b>\$ (135)</b>	<b>\$ (633)</b>	<b>\$ (344)</b>	<b>\$ 110</b>	<b>\$ 198</b>	<b>\$ (656)</b>
<b>Earnings (loss)<sup>(4)</sup></b>								
Per share – basic	\$ (2.96)	\$ 15.46	\$ (3.86)	\$ (18.12)	\$ (9.87)	\$ 3.16	\$5.57	\$(18.38)
Per share – diluted	\$ (2.96)	\$ 10.76	\$ (3.86)	\$ (18.12)	\$ (9.87)	\$ 2.68	\$5.15	\$(18.38)

(1) The results, financial position and cash flows of Air Canada are not consolidated with ACE effective October 27, 2009.

(2) Air Canada recorded a provision for cargo investigations of \$125 million in Quarter 1 2008.

(3) 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. Quarter 1 2009 includes a loss on repurchase of the convertible senior notes and preferred shares of \$33 million relating to the substantial issuer bids completed in January 2009 and March 2009. Quarter 3 2009 includes a loss on repurchase of the preferred shares of \$10 million relating to the acquisition for cancellation of the remaining preferred shares in September 2009. Quarter 4 2009 includes a dilution loss of \$411 million as a result of the shares issued by Air Canada reducing ACE's ownership interest from 75% to 27% and includes a provision for loss on ACE's Air Canada investment of \$219 million as a result of adjusting the carrying value of ACE's investment in Air Canada to \$99 million based on Air Canada's market price as at December 31, 2009.

(4) Earnings (loss) per share 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.

## 11. Financial Instruments and Risk Management

Effective October 27, 2009, the results, financial position and also cash flows of Air Canada are not consolidated with ACE. Refer to Section 5 "Investments" in this MD&A.

### Risk Management

As a result, as at December 31, 2009, ACE's financial instruments are limited to cash and cash equivalents in the amount of \$71 million, a secured loan of \$150 million to Air Canada, interest receivable of \$3 million from Air Canada and accounts payable of \$3 million. The risk exposure related to these holdings is described below.

#### 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 is exposed to interest rate risk from its holding in cash and cash equivalents of \$71 million in addition to its secured loan receivable and related interest receivable from Air Canada of \$150 million and \$3 million, respectively. The loan receivable from Air Canada bears interest at a rate based upon the greater of the bankers' acceptance rate or 3.00% plus 9.75% (12.75% as at December 31, 2009), which mitigates risk to nil.

The weighted average interest rate on ACE's cash and cash equivalents at December 31, 2009, is 0.22%, which results in limited downside risk.

#### Liquidity risk

Liquidity risk is the risk that the Corporation will encounter difficulty in meeting obligations associated with its financial liabilities. This risk is mitigated by the fact that as at December 31, 2009, the Corporation had Cash and cash equivalents of \$71 million and current financial liabilities of \$3 million.

#### Credit Risk

Credit risk is the risk of loss due to a counterparty's inability to meet its obligations. The Corporation is exposed to credit risk from its cash and cash equivalents and its secured loan receivable from Air Canada and related interest receivable from Air Canada. The maximum exposure of which is represented by the carrying amounts reported on the balance sheet.

This risk is mitigated by the fact that:

- Cash and cash equivalents are held by credit worthy institutions only. The Corporation's target is that no one financial institution hold more than 25% of the total cash balance;
- Air Canada's obligations under the Credit Facility are secured by a first priority security interest and hypothec over substantially all the present and after-acquired property of Air Canada and its subsidiaries, subject to certain exclusions and permitted liens. The Credit Facility contains customary representations and warranties and is subject to customary terms and conditions (including negative covenants, financial covenants and events of default).

### Summary of gain (loss) on financial instruments recorded at fair value

	2009 <sup>(1)</sup>	2008
Ineffective portion of fuel hedges	\$ -	\$ 83
Fuel derivatives not under hedge accounting	98	(9)
Cross currency interest rate swaps	-	4
Other	(4)	14
<b>Gain on financial instruments recorded at fair value</b>	<b>\$ 94</b>	<b>\$ 92</b>

(1) Effective October 27, 2009, the results and financial position of Air Canada are not consolidated with ACE. Refer to Section 5 "Investments" in this MD&A.

## 12. Off-Balance Sheet Arrangements

Effective October 27, 2009, the results, financial position and also cash flows of Air Canada are not consolidated with ACE. Refer to Section 5 "Investments" in this MD&A.

### Guarantees

On May 7, 2009, ACE intervened into the employment agreement between Air Canada and Mr. Calin Rovinescu, its President and Chief Executive Officer, to guarantee the payments required of Air Canada under the agreement.

In addition, ACE agreed to cause to be issued an irrevocable bank letter of credit to a maximum of \$5 million. At December 31, 2009, as agreed by the parties, the letter of credit had not been issued.

