Second Quarter 2018

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

July 27, 2018

AIR CANADA

A STAR ALLIANCE MEMBER

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1. HIGHLIGHTS

The financial and operating highlights for Air Canada for the periods indicated are as follows:

(Canadian dollars in millions, except where indicated)	Second quarter			First six months		
	2018	2017 [1]	$ Change	2018	2017 [1]	$ Change
Financial Performance Metrics						
Operating revenues	4,333	3,910	423	8,404	7,552	852
Operating income	226	292	(66)	212	262	(50)
Income (loss) before income taxes	(71)	314	(385)	(255)	301	(556)
Net income (loss)	(77)	311	(388)	(247)	298	(545)
Adjusted pre-tax income [2]	163	229	(66)	91	166	(75)
Adjusted net income [2]	114	226	(112)	62	163	(101)
Operating margin %	5.2%	7.5%	(2.3) pp	2.5%	3.5%	(1.0) pp
EBITDAR (excluding special items) [2]	646	681	(35)	1,043	1,047	(4)
EBITDAR margin (excluding special items) % [2]	14.9%	17.4%	(2.5) pp	12.4%	13.9%	(1.5) pp
Unrestricted liquidity [3]	5,064	4,493	571	5,064	4,493	571
Net cash flows from operating activities	853	829	24	1,964	1,856	108
Free cash flow [2]	(13)	305	(318)	180	775	(595)
Adjusted net debt [2]	6,111	6,393	(282)	6,111	6,393	(282)
Return on invested capital ("ROIC") % [2]	13.7%	15.7%	(2.0) pp	13.7%	15.7%	(2.0) pp
Leverage ratio [2]	2.1	2.4	(0.3)	2.1	2.4	(0.3)
Diluted earnings (loss) per share	($0.28)	$1.13	($1.41)	($0.91)	$1.07	($1.98)
Adjusted earnings per share – diluted [2]	$0.41	$0.82	($0.41)	$0.22	$0.59	($0.37)
Operating Statistics [4]			% Change			% Change
Revenue passenger miles ("RPM") (millions)	22,654	20,928	8.2	43,094	39,269	9.7
Available seat miles ("ASM") (millions)	27,269	25,357	7.5	52,131	48,251	8.0
Passenger load factor %	83.1%	82.5%	0.5 pp	82.7%	81.4%	1.3 pp
Passenger revenue per RPM ("Yield") (cents)	17.3	17.0	2.0	17.2	17.0	1.2
Passenger revenue per ASM ("PRASM") (cents)	14.4	14.0	2.7	14.2	13.8	2.8
Operating revenue per ASM (cents)	15.9	15.4	3.0	16.1	15.7	3.0
Operating expense per ASM ("CASM") (cents)	15.1	14.3	5.6	15.7	15.1	4.0
Adjusted CASM (cents) [2]	10.6	10.7	(1.0)	11.1	11.1	(0.3)
Average number of full-time equivalent ("FTE") employees (thousands) [5]	30.0	27.8	8.0	29.4	27.3	7.7
Aircraft in operating fleet at period-end	413	393	5.1	413	393	5.1
Average fleet utilization (hours per day)	10.1	10.3	(2.0)	10.1	10.1	(0.4)
Seats dispatched (thousands)	15,713	14,962	5.0	30,645	29,242	4.8
Aircraft frequencies (thousands)	145.2	141.2	2.9	281.7	275.5	2.3
Average stage length (miles) [6]	1,736	1,695	2.4	1,701	1,650	3.1
Fuel cost per litre (cents)	80.2	61.3	30.9	76.9	62.2	23.6
Fuel litres (thousands)	1,370,194	1,300,061	5.4	2,652,032	2,493,793	6.3
Revenue passengers carried (thousands) [7]	12,535	11,895	5.4	24,189	22,819	6.0

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts. ROIC and leverage ratio as at June 30, 2017 have not been restated for the adoption of this new accounting standard. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

(2) Adjusted pre-tax income, adjusted net income, adjusted earnings per share – diluted, EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent), EBITDAR margin, leverage ratio, free cash flow, ROIC and adjusted CASM are each non-GAAP financial measures and adjusted net debt is an additional GAAP measure. Refer to sections 6 and 14 of this MD&A for descriptions of Air Canada's non-GAAP financial measures and additional GAAP measures. As referenced in the table above, special items are excluded from Air Canada's reported EBITDAR calculations. Refer to section 4 of this MD&A for information on the special items.

(3) Unrestricted liquidity refers to the sum of cash, cash equivalents, short-term investments and the amount of available credit under Air Canada's revolving credit facilities. At June 30, 2018, unrestricted liquidity was comprised of cash and short-term investments of $4,670 million and undrawn lines of credit of $394 million. At June 30, 2017, unrestricted liquidity was comprised of cash and short-term investments of $4,054 million and undrawn lines of credit of $439 million.

(4) Except for the reference to average number of FTE employees, operating statistics in this table include third party carriers (such as Jazz Aviation LP ("Jazz"), Sky Regional Airlines Inc. ("Sky Regional"), Air Georgian Limited ("Air Georgian") and Exploits Valley Air Services Ltd. ("EVAS")) operating under capacity purchase agreements with Air Canada.

(5) Reflects FTE employees at Air Canada. Excludes FTE employees at third party carriers (such as Jazz, Sky Regional, Air Georgian and EVAS) operating under capacity purchase agreements with Air Canada.

(6) Average stage length is calculated by dividing the total number of available seat miles by the total number of seats dispatched.

(7) Revenue passengers are counted on a flight number basis (rather than by journey/itinerary or by leg) which is consistent with the IATA definition of revenue passengers carried.

2. INTRODUCTION AND KEY ASSUMPTIONS

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers, as the context may require, to Air Canada and/or one or more of Air Canada's subsidiaries, including its wholly-owned operating subsidiaries, Touram Limited Partnership, doing business as Air Canada Vacations® ("Air Canada Vacations") and Air Canada rouge LP, doing business as Air Canada Rouge® ("Air Canada Rouge"). This MD&A provides the reader with a review and analysis, from the perspective of management, of Air Canada's financial results for the second quarter of 2018. This MD&A should be read in conjunction with Air Canada's interim unaudited condensed consolidated financial statements and notes for the second quarter of 2018, Air Canada's 2017 annual audited consolidated financial statements and notes and Air Canada's 2017 MD&A dated February 16, 2018 ("Air Canada's 2017 MD&A"). All financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), as set out in the CPA Canada Handbook – Accounting ("CPA Handbook"), which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), except for any financial information specifically denoted otherwise.

Air Canada's interim unaudited condensed consolidated financial statements for the second quarter of 2018 are based on the accounting policies consistent with those disclosed in Note 2 of Air Canada's 2017 annual consolidated financial statements, except for the adoption of accounting standard *IFRS 15 – Revenue from Contracts with Customers*. Air Canada adopted this accounting standard effective January 1, 2018 with restatement of 2017 amounts. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

Except as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 15 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of July 26, 2018.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 18 "Risk Factors" of Air Canada's 2017 MD&A and section 12 of this MD&A. Air Canada issued a news release dated July 27, 2018 reporting on its results for the second quarter of 2018. This news release is available on Air Canada's website at **www.aircanada.com** and on SEDAR's website at **www.sedar.com**. For further information on Air Canada's public disclosures, including Air Canada's Annual Information Form, consult SEDAR at **www.sedar.com**.

CAUTION REGARDING FORWARD-LOOKING INFORMATION

Air Canada's public communications may include forward-looking statements within the meaning of applicable securities laws. Such forward-looking statements are included in this MD&A and may be included in other communications, including filings with regulatory authorities and securities regulators. Forward-looking statements may be 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. Forward-looking statements are identified using 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, including those described herein and are subject to important risks and uncertainties. Forward-looking 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, our ability to successfully achieve or sustain positive net profitability or to realize our initiatives and objectives, industry, market, credit, economic and geopolitical conditions, energy prices, currency exchange, competition, our dependence on technology, cybersecurity risks, our ability to pay our indebtedness and secure financing, our ability to successfully implement appropriate strategic initiatives or reduce operating costs, war, terrorist acts, epidemic diseases, airport user and related fees, high levels of fixed costs, liquidity, our dependence on key suppliers including regional carriers and Aimia Canada Inc., our success in transitioning from the Aeroplan program and launching our new loyalty program, casualty losses, employee and labour relations and costs, our ability to preserve and grow our brand, pension issues, environmental factors (including weather systems and other natural phenomena and factors arising from man-made sources), limitations due to restrictive covenants, insurance issues and costs, our dependence on Star Alliance, interruptions of service, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties and our ability to attract and retain required personnel, as well as the factors identified in Air Canada's public disclosure file available at www.sedar.com and, in particular, those identified in section 18 "Risk Factors" of Air Canada's 2017 MD&A. The forward-looking statements contained or incorporated by reference in this MD&A represent Air Canada's expectations as of the date of this MD&A (or as of the date they are otherwise stated to be made) and are subject to change after such date. However, Air Canada disclaims any intention or obligation to update or revise any forward-looking statements whether because of new information, future events or otherwise, except as required under applicable securities regulations.

KEY ASSUMPTIONS

Assumptions were made by Air Canada in preparing and making forward-looking statements. As part of its assumptions, Air Canada assumes continued relatively modest Canadian GDP growth for the third quarter and full year 2018. Air Canada also expects that the Canadian dollar will trade, on average, at C$1.32 per U.S. dollar in the third quarter and at C$1.30 per U.S. dollar for the full year 2018 and that the price of jet fuel will average 80 CAD cents per litre in the third quarter and 78 CAD cents per litre for the full year 2018.

INTELLECTUAL PROPERTY

Air Canada owns or has rights to trademarks, service marks or trade names used in connection with the operation of its business. In addition, Air Canada's names, logos and website names and addresses are owned or licensed by Air Canada. Air Canada also owns or has the rights to copyrights that also protect the content of its products and/or services. Solely for convenience, the trademarks, service marks, trade names and copyrights referred to in this MD&A may be listed without the ©, ® and TM symbols, but Air Canada reserves all rights to assert, to the fullest extent under applicable law, its rights or the rights of the applicable licensors to these trademarks, service marks, trade names and copyrights.

This MD&A may also include trademarks, service marks or trade names of other parties. Air Canada's use or display of other parties' trademarks, service marks, trade names or products is not intended to, and does not imply a relationship with, or endorsement or sponsorship of Air Canada by, the trademark, service mark or trade name owners or licensees.