## 13. Related Party Transactions

At February 11, 2009 ACE held a 27% ownership interest in Air Canada. On October 16, 2007, ACTS LP sold substantially all its assets, liabilities and business to ACTS Aero, a new entity established to purchase the assets of ACTS LP. ACTS Aero owns 100% of Aveos (Aveos Fleet Performance Inc.) which changed its legal name on September 23, 2008 from its previous name of ACTS Aero Technical Support and Services Inc. As at February 11, 2009 ACE held a 28.4% interest in ACTS Aero. Air Canada has various related party transactions with Aveos, an ACE related entity. Subsequent to the sale of Jazz units on January 24, 2008 and the termination of the Securityholders' Agreement on February 7, 2008, ACE no longer exercised significant influence over Jazz. Subsequent to the sale on April 24, 2008 and the termination of the Securityholders' Agreement on May 9, 2008, ACE no longer exercised significant influence over Aeroplan.

On January 22, 2010, ACE entered into a Restructuring and Lockup Agreement with Aveos, ACTS Aero, lenders and other shareholders. Under the terms of the restructuring, which is planned to be completed in Quarter 1, 2010, ACE has agreed on closing to transfer its shares in ACTS Aero to a newly formed company, in which ACE will have no interest, for nil consideration.

### Summary of significant related party agreements

#### *The Relationship between Air Canada and ACE*

##### Credit Facility

ACE is a participant lender in the Credit Facility as described in Section 5. ACE's participation in the Credit Facility represents \$150 million of the outstanding loan of \$600 million as at February 11, 2009. The participant lenders participate on a pro-rata basis with respect to any warrants and principal and interest payments. ACE's pro-rata share of interest paid by Air Canada on February 1, 2010, amounts to \$4.8 million.

##### Master Services Agreement

Air Canada provides certain accounting and administrative services to ACE in return for a fee. ACE terminated the majority of these service agreements in 2009.

##### Guarantee of Air Canada obligation

Refer to Section 12 for Off-balance sheet arrangements.

#### *The Relationship between the Air Canada and Aveos*

##### Pension and Benefits Agreement

Air Canada, ACTS and ACTS Aero entered into a Pension and Benefits Agreement effective as of October 16, 2007, as amended ("Pension and Benefits Agreement"), relating to pension and benefits arrangements pertaining to (i) the non-unionized employees of Air Canada who were previously assigned to the ACTS operation and who became employees of Aveos on October 16, 2007 and (ii) those unionized employees of Air

Canada who were assigned to ACTS Aero operation pursuant to general services agreements between Air Canada and ACTS for the assignment of unionized employees from Air Canada to ACTS (these agreements were assigned to ACTS Aero (i.e. Aveos) upon closing of the monetization). Under the Pension and Benefits Agreement, Aveos is required to establish new defined benefit and defined contribution pension plans as well as other employee and retiree benefit arrangements (including health, life and disability) (the "ACTS Benefit Arrangements").

Upon receipt of regulatory approval where required and based upon valuations of the relevant pension and benefit arrangements of Air Canada (the "Air Canada Benefit Arrangements") as at October 16, 2007, the assets and obligations under the Air Canada Benefit Arrangements pertaining to the transferring non-unionized employees are to be transferred to ACTS Aero or the ACTS Benefit Arrangements, as applicable. Amounts with a present value equal to the solvency deficiency in the defined benefit pension plans as at October 16, 2007 related to transferring non-unionized employees will be paid by Air Canada through quarterly payments to Aveos until 2014. Amounts with a present value equal to the accounting liability as at October 16, 2007 in respect of retiree and disability benefits related to transferring non-unionized employees are to be paid by Air Canada through quarterly payments to Aveos until 2012. The present value of these quarterly payments is also referred to as the compensation amount. Until such future time as the assets and obligations under the Air Canada Benefit Arrangements pertaining to non-unionized employees are to be transferred to Aveos, the current service pension cost and the current service and interest costs for other employee benefits are expensed by Air Canada with a full offset recorded as an amount charged to affiliates (Aveos).

In addition, the Pension and Benefits Agreement contemplates similar asset and liability transfer and compensation arrangements in respect of unionized employees, which arrangements would take effect at such future time as those unionized employees may commence employment with Aveos pursuant to the Transition Memorandum of Agreement ("the Transition MOA"), as described further below. However, the solvency deficiencies in respect of transferring unionized employees for which the future quarterly compensation payments would be made are determined as at October 16, 2007, subject to certain adjustments, and the discount rate used to compute the accounting liability for the unionized employees' retiree and disability benefits is fixed as at October 16, 2007. The compensation payments in respect of these solvency deficiencies and accounting liabilities will be made quarterly during the five years beginning after the unionized employees are transferred to Aveos, but only if such a transfer occurs. Until such future time as the assets and obligations under the Air Canada Benefit Arrangement pertaining to unionized employees may be transferred to Aveos, the current service pension cost and the current service and interest costs for other employee benefits in respect of Air Canada employees providing services to Aveos are charged by Air Canada to Aveos.

The Pension and Benefits Agreement also required that Air Canada provide letters of credit to Aveos on October 16, 2007, to secure the above-described payment obligations in respect of the solvency deficiencies of the defined benefit pension plans and accounting liabilities for other retiree and disability benefit arrangements. The letters of credit initially totaled \$101 million, subject to adjustment once the exact amounts of the relevant solvency deficiencies and accounting liabilities as at October 16, 2007 were determined by actuarial valuations. The face amount of the letter of credit in respect of the unionized solvency deficiency is also adjusted annually to recognize past service costs paid by Air Canada to the plan in respect of unionized employees assigned to ACTS Aero. The face amount of the letters of credit decreases as the related quarterly funding payments described above are made. During 2008, as described below under "Agreement with Aveos on Revised Payment Terms", Air Canada and Aveos also agreed to temporarily cancel certain letters of credit in the amount of \$40 million. Aveos may call the letters of credit in whole or in part, in the event of a default as defined in the Pension and Benefits Agreement. Collateral equal to the amount of the letters of credit was paid in cash with the asset recorded in deposits and other assets.

In 2008, Air Canada, Aveos, and the union representing the employees assigned to Aveos continued discussions regarding the options under which certain unionized employees would commence employment directly with Aveos and the creation of a separate bargaining unit for those employees at Aveos. On January 8, 2009, these same parties entered into the Transition MOA in order to resolve certain remaining issues and in order to (i) facilitate the orderly transition of certain Air Canada employees to Aveos and (ii) to establish terms and conditions of employment that will apply to those Air Canada employees who elect to become employees of Aveos. In relation to the Transition MOA, Air Canada and Aveos also entered into certain ancillary agreements (the "Ancillary Transition Agreements") to address commercial issues relating to the transition of employees



contemplated by the Transition MOA. On March 5, 2009, Air Canada received the decision of the arbitrator seized with resolving five issues which remained outstanding following the execution of the Transition MOA. Air Canada and the IAMAW subsequently amended the Transition MOA, by establishing timelines for the steps for the transition and by providing for a date on which the employees who will transition to Aveos will become employees of Aveos, namely, April 1, 2011.

*Non-Compete and Repair Schemes Transfer Agreement*

Aveos and Air Canada are parties to a Non-Compete and Repair Schemes Transfer Agreement, effective as of October 16, 2007. Generally described, repair schemes are processes and methods which may be used in the maintenance and repair of aircraft and related equipment. The Non-Compete and Repair Schemes Transfer Agreement confirmed an arrangement and provides for the sale from Air Canada to ACTS Aero (as successor to ACTS LP) of an undivided joint ownership interest in repair schemes owned by Air Canada or approved under Air Canada's airworthiness engineering organization as well as the sale from Aveos to Air Canada of an undivided joint ownership interest in the repair schemes owned or developed by Aveos and applicable to airframe heavy maintenance services provided by ACTS to Air Canada under the parties' airframe heavy maintenance services agreement. However, in September 2004 as part of the implementation of Air Canada's plan of arrangement under the CCAA, Air Canada had already granted ACTS full and exclusive right to these schemes on a royalty free basis.

The Non-Compete and Repair Schemes Transfer Agreement also restricts Air Canada's ability to own any equity interest in an entity (other than entities in which Air Canada previously held interests), or to carry on a business activity, related to the following commercial maintenance, repair and overhaul services in the airline industry, namely, airframe heavy maintenance and paint services, engine and auxiliary power unit ("APU") overhaul maintenance services, and component maintenance services. The applicable non-compete periods are as follows:

- With respect to airframe heavy maintenance services and paint services, the non-compete period ends one year after the current heavy maintenance services agreement is terminated or expires (the current term of the heavy maintenance services agreement expires October 1, 2011);
- With respect to engine and APU overhaul maintenance services, the non-compete period ends on October 1, 2015; and
- With respect to component maintenance services, the non-compete period ends on October 1, 2016.

The Non-Compete and Repair Schemes Transfer Agreement does not restrict Air Canada from holding interests in any entities in which it held interests at the time of concluding the agreement nor does it limit Air Canada's line maintenance activities which it continues to operate.

*Agreement with Aveos on Revised Payment Terms*

Air Canada and Aveos entered into an agreement dated October 28, 2008 pursuant to which Air Canada has agreed to temporarily extend payment terms to Aveos under certain related party agreements. In exchange for the extended payment terms, certain letters of credit related to the Pension and Benefits Agreement, as described above, were cancelled. The cancellation of the letters of credit provided cash to Air Canada of approximately \$40 million and was offset by the impact of extended payment terms to Aveos of \$22 million, for a net cash flow benefit of \$18 million to Air Canada. The extended payment terms to Aveos were originally scheduled to begin reducing in May 2009 with a corresponding return of the letters of credit to Aveos.