3. OVERVIEW

Air Canada's principal objective is to become one of the world's top global airlines. In pursuing this goal, it focuses on continuous improvement in customer experience and employee engagement and creating value for shareholders by targeting four core priorities:

- Identifying and implementing cost reduction and revenue enhancing initiatives;
- Pursuing profitable international growth opportunities and leveraging competitive attributes to expand margins, in large part by increasing connecting traffic through its strategic international gateways in Toronto, Vancouver and Montreal, and growing and competing effectively in both the business and leisure market to and from Canada;
- Engaging customers by continuously enhancing their travel experience and providing a consistently high level of customer service, with additional emphasis on premium and business passengers and products; and
- Fostering positive culture change through employee engagement programs. This includes meaningful investments in training and other tools that support delivering exceptional customer experience and that also promote improved collaboration and an appreciation of how the airline and its talented employees can better work together in a supportive and enriching environment.

Additional information on Air Canada's strategy can be found in section 4 "Strategy" of Air Canada's 2017 MD&A.

Financial Summary

The following is an overview of Air Canada's results of operations and financial position for the second quarter of 2018 compared to the second quarter of 2017.

- Record operating revenues of $4,333 million in the second quarter of 2018, an increase of $423 million or 11% from the second quarter of 2017. On capacity growth of 7.5%, record passenger revenues of $3,921 million increased $371 million or 10.4% from the second quarter of 2017.
- Operating expenses of $4,107 million in the second quarter of 2018, an increase of $489 million or 14% from the second quarter of 2017. CASM increased 5.6% from the second quarter of 2017. Adjusted CASM decreased 1.0% from the second quarter of 2017, better than the 0.5% to 1.5% increase projected in Air Canada's news release dated April 30, 2018. Air Canada's better than projected adjusted CASM performance was largely driven by the acceleration of aircraft lease extensions (mainly from the third quarter of 2018) which resulted in a decrease to maintenance provisions, the impact of cost reduction initiatives related to Air Canada's cost transformation program, and other operating expense reductions. Adjusted CASM is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Operating income of $226 million in the second quarter of 2018 compared to operating income of $292 million in the second quarter of 2017.
- EBITDAR of $646 million in the second quarter of 2018 compared to EBITDAR of $681 million in the second quarter of 2017. The airline reported a second quarter 2018 EBITDAR margin of 14.9% compared to an EBITDAR margin of 17.4% in the second quarter of 2017. Special items are excluded from all of Air Canada's reported EBITDAR calculations. Refer to section 4 of this MD&A for information on special items. EBITDAR is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

- A net loss of $77 million or $0.28 per diluted share in the second quarter of 2018 versus net income of $311 million or $1.13 per diluted share in the second quarter of 2017. In the second quarter of 2018, the net loss included a loss on disposal of assets of $186 million related to the expected sale of 25 Embraer 190 aircraft and losses on foreign exchange of $25 million. In the second quarter of 2017, net income included gains on foreign exchange of $68 million and a gain of $26 million on the sale and leaseback of two Boeing 787 aircraft. Refer to section 4 "Results of Operations" of this MD&A for additional information.

- Adjusted net income of $114 million or $0.41 per diluted share in the second quarter of 2018 versus adjusted net income of $226 million or $0.82 per diluted share in the second quarter of 2017. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

- At June 30, 2018, adjusted net debt of $6,111 million, a decrease of $5 million from December 31, 2017. An increase in long-term debt and finance lease balances of $889 million was largely offset by an increase in cash and short-term investment balances of $866 million and a decrease in capitalized operating lease balances of $28 million. Adjusted net debt is an additional GAAP measure. Refer to section 6.2 "Adjusted Net Debt" of this MD&A for additional information.

- Air Canada's leverage ratio (adjusted net debt to trailing 12-month EBITDAR) was 2.1 at June 30, 2018, unchanged from December 31, 2017. Leverage ratio is a non-GAAP financial measure. Refer to section 6.2 "Adjusted Net Debt" of this MD&A for additional information.

- Net cash flows from operating activities of $853 million in the second quarter of 2018, an improvement of $24 million from the second quarter of 2017. Negative free cash flow of $13 million represented a decrease of $318 million from the second quarter of 2017 mainly due to Air Canada having received proceeds of $371 million from the sale and leaseback of aircraft in the second quarter of 2017. No such sale and leasebacks were effected in the second quarter of 2018.

- Return on invested capital ("ROIC") for the 12 months ended June 30, 2018 of 13.7% compared to ROIC of 15.3% for the 12 months ended December 31, 2017. This decrease was mainly driven by lower adjusted net income and an increase in long-term debt as a result of Air Canada's fleet renewal strategy. ROIC is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

4. RESULTS OF OPERATIONS

The following table and discussion provides and compares results of Air Canada for the periods indicated:

(Canadian dollars in millions, except per share figures)	Second Quarter				First Six Months			
	2018	2017 [1]	Change $	Change %	2018	2017 [1]	Change $	Change %
Operating revenues								
Passenger	$ 3,921	$ 3,550	$ 371	10	$ 7,410	$ 6,670	$ 740	11
Cargo	200	168	32	19	368	316	52	16
Other	212	192	20	10	626	566	60	11
Total revenues	**4,333**	**3,910**	**423**	**11**	**8,404**	**7,552**	**852**	**11**
Operating expenses								
Aircraft fuel	964	701	263	38	1,789	1,360	429	32
Regional airlines expense								
Aircraft fuel	135	96	39	41	249	191	58	30
Other	607	552	55	10	1,168	1,089	79	7
Wages, salaries and benefits	711	663	48	7	1,411	1,307	104	8
Airport and navigation fees	237	230	7	3	458	440	18	4
Aircraft maintenance	220	226	(6)	(3)	476	454	22	5
Depreciation, amortization and impairment	278	242	36	15	545	470	75	16
Sales and distribution costs	199	188	11	6	388	369	19	5
Ground package costs	114	103	11	11	390	359	31	9
Aircraft rent	123	130	(7)	(5)	248	252	(4)	(2)
Catering and onboard services	108	97	11	11	204	182	22	12
Communications and IT	67	58	9	16	146	129	17	13
Special items	-	-	-	-	-	30	(30)	(100)
Other	344	332	12	4	720	658	62	9
Total operating expenses	**4,107**	**3,618**	**489**	**14**	**8,192**	**7,290**	**902**	**12**
Operating income	**226**	**292**	**(66)**		**212**	**262**	**(50)**	
Non-operating income (expense)								
Foreign exchange gain (loss)	(25)	68	(93)		(137)	138	(275)	
Interest income	24	14	10		44	26	18	
Interest expense	(84)	(80)	(4)		(167)	(159)	(8)	
Interest capitalized	7	9	(2)		20	18	2	
Net financing expense relating to employee benefits	(13)	(16)	3		(25)	(32)	7	
Gain (loss) on financial instruments recorded at fair value	(9)	7	(16)		(8)	7	(15)	
Gain on sale and leaseback of assets	-	26	(26)		-	52	(52)	
Gain (loss) on debt settlements and modifications	(1)	-	(1)		10	-	10	
Loss on disposal of assets	(186)	-	(186)		(186)	-	(186)	
Other	(10)	(6)	(4)		(18)	(11)	(7)	
Total non-operating income (expense)	**(297)**	**22**	**(319)**		**(467)**	**39**	**(506)**	
Income (loss) before income taxes	**(71)**	**314**	**(385)**		**(255)**	**301**	**(556)**	
Income tax (expense) recovery	(6)	(3)	(3)		8	(3)	11	
Net income (loss)	**$ (77)**	**$ 311**	**$ (388)**		**$ (247)**	**$ 298**	**$ (545)**	
Diluted earnings (loss) per share	**$ (0.28)**	**$ 1.13**	**$ (1.41)**		**$ (0.91)**	**$ 1.07**	**$ (1.98)**	
EBITDAR [2]	**$ 646**	**$ 681**	**$ (35)**		**$ 1,043**	**$ 1,047**	**$ (4)**	
Adjusted pre-tax income [2]	**$ 163**	**$ 229**	**$ (66)**		**$ 91**	**$ 166**	**$ (75)**	
Adjusted net income	**$ 114**	**$ 226**	**$ (112)**		**$ 62**	**$ 163**	**$ (101)**	
Adjusted earnings per share – diluted [2]	**$ 0.41**	**$ 0.82**	**$ (0.41)**		**$ 0.22**	**$ 0.59**	**$ (0.37)**	

(1) *Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts which are reflected in the table above. Refer to section 9 "Accounting Policies" of this MD&A for additional information.*

(2) *EBITDAR, adjusted pre-tax income, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.*

System Passenger Revenues

With the adoption of *IFRS 15 – Revenue from Contracts with Customers* effective January 1, 2018, certain passenger and cargo related fees were reclassified from Other revenue to Passenger revenue and Cargo revenue on Air Canada's consolidated statement of operations, with restatement of 2017 amounts. This reclassification has no impact on total operating revenue. Concurrent with this change in presentation, Air Canada has revised the methodology used to calculate yield and PRASM. These measures are now based on total passenger revenues, with restatement of 2017 amounts on the same basis.

In the second quarter of 2018, system passenger revenues of $3,921 million increased $371 million or 10.4% from the second quarter of 2017 on traffic growth of 8.2% and a yield improvement of 2.0%. On a stage-length adjusted basis, yield increased 3.4% when compared to the same quarter in 2017. Business cabin revenues, on a system-basis, increased $98 million or 13.7% from the second quarter of 2017 on traffic and yield growth of 10.3% and 3.1%, respectively.

The table below provides passenger revenue by geographic region for the second quarter of 2018 and the second quarter of 2017.

Passenger Revenue (Canadian dollars in millions)	**Second Quarter 2018**	**Second Quarter 2017 (1)**	**$ Change**	**% Change**
Canada	$ 1,210	$ 1,135	$ 75	6.6
U.S. transborder	865	794	71	8.9
Atlantic	1,035	878	157	17.8
Pacific	582	530	52	9.9
Other	229	213	16	7.6
System	**$ 3,921**	**$ 3,550**	**$ 371**	**10.4**

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts which are reflected in the table above. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the second quarter of 2018 versus the second quarter of 2017.

Second Quarter 2018 versus Second Quarter 2017 (1)	**Passenger Revenue % Change**	**Capacity (ASMs) % Change**	**Traffic (RPMs) % Change**	**Passenger Load Factor pp Change**	**Yield % Change**	**PRASM % Change**
Canada	6.6	3.2	2.6	(0.5)	3.9	3.2
U.S. transborder	8.9	6.8	6.6	(0.1)	2.2	2.0
Atlantic	17.8	11.9	15.5	2.6	1.9	5.3
Pacific	9.9	5.2	5.7	0.4	4.0	4.5
Other	7.6	11.7	8.6	(2.4)	(0.9)	(3.7)
System	**10.4**	**7.5**	**8.2**	**0.5**	**2.0**	**2.7**

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts which are reflected in the table above. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the second quarter of 2018 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q2'17 (1)	**Q3'17 (1)**	**Q4'17 (1)**	**Q1'18**	**Q2'18**
Passenger revenues	11.9	9.1	11.4	11.8	10.4
Capacity (ASMs)	13.5	9.1	9.5	8.6	7.5
Traffic (RPMs)	13.6	8.8	9.9	11.4	8.2
Passenger load factor (pp change)	0.1	(0.2)	0.3	2.1	0.5
Yield	(1.4)	0.4	1.4	0.4	2.0
PRASM	(1.2)	0.1	1.8	3.0	2.7

(1) To provide a more meaningful comparison, the year-over-year percentage comparisons from 2017 quarters to 2016 quarters are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in second quarter system passenger revenues included:

- The 8.2% traffic increase which reflected traffic growth in all markets and included gains in the business and premium economy cabins. Consistent with the airline's objective of increasing global international-to-international connecting traffic through its major Canadian hubs (sixth freedom traffic), the traffic growth in the second quarter of 2018 reflected an increase in connecting traffic via Canada to international destinations.