As a result of amendments, the payment terms were extended. The extended payment terms to Aveos will be reduced starting in February 2010, with the expiration of the extended terms to be completed over the following six months. By July 2010, following expiration of the extended payment terms, the letters of credit would be reinstated to the levels then required under the Pension and Benefits Agreement between the two parties.

Maintenance Agreements

Aveos and Air Canada are parties to a general terms and related services agreements effective October 1, 2006, pursuant to which Aveos provides technical services to Air Canada including engine and auxiliary power unit maintenance services, aircraft heavy maintenance services (excluding line and cabin maintenance services which are provided by Air Canada), and component maintenance. Aveos serves as Air Canada's exclusive repair agency in respect of aircraft heavy maintenance, engine maintenance, auxiliary power unit maintenance services as well as for maintenance services relating to certain components. The services agreement relating to aircraft heavy maintenance services, which expires in October 2011, will be extended to June 2013 conditional upon the issuance of an order of the Canada Industrial Relations Board establishing that Aveos is a distinct employer, bound by separate collective agreements and providing for the transition of employees from Air Canada to Aveos which are fully within the scope of the Transition MOA and the Ancillary Transition Agreements mentioned above. The services agreement relating to engine maintenance expires in October 2013, except in respect of certain engine types, for which the parties have agreed to extend the term to December 31, 2018. Each of the other maintenance agreements referred to above expire in October 2013.

Master Services Agreement (MSA)

Aveos and Air Canada are parties to an amended and restated master services agreement (the "Aveos MSA"), effective January 1, 2007, pursuant to which Air Canada provides Aveos with services including infrastructure support and services which are mostly administrative in nature, including information technology, human resources, finance and accounting services in return for fees paid by Aveos to Air Canada. Aveos may elect to terminate any services under the Aveos MSA or the entire Aveos MSA upon six months' prior written notice, with the exception of services relating to information technology which Aveos cannot terminate prior to the expiry of the Aveos MSA. Air Canada may elect to terminate any services under the Aveos MSA or the entire Aveos MSA upon 18 months' prior written notice. These amounts are recorded in the above table summarizing related party revenues and expenses under Revenues from corporate services and other.

General Services Agreements

Aveos and Air Canada are parties to an amended and restated general services agreement (the "Aveos GSA"), effective as of June 22, 2007, pursuant to which Air Canada provides Aveos with the services of a group of unionized employees for which Air Canada is reimbursed by Aveos for all costs, including salary and benefits, on a fully allocated basis. The Aveos GSA may be terminated by either party at any time upon 30 days' prior written notice.

Real Estate Agreements

Aveos and Air Canada are parties to a master lease agreement, effective as of October 1, 2006, pursuant to which Aveos leases space from Air Canada at the Vancouver, Winnipeg, Toronto and Montreal airports.

**14. Critical Accounting Estimates**

**Effective October 27, 2009, the results, financial position and also cash flows of Air Canada are not consolidated with ACE. Refer to Section 5 "Investments" in this MD&A.**

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

The Corporation has identified the following areas that contain critical accounting estimates utilized in the preparation of its consolidated financial statements:

Passenger and Cargo Revenues

Airline passenger and cargo advance sales are deferred and included in current liabilities. Advance sales also include the proceeds from the sale of flight tickets to Aeroplan, a corporation that provides loyalty program services to Air Canada and purchases seats from Air Canada pursuant to the Aeroplan Commercial Participation and Services Agreement between Aeroplan and Air Canada (the "CPSA"). Passenger and cargo revenues are recognized when the transportation is provided, except for revenue on unlimited flight passes which is

recognized on a straight-line basis over the period during which the travel pass is valid. Air Canada has formed alliances with other airlines encompassing loyalty program participation, code sharing and coordination of services including reservations, baggage handling and flight schedules. Revenues are allocated based upon formulas specified in the agreements and are recognized as transportation is provided.

Air Canada performs regular evaluations on the deferred revenue liability which may result in adjustments being recognized as revenue. Due to the complex pricing structures, the complex nature of interline, and other commercial agreements used throughout the industry, historical experience over a period of many years, and other factors including refunds, exchanges and unused tickets, certain relatively small amounts are recognized as revenue based on estimates. Events and circumstances may result in actual results that are different from estimates.

#### Income Taxes

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

Future income tax assets are recognized to the extent that realization is considered more likely than not. The Corporation considers past results, current trends and outlooks for future years in assessing realization of income tax assets.

#### Cash Tax Projections

As at December 31, 2009, the Corporation has substantial tax attributes largely in the form of loss carry forwards and other tax attributes to shelter future taxable income. The Corporation does not forecast having any significant current taxes payable within the foreseeable future.