- The 2.0% system yield increase which reflected:

  - greater proportional growth of high-yielding business and premium economy passengers;
  - growth in high-yielding local traffic, an improvement in the overall fare mix and increases in fares and carrier surcharges;
  - an increase in ancillary revenues, including through advance seat selection/preferred seating fees and airport paid upgrades; and
  - the introduction of an expanded suite of fare offerings on domestic and U.S. transborder services.

  These factors were partly offset by the following:

  - an increase in average stage length of 2.4%, due to long-haul international expansion, which had the effect of reducing system yield by 1.4 percentage points; and
  - an unfavourable currency impact of $25 million when compared to the second quarter of 2017.

In the first six months of 2018, system passenger revenues of $7,410 million increased $740 million or 11.1% from the first six months of 2017.

The table below provides passenger revenue by geographic region for the first six months of 2018 versus the first six months of 2017.

Passenger Revenue (Canadian dollars in millions)	**First Six Months 2018**	**First Six Months 2017 (1)**	**$ Change**	**% Change**
Canada	$ 2,251	$ 2,118	$ 133	6.3
U.S. transborder	1,712	1,587	125	7.9
Atlantic	1,721	1,432	289	20.1
Pacific	1,093	977	116	11.9
Other	633	556	77	13.8
System	**$ 7,410**	**$ 6,670**	**$ 740**	**11.1**

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts which are reflected in the table above. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

The table below provides year-over-year percentage changes in passenger revenues and operating statistics by geographic region for the first six months of 2018 versus the first six months of 2017.

First Six Months 2018 versus First Six Months 2017 (1)	**Passenger Revenue % Change**	**Capacity (ASMs) % Change**	**Traffic (RPMs) % Change**	**Passenger Load Factor pp change**	**Yield % Change**	**PRASM % Change**
Canada	6.3	3.3	2.8	(0.4)	3.4	2.9
U.S. transborder	7.9	6.1	6.7	0.4	1.2	1.7
Atlantic	20.1	11.0	16.3	3.8	3.3	8.3
Pacific	11.9	8.4	10.4	1.5	1.4	3.2
Other	13.8	13.7	12.9	(0.6)	0.9	0.1
System	**11.1**	**8.0**	**9.7**	**1.3**	**1.2**	**2.8**

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts which are reflected in the table above. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

Components of the year-over-year change in system passenger revenues in the first six months of 2018 versus the first six months of 2017 included:

- The 9.7% traffic increase which reflected traffic growth in all markets and included gains in the business and premium economy cabins. The traffic growth in the first six months of 2018 reflected an increase in connecting traffic via Canada to international destinations.
- The 1.2% system yield increase which reflected:
  - greater proportional growth of high-yielding business and premium economy passengers;
  - growth in high-yielding local traffic, an improvement in the overall fare mix and increases in fares and carrier surcharges;
  - an increase in ancillary revenues, including through advance seat selection/preferred seating fees and airport paid upgrades; and

- the introduction of an expanded suite of fare offerings on domestic and U.S. transborder services.

These factors were partly offset by the following:

- an increase in average stage length of 3.1%, due to long-haul international expansion, which had the effect of reducing system yield by 1.8 percentage points; and

- an unfavourable currency impact of $48 million when compared to the first six months of 2017.

Domestic Passenger Revenues

In the second quarter of 2018, domestic passenger revenues of $1,210 million increased $75 million or 6.6% from the second quarter of 2017.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the second quarter of 2018 and each of the previous four quarters.

Canada	Year-over-Year by Quarter (% Change)				
	Q2'17 (1)	Q3'17 (1)	Q4'17 (1)	Q1'18	Q2'18
Passenger revenues	4.0	3.0	5.4	5.9	6.6
Capacity (ASMs)	2.8	1.5	1.4	3.4	3.2
Traffic (RPMs)	3.3	1.0	1.6	3.0	2.6
Passenger load factor (pp change)	0.5	(0.4)	0.2	(0.3)	(0.5)
Yield	0.8	2.2	3.5	2.8	3.9
PRASM	1.4	1.7	3.8	2.5	3.2

(1) To provide a more meaningful comparison, the year-over-year percentage comparisons from 2017 quarters to 2016 quarters are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in second quarter domestic passenger revenues included:

- The 2.6% traffic increase which reflected strong passenger demand on services within Canada as well as incremental connecting traffic to international destinations.

- The 3.9% yield increase which reflected yield improvements on all major domestic services, including gains in the business cabin as well as the launch of new fare categories on domestic services.

In the first six months of 2018, domestic passenger revenues of $2,251 million increased $133 million or 6.3% from the first six months of 2017 on a yield improvement of 3.4% and traffic growth of 2.8%.

U.S. Transborder Passenger Revenues

In the second quarter of 2018, U.S. transborder passenger revenues of $865 million increased $71 million or 8.9% from the second quarter of 2017.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the second quarter of 2018 and each of the previous four quarters.

U.S. transborder	Year-over-Year by Quarter (% Change)				
	Q2'17 (1)	Q3'17 (1)	Q4'17 (1)	Q1'18	Q2'18
Passenger revenues	16.3	8.0	6.3	6.9	8.9
Capacity (ASMs)	15.2	10.9	6.7	5.5	6.8
Traffic (RPMs)	16.2	9.3	7.1	6.7	6.6
Passenger load factor (pp change)	0.7	(1.2)	0.3	0.9	(0.1)
Yield	0.3	(1.0)	(0.7)	0.1	2.2
PRASM	1.2	(2.4)	(0.3)	1.3	2.0

(1) To provide a more meaningful comparison, the year-over-year percentage comparisons from 2017 quarters to 2016 quarters are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in second quarter U.S. transborder passenger revenues included:

- The 6.6% traffic increase which reflected traffic growth on all major U.S. transborder services and included gains in the business cabin. Strong passenger demand between Canada and the U.S. and growth of international-to-international connecting passenger flows from the U.S. were also contributing factors to the yield growth year-over-year.

- The 2.2% yield increase which reflected yield growth on all major U.S. transborder services with the exception of U.S. short-haul routes. The launch of new fare categories on U.S. transborder services contributed to the yield improvement year-over-year. An unfavourable currency impact of $12 million when compared to the second quarter of 2017 was a partly offsetting factor to the yield growth year-over-year.

In the first six months of 2018, U.S. transborder passenger revenues of $1,712 million increased $125 million or 7.9% from the first six months of 2017 on traffic and yield growth of 6.7% and 1.2%, respectively.

Atlantic Passenger Revenues

In the second quarter of 2018, Atlantic passenger revenues of $1,035 million increased $157 million or 17.8% from the second quarter of 2017.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the second quarter of 2018 and each of the previous four quarters.

Atlantic	Year-over-Year by Quarter (% Change)				
	Q2'17 (1)	Q3'17 (1)	Q4'17 (1)	Q1'18	Q2'18
Passenger revenues	14.3	17.7	22.2	23.9	17.8
Capacity (ASMs)	12.6	13.3	13.9	9.6	11.9
Traffic (RPMs)	13.7	13.7	14.4	17.5	15.5
Passenger load factor (pp change)	0.8	0.3	0.3	5.4	2.6
Yield	0.6	3.5	6.8	5.4	1.9
PRASM	1.5	3.9	7.3	13.0	5.3

(1) To provide a more meaningful comparison, the year-over-year percentage comparisons from 2017 quarters to 2016 quarters are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in second quarter Atlantic passenger revenues included:

- The 15.5% traffic increase which reflected traffic growth on most major Atlantic services and included gains in all cabins. The capacity growth was largely due to the launch of new services from Vancouver to France and Switzerland; from Toronto to Ireland, Portugal, Romania and Croatia; and from Montreal to Ireland, Romania and Portugal.

- The 1.9% yield increase which reflected yield improvements on all major Atlantic services and included an increase in carrier surcharges year-over-year. An increase in average stage length of 2.2% had the effect of reducing Atlantic yield by 1.3 percentage points.

In the first six months of 2018, Atlantic passenger revenues of $1,721 million increased $289 million or 20.1% from the first six months of 2017 on traffic and yield growth of 16.3% and 3.3%, respectively.

Pacific Passenger Revenues

In the second quarter of 2018, Pacific passenger revenues of $582 million increased $52 million or 9.9% from the second quarter of 2017.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the second quarter of 2018 and each of the previous four quarters.

Pacific	Year-over-Year by Quarter (% Change)				
	Q2'17 (1)	Q3'17 (1)	Q4'17 (1)	Q1'18	Q2'18
Passenger revenues	12.5	5.7	13.5	14.2	9.9
Capacity (ASMs)	23.2	10.1	12.2	12.0	5.2
Traffic (RPMs)	19.7	9.4	13.7	15.9	5.7
Passenger load factor (pp change)	(2.5)	(0.6)	1.0	2.8	0.4
Yield	(6.0)	(3.4)	(0.2)	(1.5)	4.0
PRASM	(8.7)	(4.0)	1.1	1.9	4.5

(1) To provide a more meaningful comparison, the year-over-year percentage comparisons from 2017 quarters to 2016 quarters are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in second quarter Pacific passenger revenues included:

- The 5.7% traffic increase which reflected traffic growth on all major Pacific services with the exception of services to Japan and Hong Kong where capacity was reduced year-over-year. The overall traffic increase included gains in the business and premium economy cabins.

- The 4.0% yield increase which reflected yield growth on all Pacific services. The yield improvement year-over-year was in large part due to an increase in carrier surcharges, particularly in Japan and Korea, and an improvement in the Pacific fare mix.

In the first six months of 2018, Pacific passenger revenues of $1,093 million increased $116 million or 11.9% from the first six months of 2017 on traffic and yield growth of 10.4% and 1.4%, respectively.

Other Passenger Revenues

In the second quarter of 2018, Other passenger revenues (from routes to and from the Caribbean, Mexico and Central and South America) of $229 million increased $16 million or 7.6% from the second quarter of 2017.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the second quarter of 2018 and each of the previous four quarters.