## 15. Risk Factors

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

### Risks Related to ACE

#### Exposure to Air Canada

ACE's principal investments are equity and debt interests in Air Canada. The value of ACE's equity interest in Air Canada is subject to market conditions based on the financial performance of Air Canada, movements in the price of publicly-traded airline stocks and general market conditions. Any decrease in the market price of Air Canada shares will reduce the value of these shares which can be realized. The value of ACE's debt interest is dependent on the performance of Air Canada and the value of the security for the Air Canada Credit Facility in which ACE participates. Detailed risk factors for Air Canada are set out below.

#### A Substantial Portion of ACE's Cash is Invested in Cash Equivalents

A substantial portion of ACE's cash is invested in cash equivalents which are subject to credit exposure and interest rate fluctuations which could change the value of these investments. These investments are made in accordance with an investment policy approved by the Board of Directors. Although ACE's investment policy is designed to provide for short-term liquidity and low levels of risk, such investments are subject to credit exposure and interest rate fluctuations. Consequently, the value of such investments could increase or decrease accordingly. Any decrease in the fair value of these investments would reduce the amount available for distribution to stakeholders.

#### Going Concern

On July 29, 2009, ACE announced that its participation in the \$600 million Air Canada Credit Facility amounted to \$150 million. Given ACE's participation in the facility, it is not management's intention to liquidate at this time.

If ACE subsequently proceeds with the liquidation of its net assets, ACE will again adopt a liquidation basis of presentation which will result in net assets in liquidation being presented on a net realizable basis.

### Risks Relating to Air Canada

#### Operating Results

Prior to emergence from its restructuring under the Companies Creditors Arrangement Act, as amended ("CCAA") on September 30, 2004, Air Canada had sustained significant losses and Air Canada may sustain significant losses in the future. In 2008, Air Canada recorded an operating loss before a provision for cargo investigations and proceedings of \$39 million. During 2009, Air Canada recorded an operating loss of \$316 million. Current economic conditions may result in significant losses for Air Canada. Despite ongoing business initiatives and efforts at securing cost reductions, revenue improvements and additional sources of financing, Air Canada may not be able to successfully achieve positive net profitability or realize the objectives of any or all of its initiatives, including those which seek to improve yield or offset or mitigate risks facing Air Canada, including those relating to economic conditions, liquidity, pension funding, unexpected volatility in fuel costs and other expenses.

#### Leverage

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

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

*Need for Additional Capital and Liquidity*

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

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

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

*Economic and Geopolitical Conditions*

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

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

*Pension Plans*

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

Pension plan solvency valuations are influenced primarily by long-term interest rates and by the investment return on plan assets, which in turn may be dependent on a variety of factors, including economic conditions.

The interest rate used to calculate benefit obligations for solvency purposes is a prescribed rate derived from the interest rates on long-term Government of Canada bonds. Deteriorating economic conditions may result in significant increases in Air Canada's funding obligations, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

In particular, as of 2014, the Air Canada 2009 Pension Regulations will cease to have effect and Air Canada's pension funding obligations may vary significantly based on several factors, including regulatory developments, assumptions and methods used and changes in the economic conditions (mainly the return on fund assets and changes in interest rates). Underfunded pension plans or a failure or inability by Air Canada to make required cash contributions to its registered pension plans could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

#### Fuel Costs

Fuel costs constituted the largest percentage of the total operating costs of Air Canada in 2009. Fuel prices fluctuate widely depending on many factors including international market conditions, geopolitical events and the Canada/U.S. dollar exchange rate. Air Canada cannot accurately predict fuel prices. During 2006, 2007 and 2008, fuel prices increased and fluctuated near or at historically high levels. Should fuel prices fluctuate significantly or increase significantly above current levels, fuel costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Due to the competitive nature of the airline industry, Air Canada may not be able to pass on increases in fuel prices to its customers by increasing its fares. Based on 2009 volumes, Air Canada estimates that a US\$1 per barrel movement in the average price of WTI crude oil would have resulted in an approximate \$25 million change in 2009 fuel expense for Air Canada (excluding any impact of fuel surcharges, foreign exchange rates and fuel hedging), assuming flying capacity remained unchanged and that refining spreads between WTI crude oil and jet fuel as well as foreign exchange rates remained constant.