Other	Year-over-Year by Quarter (% Change)				
	Q2'17 (1)	Q3'17 (1)	Q4'17 (1)	Q1'18	Q2'18
Passenger revenues	34.7	15.3	23.7	17.7	7.6
Capacity (ASMs)	24.1	8.4	18.7	15.0	11.7
Traffic (RPMs)	26.4	10.1	17.9	15.6	8.6
Passenger load factor (pp change)	1.5	1.4	(0.6)	0.4	(2.4)
Yield	6.5	4.4	4.8	1.9	(0.9)
PRASM	8.4	6.1	4.1	2.4	(3.7)

(1) To provide a more meaningful comparison, the year-over-year percentage comparisons from 2017 quarters to 2016 quarters are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in second quarter Other passenger revenues included:

- The 8.6% traffic increase which reflected traffic growth on services to South America and on routes to traditional sun destinations. The traffic growth included gains in all cabins.
- The 0.9% yield decrease which mainly reflected a yield decline on services to South America and Mexico. Caribbean markets performed well in the second quarter of 2018, with yield growth when compared to the second quarter of 2017.

In the first six months of 2018, Other passenger revenues of $633 million increased $77 million or 13.8% from the first six months of 2017 on traffic and yield growth of 12.9% and 0.9%, respectively.

Cargo Revenues

Cargo revenues of $200 million in the second quarter of 2018 and $368 million in the first six months of 2018 increased $32 million or 19.4% and $52 million and 16.6%, respectively, from the same periods in 2017. When compared to the 2017 periods, cargo traffic and yield increased 10.6% and 8.0%, respectively, in the second quarter of 2018, and 8.7% and 7.3%, respectively, in the first six months of 2018. The growth in traffic was in part due to the introduction of new international routes. In the second quarter and the first six months of 2018, the Atlantic and Pacific markets experienced particularly strong performances from both a traffic and yield perspective.

The table below provides cargo revenue by geographic region for the periods indicated.

Cargo revenue (Canadian dollars in millions)	Second Quarter				First Six Months			
	2018	2017 (1)	Change $	Change %	2018	2017 (1)	Change $	Change %
Canada	$ 24	$ 20	$ 4	19.1	$ 43	$ 38	$ 5	12.5
U.S. transborder	10	10	-	12.7	19	18	1	9.2
Atlantic	70	57	13	22.5	132	111	21	18.7
Pacific	82	67	15	21.9	146	121	25	20.0
Other	14	14	-	0.5	28	28	-	3.8
System	**$ 200**	**$ 168**	**$ 32**	**19.4**	**$ 368**	**$ 316**	**$ 52**	**16.6**

(1) *Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts which are reflected in the table above. Refer to section 9 "Accounting Policies" of this MD&A for additional information.*

Other Revenues

Other revenues of $212 million in the second quarter of 2018 and $626 million in the first six months of 2018 increased $20 million or 10% and $60 million or 11%, respectively, from the same periods in 2017. These increases reflected growth in ground package revenues at Air Canada Vacations, primarily the result of higher passenger volumes.

CASM and Adjusted CASM

In the second quarter of 2018, CASM increased 5.6% and adjusted CASM decreased 1.0%. In the first six months of 2018, CASM increased 4.0% and adjusted CASM decreased 0.3%. The following table compares Air Canada's CASM and adjusted CASM for the periods indicated.

(cents per ASM)	Second Quarter				First Six Months			
	2018	2017 (1)	Change ¢	Change %	2018	2017 (1)	Change ¢	Change %
Aircraft fuel	3.53	2.77	0.76	27.8	3.43	2.82	0.61	21.8
Regional airlines expense								
Aircraft fuel	0.50	0.38	0.12	31.5	0.48	0.40	0.08	20.9
Other	2.22	2.17	0.05	2.3	2.24	2.26	(0.02)	(0.8)
Wages and salaries	1.95	1.99	(0.04)	(1.9)	2.01	2.02	(0.01)	(0.7)
Benefits	0.65	0.62	0.03	4.8	0.70	0.68	0.02	1.9
Airport and navigation fees	0.87	0.91	(0.04)	(4.6)	0.88	0.91	(0.03)	(3.9)
Aircraft maintenance	0.81	0.89	(0.08)	(9.5)	0.91	0.94	(0.03)	(3.0)
Depreciation, amortization and impairment	1.02	0.95	0.07	7.0	1.04	0.97	0.07	7.2
Sales and distribution costs	0.73	0.74	(0.01)	(1.1)	0.74	0.76	(0.02)	(2.7)
Ground package costs	0.42	0.40	0.02	2.9	0.75	0.74	0.01	0.5
Aircraft rent	0.45	0.51	(0.06)	(11.9)	0.48	0.52	(0.04)	(8.9)
Catering and onboard services	0.40	0.38	0.02	4.3	0.39	0.38	0.01	4.1
Communications and IT	0.25	0.23	0.02	9.3	0.28	0.27	0.01	5.2
Special items	-	-	-	-	-	0.06	(0.06)	(100.0)
Other	1.26	1.33	(0.07)	(4.2)	1.38	1.38	-	1.1
CASM	**15.06**	**14.27**	**0.79**	**5.6**	**15.71**	**15.11**	**0.60**	**4.0**
Remove:								
Aircraft fuel expense (2), ground package costs at Air Canada Vacations and special items	(4.45)	(3.55)	(0.90)	(25.4)	(4.65)	(4.02)	(0.63)	(15.9)
Adjusted CASM (3)	**10.61**	**10.72**	**(0.11)**	**(1.0)**	**11.06**	**11.09**	**(0.03)**	**(0.3)**

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts which are reflected in the table above. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

(2) Includes aircraft fuel expense related to regional airline operations.

(3) Adjusted CASM is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating Expenses

In the second quarter of 2018, operating expenses of $4,107 million increased $489 million or 14% from the second quarter of 2017 on capacity growth of 7.5%. In the second quarter of 2018, the favourable impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), compared to the second quarter of 2017, decreased operating expenses by $47 million (comprised of $11 million relating to aircraft fuel expense and an aggregate of $36 million relating to non-fuel operating expenses).

In the first six months of 2018, operating expenses of $8,192 million increased $902 million or 12% from the first six months of 2017 on capacity growth of 8.0%. In the first six months of 2018, the favourable impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), compared to the first six months of 2017, decreased operating expenses by $123 million (comprised of $48 million relating to aircraft fuel expense and an aggregate of $75 million relating to non-fuel operating expenses).

The more notable components of the year-over-year change in operating expenses are described below.

Aircraft Fuel Expense

In the second quarter of 2018, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to $1,099 million, an increase of $302 million or 38% from the second quarter of 2017. This increase reflected higher jet fuel prices (before the impact of foreign exchange), which accounted for an increase of $272 million, and a higher volume of fuel litres consumed, which accounted for an increase of $43 million. These increases were partly offset by a favourable currency impact of $11 million and other factors of $2 million.

In the first six months of 2018, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to $2,038 million, an increase of $487 million or 31% from the first six months of 2017. This increase reflected higher jet fuel prices (before the impact of foreign exchange), which accounted for an increase of $443 million, and a higher volume of fuel litres consumed, which accounted for an increase of $98 million. These increases were partly offset by a favourable currency impact of $48 million and other factors of $6 million.

Regional Airlines Expense

Regional airlines expense of $742 million in the second quarter of 2018 and $1,417 million in the first six months of 2018 increased $94 million or 15% and $137 million or 11%, respectively, from the same periods in 2017. These increases primarily reflected an increase in aircraft fuel expense year-over-year, higher CPA rates versus the same periods of 2017, and increased flying, particularly in the first quarter of 2018. A favourable currency impact was a partly offsetting factor. The growth in CPA rates in the second quarter of 2018 was primarily driven by an increase in engine maintenance expense when compared to the second quarter of 2017, in large part due to a higher volume of maintenance activity.

The following table provides a breakdown of regional airlines expense for the periods indicated:

(Canadian dollars in millions)	Second Quarter				First Six Months			
	2018	2017	Change $	Change %	2018	2017	Change $	Change %
Capacity purchase fees	$ 360	$ 314	$ 46	15	$ 679	$ 622	$ 57	9
Aircraft fuel	135	96	39	41	249	191	58	30
Airport and navigation	76	73	3	4	145	142	3	2
Sales and distribution costs	41	40	1	3	75	77	(2)	(3)
Depreciation, amortization and impairment	9	7	2	29	18	13	5	38
Aircraft rent	10	10	-	-	20	20	-	-
Other operating expenses	111	108	3	3	231	215	16	7
Total regional airlines expense	**$ 742**	**$ 648**	**$ 94**	**15**	**$ 1,417**	**$ 1,280**	**$ 137**	**11**

Wages, Salaries and Benefits Expense

Wages and salaries expense of $533 million in the second quarter of 2018 and $1,048 million in the first six months of 2018 increased $28 million or 6% and $71 million or 7%, respectively, from the same periods in 2017. These increases were largely due to a higher number of full-time equivalent ("FTE") employees, largely in support of the airline's international growth. A reduction in stock-based compensation expense, particularly in the second quarter of 2018, was a partly offsetting factor.

Employee benefits expense of $178 million in the second quarter of 2018 and $363 million in the first six months of 2018 increased $20 million or 13% and $33 million or 10%, respectively, from the same periods in 2017. These increases were mainly due to the higher level of FTE employees and the impact of lower discount rates, which increased the current service cost of defined benefit pension plans.

Airport and Navigation Fees

Airport and navigation fees of $237 million in the second quarter of 2018 and $458 million in the first six months of 2018 increased $7 million or 3% and $18 million or 4%, respectively, from the same periods in 2017. These increases were largely due to growth in wide-body and international flying. The favourable impact of Air Canada's agreement with the Greater Toronto Airports Authority, which is allowing the airline to increase international connecting traffic at Toronto Pearson International Airport on a more cost-effective basis, a 3.9% Nav Canada rate reduction effective September 1, 2017, and a favourable currency impact were largely offsetting factors.

Aircraft Maintenance Expense

In the second quarter of 2018, aircraft maintenance expense of $220 million decreased $6 million or 3% from the second quarter of 2017 reflecting, in large part, the impact of having a greater number of aircraft leases being extended in the second quarter of 2018 and a favourable currency impact. Lease term extensions postpone the expected timing of the end of lease costs and lengthen the period over which expenses are recorded, resulting in a cumulative adjustment to reflect the revised provision required as at the balance sheet date, thus reducing maintenance expense in the period. These increases were partly offset by a higher level of engine maintenance activity year-over-year.

In the first six months of 2018, aircraft maintenance expense of $476 million increased $22 million or 5% from the first six months of 2017. This increase was mainly due to a higher level of engine maintenance activity in the first six months of 2018 versus the first six months of 2017, and largely offset by the impact of having a greater number of aircraft leases being extended in the first six months of 2018 versus the same period in 2017, more favourable end-of-lease conditions on aircraft lease extensions, and a favourable currency impact.

The following table provides a breakdown of the more significant items included in maintenance expense for the periods indicated:

(Canadian dollars in millions)	Second Quarter				First Six Months			
	2018	2017	Change $	Change %	2018	2017	Change $	Change %
Technical maintenance	$ 232	$ 220	$ 12	5	$ 457	$ 415	$ 42	10
Maintenance provisions (1)	(16)	7	(23)	(329)	4	34	(30)	(88)
Other	4	(1)	5	500	15	5	10	200
Total aircraft maintenance expense	**$ 220**	**$ 226**	**$ (6)**	**(3)**	**$ 476**	**$ 454**	**$ 22**	**5**

(1) Maintenance provisions relate to return conditions on aircraft leases which are recorded over the term of the lease.

Depreciation, Amortization and Impairment Expense

Depreciation, amortization and impairment expense of $278 million in the second quarter of 2018 and $545 million in the first six months of 2018 increased $36 million or 15% and $75 million or 16%, respectively, from the same periods in 2017. These increases were largely due to the addition of Boeing 787 and 737 MAX aircraft into the mainline fleet.

Sales and Distribution Costs

Sales and distribution costs of $199 million in the second quarter of 2018 and $388 million in the first six months of 2018 increased $11 million or 6% and $19 million or 5%, respectively, from the same periods in 2017. These increases reflected, in large part, the growth in passenger revenue. The favourable impact of new commission programs introduced in North America in April 2018 and growth in direct bookings when compared to the same periods in 2017 were offsetting factors.

Ground Package Costs

The cost of ground packages at Air Canada Vacations of $114 million in the second quarter of 2018 and $390 million in the first six months of 2018 increased $11 million or 11% and $31 million or 9%, respectively, from the same periods in 2017. These increases reflected higher passenger volumes year-over-year and a higher cost of ground packages (before the impact of foreign exchange), partly offset by a favourable currency impact.

Aircraft Rent

Aircraft rent expense of $123 million in the second quarter of 2018 and $248 million in the first six months of 2018 decreased $7 million or 5% and $4 million or 2%, respectively, from the same periods in 2017. These decreases reflected a favourable currency impact and the impact of lower rates on certain lease renewals, largely offset by the impact of a greater number of leased aircraft, primarily Boeing 787 aircraft.

Special Items

In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations. Air Canada paid the fine in the second quarter of 2017. Air Canada has appealed the decision. While Air Canada cannot predict with certainty the outcome of its appeal or any related proceedings, Air Canada believes it has reasonable grounds to challenge the European Commission's ruling. Refer to "Current legal proceedings' under section 18 "Risk Factors" of Air Canada's 2017 MD&A for additional information.

Other Expenses

Other expenses of $344 million in the second quarter of 2018 and $720 million in the first six months of 2018 increased $12 million or 4% and $62 million or 9%, respectively, from the same periods in 2017. These increases reflected, in large part, the capacity growth and Air Canada's international expansion strategy. The first quarter of 2018 included expenses of $26 million related to new uniforms as well as an increase in customer service expense of $9 million, reflecting the impact of operational disruptions caused by severe weather.

The following table provides a breakdown of the more significant items included in other expenses:

(Canadian dollars in millions)	Second Quarter 2018	Second Quarter 2017	Change $	Change %	First Six Months 2018	First Six Months 2017	Change $	Change %
Terminal handling	$ 82	$ 73	$ 9	12	$ 156	$ 141	$ 15	11
Crew cycle	51	47	4	9	98	91	7	8
Building rent and maintenance	42	43	(1)	(2)	85	85	-	-
Miscellaneous fees and services	35	37	(2)	(5)	77	74	3	4
Remaining other expenses	134	132	2	2	304	267	37	14
Total other expenses	**$ 344**	**$ 332**	**$ 12**	**4**	**$ 720**	**$ 658**	**$ 62**	**9**

Non-operating Income (Expense)

In the second quarter of 2018, non-operating expense amounted to $297 million versus non-operating income of $22 million in the second quarter of 2017. In the first six months of 2018, non-operating expense amounted to $467 million versus non-operating income of $39 million in the first six months of 2017.

Components of the year-over-year change in non-operating income (expense) included:

- In the second quarter of 2018, losses on foreign exchange amounted to $25 million compared to gains on foreign exchange of $68 million in the second quarter of 2017. Foreign exchange losses on U.S. denominated long-term debt of $108 million were offset by foreign exchange gains on foreign currency derivatives of $111 million. The foreign exchange losses in the second quarter of 2018 were attributable to a weaker Canadian dollar at June 30, 2018 when compared to March 31, 2018. The June 30, 2018 closing exchange rate was US$1=C$1.3133 while the March 31, 2018 closing exchange rate was US$1=C$1.2900. In the first six months of 2018, losses on foreign exchange amounted to $137 million compared to gains on foreign exchange of $138 million in the first six months of 2017. Foreign exchange losses on U.S. denominated long-term debt of $280 million were partly offset by foreign exchange gains on foreign currency derivatives of $174 million. The foreign exchange losses in the first six months of 2018 were attributable to a weaker Canadian dollar at June 30, 2018 when compared to December 31, 2017. The December 31, 2017 closing exchange rate was US$1=C$1.2571.

- Air Canada recorded a gain of $26 million on the sale and leaseback of two Boeing 787-9 aircraft in the second quarter of 2017 ($52 million in the first six months of 2017 on the sale and leaseback of four Boeing 787-9 aircraft), whereas no such gains were recorded in the second quarter of 2018.

- Air Canada recorded a gain of $11 million on debt modifications related to the repricing (in February 2018) of the airline's US$1.1 billion senior secured credit facility in the first six months of 2018, whereas no such gains were recorded in the first six months of 2017.

- Air Canada recorded a loss on disposal of assets of $186 million in the second quarter of 2018 related to the expected sale of 25 Embraer 190 aircraft, whereas no such loss was recorded in the second quarter of 2017. Net proceeds from the sale of these aircraft of $296 million are expected in the third quarter of 2018.

5. FLEET

The table below provides the number of aircraft in Air Canada's operating fleet as at June 30, 2018 and December 31, 2017 as well as Air Canada's planned operating fleet, including aircraft operating and expected to be operated by Air Canada Rouge, as at December 31, 2018 and December 31, 2019.

	Actual			Planned			
	December 31, 2017	**First Six Months 2018 Fleet Changes**	**June 30, 2018**	**Remainder of 2018 Fleet Changes**	**December 31, 2018**	**2019 Fleet Changes**	**December 31, 2019**
Mainline							
Wide-body Aircraft							
Boeing 787-8	**8**	-	**8**	-	**8**	-	**8**
Boeing 787-9	**22**	5	**27**	-	**27**	2	**29**
Boeing 777-300ER	**19**	-	**19**	-	**19**	-	**19**
Boeing 777-200LR	**6**	-	**6**	-	**6**	-	**6**
Boeing 767-300ER	**10**	(3)	**7**	(1)	**6**	(5)	**1**
Airbus A330-300	**8**	-	**8**	-	**8**	4	**12**
Narrow-body Aircraft							
Boeing 737 MAX 8	**2**	16	**18**	-	**18**	18	**36**
Airbus A321	**15**	-	**15**	-	**15**	-	**15**
Airbus A320	**42**	-	**42**	-	**42**	(11)	**31**
Airbus A319	**18**	(2)	**16**	-	**16**	(2)	**14**
Airbus A220-300	**-**	-	**-**	-	**-**	1	**1**
Embraer 190	**25**	-	**25**	(6)	**19**	(5)	**14**
Total Mainline	**175**	**16**	**191**	**(7)**	**184**	**2**	**186**
Air Canada Rouge							
Wide-body Aircraft							
Boeing 767-300ER	**24**	1	**25**	-	**25**	-	**25**
Narrow-body Aircraft							
Airbus A321	**5**	1	**6**	-	**6**	-	**6**
Airbus A320	**-**	-	**-**	-	**-**	3	**3**
Airbus A319	**20**	2	**22**	-	**22**	-	**22**
Total Air Canada Rouge	**49**	**4**	**53**	**-**	**53**	**3**	**56**
Total Wide-body Aircraft	**97**	3	**100**	(1)	**99**	1	**100**
Total Narrow-body Aircraft	**127**	17	**144**	(6)	**138**	4	**142**
Total Mainline and Air Canada Rouge	**224**	**20**	**244**	**(7)**	**237**	**5**	**242**

Sale of Embraer 190 Aircraft

In July 2018, Air Canada entered into final negotiations for the sale and leaseback of 25 Embraer 190 aircraft. Air Canada will continue to operate these until they gradually exit the fleet between 2018 to 2020.

Air Canada Express

The table below provides, as at June 30, 2018, the number of aircraft operated, on behalf of Air Canada, by Jazz, Sky Regional and other airlines operating flights under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada. No changes are expected to the Air Canada Express fleet between June 30, 2018 and December 31, 2018.

	As at June 30, 2018			
	Jazz	**Sky Regional**	**Other**	**Total**
Embraer 175	-	25	-	25
Bombardier CRJ-100/200	10	-	14	24
Bombardier CRJ-705/900	21	-	-	21
Bombardier Dash 8-100	15	-	-	15
Bombardier Dash 8-300	26	-	-	26
Bombardier Dash 8-Q400	44	-	-	44
Total Air Canada Express	**116**	**25**	**14**	**155**

Other Aircraft with CPA Carriers

Air Georgian and EVAS also operate a total of 14 18-passenger Beech 1900 aircraft on behalf of Air Canada pursuant to their capacity purchase agreements with Air Canada.

6. FINANCIAL AND CAPITAL MANAGEMENT

6.1. Financial Position

The following table provides a condensed consolidated statement of financial position of Air Canada as at June 30, 2018 and as at December 31, 2017:

(Canadian dollars in millions)	June 30, 2018	December 31, 2017 (1)	$ Change
Assets			
Cash, cash equivalents and short-term investments	$ 4,670	$ 3,804	$ 866
Other current assets	1,904	1,593	311
Current assets	**$ 6,574**	**$ 5,397**	**$ 1,177**
Deposits and other assets	418	465	(47)
Property and equipment	9,911	9,252	659
Pension assets	2,383	1,583	800
Deferred income tax	190	456	(266)
Intangible assets	350	318	32
Goodwill	311	311	-
Total assets	**$ 20,137**	**$ 17,782**	**$ 2,355**
Liabilities			
Current liabilities	$ 5,916	$ 5,101	$ 815
Long-term debt and finance leases	6,567	5,448	1,119
Pension and other benefit liabilities	2,502	2,592	(90)
Maintenance provisions	1,065	1,003	62
Other long-term liabilities	180	216	(36)
Total liabilities	**$ 16,230**	**$ 14,360**	**$ 1,870**
Total shareholders' equity	**$ 3,907**	**$ 3,422**	**$ 485**
Total liabilities and shareholders' equity	**$ 20,137**	**$ 17,782**	**$ 2,355**

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts which are reflected in the table above. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

Movements in current assets and current liabilities are described in section 6.3 "Working Capital" of this MD&A. Long-term debt and finance leases are discussed in sections 6.2 "Adjusted Net Debt" and 6.4 "Consolidated Cash Flow Movements" of this MD&A.