#### Foreign Exchange

Air Canada's financial results are sensitive to the fluctuating value of the Canadian dollar. In particular, Air Canada has a significant annual net outflow of U.S. dollars and is affected by fluctuations in the Canada/U.S. dollar exchange rate. Air Canada estimates that during 2009, a \$0.01 increase in the Cdn/U.S. dollar exchange rate (i.e., \$1.09 to \$1.08 per U.S. dollar) would have had an estimated \$23 million favourable impact on operating income and a \$57 million favourable impact on pre-tax income. Conversely, an opposite change in the exchange rate would have had the opposite effect. Air Canada incurs significant expenses in U.S. dollars for such items as fuel, aircraft rental and maintenance charges, interest payments, debt servicing and computerized reservations system fees, while a substantial portion of its revenues are generated in Canadian dollars. A significant deterioration of the Canadian dollar relative to the U.S. dollar would increase the costs of Air Canada relative to its U.S. competitors and could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, Air Canada may be unable to appropriately hedge the risks associated with fluctuations in exchange rates.

#### Labour Costs and Labour Relations

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

Most of Air Canada's employees are unionized. The collective agreements representing the majority of the unionized workforce were renewed or extended in 2009 and will now expire in 2011. No strikes or lock-outs may lawfully occur during the term of the collective agreements, nor during the negotiations of their renewal until a number of pre-conditions, in respect of the unions for Canadian-based employees, prescribed by the Canada Labour Code, have been satisfied. There can be no assurance that collective agreements will be further renewed without labour conflict or action or that there will not be a labour conflict that could lead to a dispute or to an interruption or stoppage in Air Canada's service or otherwise adversely affect the ability of Air Canada

to conduct its operations, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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

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

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

*Competition*

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

Canadian low-cost and other carriers have entered and/or expanded or announced their intention to compete in many of Air Canada's key domestic markets and, along with some U.S. carriers have also entered and/or expanded their operations in the U.S. transborder and leisure-oriented markets. Carriers against which Air Canada may compete, including U.S. carriers, may undergo (and some of whom who have undergone) substantial reorganizations (including by way of merger with or acquisition by another carrier), creating reduced levels of indebtedness and lower operating costs and may be in a position to more effectively compete with Air Canada. Air Canada is also facing increasing competition in international markets as carriers increase their international capacity, both by expansion and by shifting existing domestic capacity to international operations to avoid low-cost domestic competition.

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

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

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

*Limitations Due to Restrictive Covenants*

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

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

*Airport User Fees and Air Navigation Fees*

With the privatization of airports and air navigation authorities over the last decade in Canada, new airport and air navigation authorities have imposed significant increases in their fees. Though certain authorities have implemented some fee reductions, if authorities in Canada or elsewhere were to increase their fees Air Canada, its business, results from operations and financial condition could be materially adversely affected.

*Strategic, Business, Technology and Other Important Initiatives*

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

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

*Dependence on Technology*

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

These technology systems may be vulnerable to a variety of sources of failure, interruption or misuse, including by reason of third party suppliers' acts or omissions, natural disasters, terrorist attacks, telecommunications failures, power failures, computer viruses, unauthorized or fraudulent users, and other operational and security issues. While Air Canada continues to invest in initiatives, including security initiatives and disaster recovery plans, these measures may not be adequate or implemented properly. Any such technology systems failure,



interruption or misuse could materially and adversely affect Air Canada's operations and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

#### Key Supplies and Suppliers

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

#### Aeroplan

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

#### Jazz

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

#### Star Alliance®

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

#### Interruptions or Disruptions in Service

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

*Current Legal Proceedings*

The European Commission, the United States Department of Justice and the Competition Bureau in Canada are investigating alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including Air Canada. Competition authorities have sought or requested information from Air Canada as part of their investigations. Air Canada is cooperating with these investigations, which are likely to lead, or have led, to proceedings against Air Canada and a number of airlines and other cargo operators in certain jurisdictions including in the European Union where all formal procedural steps preceding a decision have been completed. Air Canada is also named as a defendant in a number of class action lawsuits that have been filed before the United States District Court and in Canada in connection with these allegations.

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

In February 2006, Jazz commenced proceedings before the Ontario Superior Court of Justice against Porter Airlines Inc. ("Porter") and other defendants (collectively the "Porter Defendants") after Jazz became aware that it would be excluded from operating flights from Toronto City Centre (Island) Airport (the "TCCA"). On October 26, 2007, the Porter Defendants counter-claimed against Jazz and Air Canada alleging various violations of competition law, including that Jazz and Air Canada's commercial relationship contravenes Canadian competition laws, and claiming \$850 million in damages. Concurrently with the Ontario Superior Court of Justice proceedings, Jazz commenced judicial review proceedings against the Toronto Port Authority ("TPA") before the Federal Court of Canada relating to Jazz's access to the TCCA. The Porter Defendants were granted intervener and party status in these proceedings. In January of 2008, Porter filed a defence and counterclaim against Jazz and Air Canada making allegations and seeking conclusions similar to those in the Ontario Superior Court counterclaim. On October 16, 2009, Jazz discontinued its suit in the Ontario Superior Court against Porter. However, Jazz is continuing its proceedings in the Federal Court of Canada against the TPA, to which Porter intervened. The counterclaim filed by Porter in the Ontario Court against Jazz and Air Canada has been stayed pending the outcome of the mirror counterclaim in the Federal Court. Air Canada views Porter's counterclaims in both jurisdictions as being without merit.