At June 30, 2018, property and equipment amounted to $9,911 million, an increase of $659 million from December 31, 2017. This increase was mainly due to additions to property and equipment of $1,733 million, offset by the impact of depreciation expense of $536 million and the reclassification of 25 Embraer 190 aircraft to Assets held for sale on Air Canada's consolidated statement of financial position.

In the first six months of 2018, additions to property and equipment included five Boeing 787-9 aircraft and 16 Boeing 737 MAX 8 aircraft. Four Boeing 787 and nine Boeing 737 aircraft were financed with proceeds from the sale of enhanced equipment trust certificates (EETCs) issued through a U.S. dollar private offering in 2017, one Boeing 787 and four Boeing 737 aircraft were financed with proceeds from the sale of EETCs issued through a Canadian dollar private offering in 2018, and three Boeing 737 aircraft were purchased with cash. Additional information on these EETC private offerings can be found in section 6.7 "Contractual Obligations" of this MD&A. In the first six months of 2018, additions to property and equipment also included progress payments on future aircraft deliveries and capitalized maintenance costs.

The net long-term pension and other benefit liabilities of $119 million (comprised of pension and other benefit liabilities of $2,502 million net of pension assets of $2,383 million) decreased $890 million from December 31, 2017. This decrease was mainly due to a 20-basis point increase in the discount rate used to value the liabilities and the impact of revised demographic assumptions, resulting in a net gain on remeasurements on employee liabilities of $1,026 million for the six months ended June 30, 2018 ($751 million, net of tax) recorded on Air Canada's consolidated statement of comprehensive income. The revised demographic assumptions relate mainly to updated actuarial assumptions regarding retirement rates, which resulted in a decrease to the actuarial liability of $262 million.

6.2. Adjusted Net Debt

The following table reflects Air Canada's adjusted net debt balances as at June 30, 2018 and as at December 31, 2017:

(Canadian dollars in millions, except where indicated)	June 30, 2018	December 31, 2017	$ Change
Total long-term debt and finance leases	$ 6,567	$ 5,448	$ 1,119
Current portion of long-term debt and finance leases	441	671	(230)
Total long-term debt and finance leases (including current portion)	**$ 7,008**	**$ 6,119**	**$ 889**
Less cash, cash equivalents and short-term investments	(4,670)	(3,804)	(866)
Net debt	**$ 2,338**	**$ 2,315**	**$ 23**
Capitalized operating leases (1)	3,773	3,801	(28)
Adjusted net debt (1)	**$ 6,111**	**$ 6,116**	**$ (5)**
EBITDAR (trailing 12 months)	**$ 2,924**	**$ 2,928**	**$ (4)**
Adjusted net debt to EBITDAR ratio (2)	**2.1**	**2.1**	**-**

(1) *Adjusted net debt is an additional GAAP financial measure and a key component of the capital managed by Air Canada and provides management with a measure of its net indebtedness. Air Canada includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7. This definition of capitalized operating leases is used by Air Canada and may not be comparable to similar measures presented by other public companies. Aircraft rent (including aircraft rent expense related to regional airline operations) was $539 million for the 12 months ended June 30, 2018 and $543 million for the 12 months ended December 31, 2017.*

(2) *Adjusted net debt to trailing 12-month EBITDAR ratio (also referred to as "leverage ratio" in this MD&A) is a non-GAAP financial measure and is used by Air Canada as a means to measure financial leverage. Leverage ratio is calculated by dividing adjusted net debt by trailing 12-month EBITDAR. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information. Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts. Refer to section 9 "Accounting Policies" of this MD&A for additional information.*

At June 30, 2018, total long-term debt and finance leases (including current portion) of $7,008 million increased $889 million from December 31, 2017. In the first six months of 2018, new aircraft-related borrowings amounted to $1,210 million and the unfavourable impact of a weaker Canadian dollar, as at June 30, 2018 compared to December 31, 2017, increased foreign currency denominated debt (mainly U.S. dollars) by $280 million. These increases were partly offset by debt repayments of $584 million.

At June 30, 2018, adjusted net debt of $6,111 million, decreased $5 million from December 31, 2017, as the increase in long-term debt and finance lease balances of $889 million was largely offset by the increase in cash and short-term investment balances of $866 million and the decrease in capitalized operating lease balances of $28 million. At June 30, 2018, Air Canada's leverage ratio (adjusted net debt to trailing 12-month EBITDAR) ratio was 2.1, unchanged from December 31, 2017.

At June 30, 2018, Air Canada's weighted average cost of capital ("WACC"), on a pre-tax basis, was approximately 7.5% (compared to approximately 7.6% at December 31, 2017). WACC is based on an estimate by management and consists of an estimated cost of equity of 20% and an average cost of debt and finance leases of 4.3% (compared to an estimated cost of equity of 20.0% and an average cost of debt and finance leases of 4.5% at December 31, 2017).

6.3. Working Capital

The following table provides information on Air Canada's working capital balances as at June 30, 2018 and as at December 31, 2017:

(Canadian dollars in millions)	June 30, 2018	December 31, 2017 (1)	$ Change
Cash, cash equivalents and short-term investments	$ 4,670	$ 3,804	$ 866
Accounts receivable	976	814	162
Other current assets	928	779	149
Total current assets	**$ 6,574**	**$ 5,397**	**$ 1,177**
Accounts payable and accrued liabilities	1,945	1,961	(16)
Advance ticket sales	3,530	2,469	1,061
Current portion of long-term debt and finance leases	441	671	(230)
Total current liabilities	**$ 5,916**	**$ 5,101**	**$ 815**
Net working capital	**$ 658**	**$ 296**	**$ 362**

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

The net working capital of $658 million at June 30, 2018 represented an increase of $362 million from December 31, 2017. Current assets include Assets held for sale of $296 million recorded as at June 30, 2018 representing the expected net proceeds on the sale of 25 Embraer 190 aircraft, as further described in section 4 "Results of Operations" of this MD&A.

The net cash flows from operating activities of $1,964 million for the six months ended June 30, 2018 included $1,211 million in changes in non-cash working capital, largely related to the growth in advance ticket sales. The growth in advance ticket sales largely reflected Air Canada capacity growth and the seasonal build-up of advance ticket sales, accounts receivable and general activity levels heading into third quarter of 2018.

Cash from operations of $753 million, before the impact of changes in non-cash working capital balances, was partly offset by the impact of net capital expenditures of $574 million (capital expenditures of $1,784 million less the financial proceeds drawn on the delivery of five Boeing 787 and 13 Boeing 737 aircraft of $1,210 million). In the first six months of 2018, Air Canada purchased three Boeing 737 aircraft using cash.

6.4. Consolidated Cash Flow Movements

The following table provides the cash flow movements for Air Canada for the periods indicated:

	Second Quarter			First Six Months		
(Canadian dollars in millions)	**2018**	**2017**	**$ Change**	**2018**	**2017**	**$ Change**
Net cash flows from operating activities	**$ 853**	**$ 829**	**$ 24**	**$ 1,964**	**$ 1,856**	**$ 108**
Proceeds from borrowings	521	362	159	1,210	733	477
Reduction of long-term debt and finance lease obligations	(358)	(219)	(139)	(584)	(371)	(213)
Shares purchased for cancellation	(22)	(3)	(19)	(23)	(36)	13
Issue of shares	1	2	(1)	2	3	(1)
Financing fees	(4)	(9)	5	(8)	(12)	4
Net cash flows from financing activities	**$ 138**	**$ 133**	**$ 5**	**$ 597**	**$ 317**	**$ 280**
Short-term investments	(504)	(413)	(91)	(625)	(575)	(50)
Additions to property, equipment and intangible assets	(866)	(895)	29	(1,784)	(1,821)	37
Proceeds from sale of assets	5	1	4	6	2	4
Proceeds from sale-leaseback of assets	-	371	(371)	-	740	(740)
Other	30	5	25	45	(1)	46
Net cash flows used in investing activities	**$ (1,335)**	**$ (931)**	**$ (404)**	**$ (2,358)**	**$ (1,655)**	**$ (703)**
Effect of exchange rate changes on cash and cash equivalents	**$ 3**	**$ (2)**	**$ 5**	**$ 11**	**$ (6)**	**$ 17**
Increase (decrease) in cash and cash equivalents	**$ (341)**	**$ 29**	**$ (370)**	**$ 214**	**$ 512**	**$ (298)**

The following table provides the calculation of free cash flow for Air Canada for the periods indicated:

	Second Quarter			First Six Months		
(Canadian dollars in millions)	**2018**	**2017**	**$ Change**	**2018**	**2017**	**$ Change**
Net cash flows from operating activities	**$ 853**	**$ 829**	**$ 24**	**$ 1,964**	**$ 1,856**	**$ 108**
Additions to property, equipment and intangible assets, net of proceeds from sale-leaseback transactions	(866)	(524)	(342)	(1,784)	(1,081)	(703)
Free cash flow (1)	**$ (13)**	**$ 305**	**$ (318)**	**$ 180**	**$ 775**	**$ (595)**

(1) *Free cash flow is a non-GAAP financial measure used by Air Canada as an indicator of the financial strength and performance of its business, indicating how much cash it is able to generate from operations and after capital expenditures. Free cash flow is calculated as net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale and leaseback transactions. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.*

Free Cash Flow

In the second quarter of 2018, net cash flows from operating activities of $853 million improved $24 million when compared to the same quarter in 2017. In the second quarter of 2018, negative free cash flow of $13 million represented a decrease of $318 million from the second quarter of 2017 mainly due to Air Canada having received proceeds of $371 million from the sale and leaseback of aircraft in the second quarter of 2017, while no such sale and leasebacks were effected in the second quarter of 2018.

In the first six months of 2018, net cash flows from operating activities of $1,964 million improved $108 million when compared to the same period in 2017. This increase was mainly due to the impact of higher cash inflows from working capital, driven by the growth in advance ticket sales. In the first six months of 2018, free cash flow of $180 million decreased $595 million from the first six months of 2017 mainly due to Air Canada having received proceeds of $740 million from the sale and leaseback of aircraft in the first six months of 2017, while no such sale and leasebacks were effected in the first six months of 2018.

Net Cash Flows from Financing Activities

Reduction of long-term debt and finance lease obligations amounted to $358 million in the second quarter of 2018 and $584 million in the first six months of 2018 while proceeds from borrowings totaled to $521 million and $1,210 million, respectively.

Refer to sections 6.3 "Working Capital", 6.1 "Financial Position" and 6.2 "Adjusted Net Debt" of this MD&A for additional information.

6.5. Capital Expenditures and Related Financing Arrangements

Boeing 787 Aircraft

Air Canada has outstanding purchase commitments with The Boeing Company ("Boeing") for two Boeing 787 aircraft scheduled for delivery in early 2019. Air Canada also has purchase options for 13 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing and delivery positions), and purchase rights for 10 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on Boeing's then current pricing and available delivery positions).

Subject to certain conditions, Air Canada has financing commitments covering the two Boeing 787 aircraft scheduled for delivery in early 2019. The financing terms are for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments.

Boeing 737 Aircraft

Air Canada has an agreement with Boeing for the purchase of Boeing 737 MAX aircraft which provides for:

- Firm orders for 61 737 MAX aircraft, consisting of 50 737 MAX 8 and 11 737 MAX 9 aircraft with substitution rights between them as well as for the 737 MAX 7 aircraft.
- Purchase options for 18 Boeing 737 MAX aircraft.
- Certain rights to purchase an additional 30 Boeing 737 MAX aircraft.

As of the date of this MD&A, 18 Boeing 737 MAX 8 aircraft have been delivered, with the remaining 43 Boeing 737 MAX aircraft scheduled for delivery from 2019 to 2024.

In April 2018, Air Canada concluded an amendment to its Boeing 737 purchase agreement, pursuant to which certain aircraft delivery positions were accelerated and others deferred. The amendment accelerates the delivery of five 737 MAX aircraft by one year, to 2020, and defers the delivery of 11 737 MAX aircraft by up to 36 months.

Subject to certain conditions, Air Canada also has financing commitments covering 25 Boeing 737 MAX firm aircraft scheduled for delivery in 2020, 2023 and 2024. The financing terms are for 80% of the aircraft delivery price and the term to maturity is 10 years with mortgage-style repayments.

Airbus A220-300 Aircraft

In June 2016, Air Canada and Bombardier Inc. ("Bombardier") finalized a purchase agreement which includes a firm order for 45 Airbus A220-300 aircraft (formerly called Bombardier C-Series CS300 aircraft) and options for an additional 30 Airbus A220-300 aircraft. Deliveries are scheduled to begin in late 2019 and extend to 2022. The first 25 aircraft on delivery are expected to replace Air Canada's existing mainline fleet of Embraer 190 aircraft, with incremental aircraft supporting Air Canada's hub and network growth.

Reconfiguration of Airbus A330 Aircraft

In order to provide customers with a product that is consistent across its wide-body fleet, Air Canada plans on reconfiguring 12 Airbus A330 aircraft (eight of which are currently in service and four scheduled to be added in 2019) to the new Boeing 787 state-of-the-art standard. The reconfiguration of the Airbus A330 aircraft is expected to begin in late 2019 for completion in the first half of 2020. The capital expenditure related to this refurbishment program (which is included in the table below) is approximately $275 million.

Capital Commitments

As outlined in the table below, the estimated aggregate cost of the future firm Boeing 787, Boeing 737 MAX and Airbus A220-300 aircraft deliveries and other capital purchase commitments as at June 30, 2018 approximates $5,152 million. The table below also includes the impact of the amendment to the Boeing 737 purchase agreement discussed above.

(Canadian dollars in millions)	Remainder of 2018	2019	2020	2021	2022	Thereafter	Total
Projected committed expenditures	$ 290	$ 1,530	$ 1,396	$ 711	$ 664	$ 561	$ 5,152
Projected planned but uncommitted expenditures	150	526	279	338	321	Not available	Not available
Projected planned but uncommitted capitalized maintenance (1)	71	176	178	57	97	Not available	Not available
Total projected expenditures (2)	**$ 511**	**$ 2,232**	**$ 1,853**	**$ 1,106**	**$ 1,082**	**Not available**	**Not available**

(1) *Future capitalized maintenance amounts for 2021 and 2022 and beyond are not yet determinable, however estimates of $57 million and $97 million, respectively, have been made for 2021 and 2022.*

(2) *U.S. dollar amounts are converted using the June 30, 2018 closing exchange rate of US$1=C$1.3133. The estimated aggregate cost of aircraft is based on delivery prices that include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day U.S. LIBOR rate at June 30, 2018.*

6.6. Pension Funding Obligations

Based on actuarial valuations, as at January 1, 2018, the aggregate solvency surplus in Air Canada's domestic registered pension plans is $2.6 billion. As a result, Air Canada will not make any past service payments in 2018.

As permitted by applicable legislation and subject to applicable plan rules, amounts in excess of 105% on a solvency basis may be used to reduce current service contributions under the defined benefit component or to fund the employer contribution to a defined contribution component within the same pension plan. Pension funding obligations for 2018 are expected to be $90 million.

As at June 30, 2018, taking into account the effect of financial instrument risk management tools, approximately 75% of Air Canada's pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk. Air Canada may continue to increase the percentage of fixed income products matched to pension liabilities, subject to favourable market conditions.

For additional information on Air Canada's pension funding obligations, refer to section 9.7 "Pension Funding Obligations" of Air Canada's 2017 MD&A.

6.7. Contractual Obligations

Private offering of enhanced equipment trust certificates

In December 2017, in connection with the financing of four new Boeing 787-9 and nine new Boeing 737 MAX 8 aircraft, Air Canada completed the closing of a private offering of three tranches of EETCs with a combined aggregate face amount of approximately US$719 million. The three tranches of certificates have a combined weighted average interest rate of 3.422% per annum. All 13 aircraft under this transaction were delivered and financed in the first six months of 2018.

In March 2018, in connection with the financing of one new Boeing 787-9 and four new Boeing 737 MAX 8 aircraft, Air Canada completed the closing of a Canadian dollar private offering of two tranches of EETCs with a combined aggregate face amount of approximately $301 million. All aircraft under this transaction were delivered and financed in the second quarter of 2018. The private offering was comprised of Class A and Class B certificates.

- The Class A certificates, with a $238 million face amount, have an interest rate of 3.670% per annum and a final expected distribution date of April 15, 2030.
- The Class B certificates, with a $63 million face amount, have an interest rate of 4.190% per annum and a final expected distribution date of January 15, 2026.

The two tranches of certificates have a combined weighted average interest rate of 3.760% per annum.

The table below provides Air Canada's contractual obligations as at June 30, 2018, including those relating to interest and principal repayment obligations on Air Canada's long-term debt and finance lease obligations, operating lease obligations and committed capital expenditures. In connection with the upcoming sale of 25 Embraer 190 aircraft, long-term debt of $144 million (US$109 million), most of which is reflected in the 2019 repayments presented in the table below, will be repaid in the third quarter of 2018. The interest repayment requirements presented in the table below will reduce by $8 million.

(Canadian dollars in millions)	**Remainder 2018**	**2019**	**2020**	**2021**	**2022**	**Thereafter**	**Total**
Principal							
Long-term debt obligations	$ 180	$ 504	$ 629	$ 970	$ 332	$ 4,303	$ 6,918
Finance lease obligations	22	45	49	17	15	55	203
Total principal obligations	**$ 202**	**$ 549**	**$ 678**	**$ 987**	**$ 347**	**$ 4,358**	**$ 7,121**
Interest							
Long-term debt obligations	140	279	255	212	176	476	1,538
Finance lease obligations	8	14	9	6	5	15	57
Total interest obligations	**$ 148**	**$ 293**	**$ 264**	**$ 218**	**$ 181**	**$ 491**	**$ 1,595**
Total long-term debt and finance lease obligations	**$ 350**	**$ 842**	**$ 942**	**$ 1,205**	**$ 528**	**$ 4,849**	**$ 8,716**
Operating lease obligations	**$ 345**	**$ 586**	**$ 471**	**$ 344**	**$ 257**	**$ 1,019**	**$ 3,022**
Committed capital expenditures	**$ 290**	**$ 1,530**	**$ 1,396**	**$ 711**	**$ 664**	**$ 561**	**$ 5,152**
Total contractual obligations (1)	**$ 985**	**$ 2,958**	**$ 2,809**	**$ 2,260**	**$ 1,449**	**$ 6,429**	**$16,890**

(1) Total contractual obligations exclude commitments for goods and services required in the ordinary course of business. Also excluded are long-term liabilities other than long-term debt in finance lease obligations due to reasons of uncertainty of timing of cash flows and items that are non-cash in nature.

6.8. Share Information

The issued and outstanding shares of Air Canada, along with shares potentially issuable, as of the dates indicated below, are as follows:

	June 30, 2018	December 31, 2017
Issued and outstanding shares		
Variable voting shares	114,139,480	115,986,084
Voting shares	158,303,599	157,090,562
Total issued and outstanding shares	**272,443,079**	**273,076,646**
Class A variable voting and Class B voting shares potentially issuable		
Stock options	6,990,724	6,121,252
Total shares potentially issuable	**6,990,724**	**6,121,252**
Total outstanding and potentially issuable shares	**279,433,803**	**279,197,898**

Issuer Bid

In May 2018, Air Canada received approval from the Toronto Stock Exchange for the renewal of its normal course issuer bid for its Class A variable voting shares and Class B voting shares (collectively the "shares"), authorizing, between May 31, 2018 and May 30, 2019, the purchase of up to 24,040,243 shares, representing 10% of Air Canada's public float as at May 17, 2018. The renewal followed the conclusion of the 2017 normal course issuer bid which expired on May 30, 2018.

In the second quarter of 2018, Air Canada purchased, for cancellation, a total of 859,565 shares at an average cost of $24.92 per share for aggregate consideration of $22 million (914,218 shares at an average cost of $24.78 per share for aggregate consideration of $23 million for the six months ended June 30, 2018). As at June 30, 2018, a total of 24,040,243 shares remained available for repurchase under the existing issuer bid.