The Canadian Union of Public Employees ("CUPE"), which represents Air Canada's flight attendants, has filed a complaint before the Canadian Human Rights Commission where it alleges gender-based wage discrimination. CUPE claims the predominantly female flight attendant group should be paid the same as the predominantly male pilot and mechanics groups because their work is of equal value. The complaint dates from 1991 but has not been investigated on the merits because of a legal dispute over whether the three groups work in the same "establishment" within the meaning of the Canadian Human Rights Act. On January 26, 2006, the Supreme Court of Canada ruled that they do work in the same "establishment" and sent the case back to the Canadian Human Rights Commission, which may now proceed to assess the merits of CUPE's complaint. On March 16, 2007, the Canadian Human Rights Commission referred the complaint against Air Canada for investigation. Air Canada considers that any investigation will show that it is complying with the equal pay provisions of the Canadian Human Rights Act, however, Air Canada has determined that it is not possible at this time to predict with any degree of certainty the final outcome of the Commission's investigation.

Air Canada is engaged in a number of proceedings involving challenges to the mandatory retirement provisions of certain of its collective agreements, including the Air Canada-Air Canada Pilots Association collective agreement which incorporate provisions of the pension plan terms and conditions applicable to pilots requiring them to retire at age 60.

Air Canada is defending these challenges. At this time, it is not possible to determine with any degree of certainty the extent of any financial liability that may arise from Air Canada being unsuccessful in its defense of these proceedings, though any such financial liability, if imposed, would not be expected to be material.

*Future Legal proceedings*

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

*Key Personnel*

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

**Risks Relating to the Airline Industry***Terrorist Attacks and Security Measures*

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

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

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

*Casualty Losses*

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

*Seasonal Nature of the Business, Other Factors and Prior Performance*

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

As described elsewhere, demand for and cost of air travel is also affected by factors such as geopolitical and economic conditions, war or the threat of war or terrorist attacks, fare levels and weather conditions. Due to

these and other factors, operating results for an interim period are not necessarily indicative of operating results for an entire year, and operating results for a historical period are not necessarily indicative of operating results for a future period.

#### Regulatory Matters

The airline industry is subject to extensive Canadian and foreign government regulations relating to, among other things, security, safety, privacy, licensing, competition, environment (including noise levels and carbon emissions) and, in some measure, pricing.

For example, new and proposed legislation have been considered or adopted concerning carbon emissions emanating from the aviation industry; such legislative initiatives include, for example, market-based mechanisms called emissions trading systems which are being proposed and implemented to reduce the amount of carbon emissions through the setting of emissions allowances and charging aircraft operators for a certain percentage of these allowances. The implementation of additional regulations or decisions, including those relating to carbon emissions, and others, whether by Transport Canada, the Competition Bureau and/or the Competition Tribunal, the Canadian Transportation Agency or other domestic or foreign governmental entities, may have a material adverse effect on Air Canada, its business, results from operations and financial condition.

The European Union passed legislation for an Emissions Trading System which will include carbon emissions from aviation commencing in January 2012, including for flights operated between Canada and countries within the European Union. The legislation would require aircraft operators to monitor and report on fuel use and emissions data. While this legislation would be expected to result in increased costs relating to the purchase of emissions allowances, the net financial impact would, in part, depend upon how much of such cost, if any, would be recoverable in the form of higher passenger and cargo fares.

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

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

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

#### Increased Insurance Costs

Since September 11, 2001 the aviation insurance industry has been continually re-evaluating the terrorism risks that it covers, and this activity may adversely affect some of Air Canada's existing insurance carriers or Air Canada's ability to obtain future insurance coverage. To the extent that Air Canada's existing insurance carriers are unable or unwilling to provide it with insurance coverage, and in the absence of measures by the Government of Canada to provide the required coverage, Air Canada's insurance costs may increase further and may result in Air Canada being in breach of regulatory requirements or contractual arrangements requiring that specific insurance be maintained, which may have a material adverse effect on Air Canada, its business, results from operations and financial condition.

#### Third Party War Risk Insurance

There is a risk that the Government of Canada may not continue to provide an indemnity for third party war risk liability coverage, which it currently provides to Air Canada and certain other carriers in Canada. In the event that the Government of Canada does not continue to provide such indemnity or amends such indemnity, Air Canada and other industry participants would have to turn to the commercial insurance market to seek such coverage. Air Canada estimates that such coverage would cost Air Canada approximately \$5 million per year. Alternative solutions, such as those envisioned by the International Civil Aviation Organization ("ICAO") and the International Air Transport Association ("IATA"), have not developed as planned, due to actions taken by other countries and the recent availability of supplemental insurance products. ICAO and IATA are continuing their

efforts in this area, however, the achievement of a global solution is not likely in the immediate or near future. The U.S. federal government has set up its own facility to provide war risk coverage to U.S. carriers, thus removing itself as a key component of any global plan.

## **16. Controls and Procedures**

### **Disclosure Controls and Procedures and Internal Controls over Financial Reporting**

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

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

The Corporation will file certifications, signed by the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO"), with the Canadian Securities Administrators ("CSA") upon filing of the Corporation's 2010 Annual Information Form. In those filings, the Corporation's CEO and CFO will certify, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design and effectiveness of the Corporation's disclosure controls and procedures and the design and effectiveness of internal controls over financial reporting. The Corporation's CEO and CFO also certify the appropriateness of the financial disclosures in the Corporation's interim filings with securities regulators. In those interim filings, the Corporation's CEO and CFO also certify the design of the Corporation's disclosure controls and procedures and the design of internal controls over financial reporting.

### **Management's Report on Disclosure Controls and Procedures**

Management, with the participation of the Corporation's CEO and CFO, concluded, as at December 31, 2009, that such disclosure controls and processes were designed to provide reasonable assurance that:

- (i) material information relating to the Corporation was made known to its Disclosure Policy Committee by others; and
- (ii) information required to be disclosed by the Corporation in its annual filings, interim filings and other reports filed or submitted by the Corporation under securities legislation was recorded, processed, summarized and reported within the time periods specified in securities legislation.

In addition, the evaluation covered the Corporation's processes, systems and capabilities relating to regulatory filings, public disclosures and the identification and communication of material information.

### **Management's Report on Internal Controls over Financial Reporting**

Management, with the participation of the Corporation's CEO and CFO, assessed the effectiveness of the Corporation's internal controls over financial reporting. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control - Integrated Framework. Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2009, the Corporation's internal controls over financial reporting were effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. This evaluation took into consideration the Corporation's Corporate Disclosure Policy and the functioning of its Disclosure Policy Committee.

### **Changes in Internal Controls over Financial Reporting**

There have been no changes to the Corporation's internal controls over financial reporting during the year ended December 31, 2009 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

**17. Selected Annual Information**

The following table provides selected annual information for ACE for the years 2009, 2008 and 2007. The information provided below may not be directly comparable as a result of changes in accounting policies relating to Air Canada, Aeroplan, Jazz and ACTS.

(\$ millions, except per share figures)	2009 <sup>(1)</sup>	2008	2007 <sup>(2)</sup>
Operating revenues	\$ 8,206	\$ 11,080	\$ 10,826
Operating expenses	(8,450)	(11,154)	(10,373)
<b>Operating income (loss) before the provision for cargo investigations</b>	<b>(244)</b>	<b>(74)</b>	<b>453</b>
Provision for cargo investigations <sup>(3)</sup>	-	(125)	-
<b>Operating income (loss)</b>	<b>(244)</b>	<b>(199)</b>	<b>453</b>
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax <sup>(4)</sup>	(448)	79	945
<b>Net income (loss)</b>	<b>\$ (692)</b>	<b>\$ (120)</b>	<b>\$ 1,398</b>
<b>Earning (loss) per share</b>			
- Basic	<b>\$(19.56)</b>	<b>\$ (2.59)</b>	<b>\$ 13.51</b>
- Diluted	<b>\$(19.56)</b>	<b>\$ (2.59)</b>	<b>\$ 11.44</b>
<b>Cash, cash equivalents and short-term investments</b>	<b>\$ 71</b>	<b>\$ 1,813</b>	<b>\$ 3,139</b>
<b>Total assets</b>	<b>\$ 323</b>	<b>\$ 11,871</b>	<b>\$ 13,754</b>
<b>Total long-term liabilities <sup>(5)</sup></b>	<b>\$ -</b>	<b>\$ 7,804</b>	<b>\$ 7,181</b>

(1) The results, financial position and cash flows of Air Canada are not consolidated with ACE effective October 27, 2009.

(2) The results and financial position of Aeroplan, Jazz and ACTS are not consolidated with ACE effective March 14, 2007, May 24, 2007 and October 16, 2007, respectively.

(3) Air Canada recorded a provision for cargo investigations of \$125 million in 2008.

(4) Non-operating income (expense) includes losses on ACE's investment in Air Canada of \$630 million in 2009, includes gains on assets which amounted to \$946 million in 2008, \$1,366 million in 2007. Also included are net gains on foreign exchange of \$531 million in 2009; net losses on foreign exchange of \$655 million in 2008; net gains on foreign exchange of \$313 million in 2007.

(5) Total long-term liabilities include long-term debt (including current portion) and capital leases, convertible preferred shares, pension and other benefit liabilities and other long-term liabilities.

**18. 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.

**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.