7. QUARTERLY FINANCIAL DATA

The following table summarizes quarterly financial results for Air Canada for the last eight quarters:

(Canadian dollars in millions, except where indicated)	2016 [1]		2017 [1]				2018	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Passenger	$ 4,106	$ 3,035	$ 3,120	$ 3,550	$ 4,514	$ 3,409	$ 3,489	$ 3,921
Cargo	130	155	148	168	194	198	168	200
Other	215	235	374	192	172	213	414	212
Operating revenues	**4,451**	**3,425**	**3,642**	**3,910**	**4,880**	**3,820**	**4,071**	**4,333**
Aircraft fuel	708	598	659	701	832	735	825	964
Regional airlines expense								
Aircraft fuel	96	90	95	96	109	112	114	135
Other	543	532	537	552	553	563	561	607
Wages, salaries & benefits	658	633	644	663	690	674	700	711
Airport and navigation fees	247	203	210	230	264	201	221	237
Aircraft maintenance	230	200	228	226	241	243	256	220
Depreciation, amortization and impairment	220	212	228	242	241	245	267	278
Sales and distribution costs	179	172	181	188	232	169	189	199
Ground package costs	72	101	256	103	73	106	276	114
Aircraft rent	118	120	122	130	125	126	125	123
Catering and onboard services	104	82	85	97	112	89	96	108
Communications and information technology	56	60	71	58	63	62	79	67
Special items	-	91	30	-	-	-	-	-
Other	324	313	326	332	369	362	376	344
Operating expenses	**3,555**	**3,407**	**3,672**	**3,618**	**3,904**	**3,687**	**4,085**	**4,107**
Operating income (loss)	**896**	**18**	**(30)**	**292**	**976**	**133**	**(14)**	**226**
Foreign exchange gain (loss)	(42)	(29)	70	68	44	(62)	(112)	(25)
Interest income	12	13	12	14	16	18	20	24
Interest expense	(97)	(83)	(79)	(80)	(73)	(79)	(83)	(84)
Interest capitalized	12	8	9	9	9	9	13	7
Net financing expense relating to employee benefits	(17)	(24)	(16)	(16)	(15)	(18)	(12)	(13)
Gain (loss) on financial instruments recorded at fair value	6	9	-	7	17	(1)	1	(9)
Gain on sale and leaseback of assets	-	-	26	26	-	-	-	-
Gain (loss) on debt settlements and modifications	-	(82)	-	-	(3)	24	11	(1)
Loss on disposal of assets	-	-	-	-	-	-	-	(186)
Other	(2)	(8)	(5)	(6)	(6)	(4)	(8)	(10)
Total non-operating income (expense)	**(128)**	**(196)**	**17**	**22**	**(11)**	**(113)**	**(170)**	**(297)**
Income (loss) before income taxes	**768**	**(178)**	**(13)**	**314**	**965**	**20**	**(184)**	**(71)**
Income tax (expense) recovery	-	(1)	-	(3)	758	(12)	14	(6)
Net income (loss)	**$ 768**	**$ (179)**	**$ (13)**	**$ 311**	**$ 1,723**	**$ 8**	**$ (170)**	**$ (77)**
Diluted earnings (loss) per share	**$ 2.74**	**$ (0.66)**	**$ (0.05)**	**$ 1.13**	**$ 6.22**	**$ 0.02**	**$ (0.62)**	**$ (0.28)**
EBITDAR [2]	**$ 1,248**	**$ 455**	**$ 366**	**$ 681**	**$ 1,360**	**$ 521**	**$ 397**	**$ 646**
Adjusted pre-tax income (loss) [2]	**$ 821**	**$ 39**	**$ (63)**	**$ 229**	**$ 922**	**$ 77**	**$ (72)**	**$ 163**
Adjusted net income (loss) [2]	**$ 821**	**$ 38**	**$ (63)**	**$ 226**	**$ 922**	**$ 61**	**$ (52)**	**$ 114**
Adjusted earnings (loss) per share – diluted [2]	**$ 2.93**	**$ 0.14**	**$ (0.23)**	**$ 0.82**	**$ 3.33**	**$ 0.22**	**$ (0.19)**	**$ 0.41**

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts. 2016 amounts have not been restated for the adoption of this new accounting standard. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

(2) EBITDAR, adjusted pre-tax income (loss), adjusted net income (loss) and adjusted earnings (loss) per share – diluted are non-GAAP financial measures. Reconciliations of these measures to comparable GAAP measures can be found in "Non-GAAP Financial Measures" of this MD&A and in Air Canada's MD&A reports, available at aircanada.com.

The following table provides a breakdown of the most significant items included in regional airlines expense for the last eight quarters:

	2016		2017				2018	
(Canadian dollars in millions)	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**
Capacity purchase fees	$ 313	$ 304	$ 308	$ 314	$ 315	$ 330	$ 319	$ 360
Aircraft fuel	96	90	95	96	109	112	114	135
Airport and navigation	79	72	69	73	80	71	69	76
Sales and distribution costs	36	36	37	40	34	35	34	41
Aircraft rent	8	8	10	10	10	10	10	10
Depreciation, amortization and impairment	6	6	6	7	8	7	9	9
Other operating expenses	101	106	107	108	106	110	120	111
Total regional airlines expense	**$ 639**	**$ 622**	**$ 632**	**$ 648**	**$ 662**	**$ 675**	**$ 675**	**$ 742**

The following table provides major quarterly operating statistics for Air Canada for the last eight quarters:

	2016 (1)		2017 (1)				2018	
System	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**
Passenger PRASM (cents)	14.2	13.5	13.6	14.0	14.5	14.1	14.0	14.4
CASM (cents)	12.5	15.4	16.0	14.3	12.6	15.2	16.4	15.1
Adjusted CASM (cents) (2)	9.4	11.4	11.5	10.7	9.3	11.3	11.5	10.6
Fuel cost per litre (cents) (3)	55.2	59.4	63.2	61.3	59.4	67.5	73.3	80.3

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts. 2016 amounts have not been restated for the adoption of this new accounting standard. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

(2) Adjusted CASM is a non-GAAP financial measure. A reconciliation of this measure to a comparable GAAP measure can be found in "Non-GAAP Financial Measures" of this MD&A and in Air Canada's MD&A reports, available at aircanada.com.

(3) Includes aircraft fuel expense related to regional airline operations. Includes fuel handling expenses.

The following table provides Air Canada's revenue passenger miles (RPMs), available seat miles (ASMs) and passenger load factors, on a system-basis and by market, for the last eight quarters:

	2016		2017				2018	
System	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**
RPMs (millions)	24,328	17,643	18,341	20,928	26,472	19,396	20,440	22,654
ASMs (millions)	28,458	22,091	22,894	25,357	31,050	24,191	24,862	27,269
Passenger load factor (%)	85.5%	79.9%	80.1%	82.5%	85.3%	80.2%	82.2%	83.1%
Domestic								
RPMs (millions)	6,068	4,534	4,101	4,875	6,130	4,607	4,226	5,003
ASMs (millions)	7,066	5,510	5,108	5,837	7,173	5,584	5,280	6,026
Passenger load factor (%)	85.9%	82.3%	80.3%	83.5%	85.4%	82.5%	80.0%	83.0%
U.S. Transborder								
RPMs (millions)	3,613	3,182	3,782	3,609	3,951	3,408	4,037	3,848
ASMs (millions)	4,223	3,985	4,687	4,376	4,683	4,252	4,945	4,673
Passenger load factor (%)	85.6%	79.9%	80.7%	82.5%	84.4%	80.1%	81.6%	82.3%
Atlantic								
RPMs (millions)	8,270	4,437	3,891	6,131	9,406	5,076	4,573	7,084
ASMs (millions)	9,785	5,778	5,248	7,661	11,087	6,582	5,753	8,571
Passenger load factor (%)	84.5%	76.8%	74.1%	80.0%	84.8%	77.1%	79.5%	82.7%
Pacific								
RPMs (millions)	5,002	3,959	3,943	4,671	5,471	4,501	4,572	4,936
ASMs (millions)	5,821	4,977	4,862	5,540	6,412	5,586	5,447	5,829
Passenger load factor (%)	85.9%	79.6%	81.1%	84.5%	85.3%	80.6%	83.9%	84.7%
Other								
RPMs (millions)	1,375	1,531	2,624	1,642	1,514	1,804	3,032	1,783
ASMs (millions)	1,563	1,841	2,989	1,943	1,695	2,187	3,437	2,170
Passenger load factor (%)	87.9%	83.1%	87.8%	84.5%	89.3%	82.5%	88.2%	82.1%

8. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Air Canada's financial instruments and risk management practices are summarized in section 12 of Air Canada's 2017 MD&A. There have been no material changes to Air Canada's financial instruments and risk management practices from that which was disclosed at that time. Additional information on Air Canada's risk management practices and financial instruments is discussed in Note 10 of Air Canada's second quarter 2018 interim unaudited condensed consolidated financial statements.

9. ACCOUNTING POLICIES

Air Canada's accounting policies are as disclosed in Note 2 of Air Canada's 2017 annual audited consolidated financial statements. There have been no material changes to Air Canada's accounting policies from what was disclosed at that time, with the exception of the adoption of *IFRS 15 – Revenue from Contract with Customers* as described below.

IFRS 15 – Revenue from Contracts with Customers

IFRS 15 replaces *IAS 18 Revenue and related interpretations*. The core principle of the new standard is to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the entity expects to be entitled in exchange for those goods or services. The new standard is intended to enhance disclosures about revenue, provide more comprehensive guidance for transactions that were not previously addressed and improve guidance for multiple-element arrangements, with additional information provided in Note 2 of Air Canada's second quarter 2018 interim unaudited condensed consolidated financial statements. Air Canada adopted the standard effective January 1, 2018 using the full retrospective method.

IFRS 16 – Leases

IFRS 16 **–** *Leases* replaces *IAS 17 Leases and related interpretations*. The core principle is that a lessee recognizes assets and liabilities for all leases with a lease term of more than 12 months. A lessee is required to recognize a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments. Assets and liabilities arising from a lease are initially measured on a present value basis. The measurement of the lease liability includes non-cancellable lease payments (including inflation-linked payments), and includes payments to be made in optional periods if the lessee is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease. Purchase options which are reasonably certain of being exercised are also included in the measurement of the lease liability. Lease payments will not include variable lease payments other than those that depend on an index or rate. The right-of-use asset will be derived from the calculation of the lease liability and will also include any provisions the lessee will owe for return conditions on leased assets.

The new standard is intended to provide an improved representation of leasing transactions, in particular those that do not currently require the lessee to recognize an asset and liability arising from an operating lease. *IFRS 16* is effective for annual periods beginning on January 1, 2019. Entities have the option of adopting a full retrospective approach or a modified retrospective approach on transition to *IFRS 16*.

Air Canada will apply the standard effective January 1, 2019 and plans to transition with a full retrospective approach with restatement to each prior reporting period presented. Air Canada expects to elect the package of practical expedients to not reassess prior conclusions related to contracts containing leases and apply the recognition exemption for short term leases. Other practical expedients available under the guidance are still being evaluated.

Air Canada continues to assess the impacts the adoption of this standard will have on its consolidated financial statements but expects this standard will have a significant impact on its consolidated balance sheet, along with a change to the recognition, measurement and presentation of lease expenses in the consolidated statement of operations. Based on a review of current contracts and the requirements of the standard, Air Canada has largely concluded the accounting policy determination and scoping exercise for *IFRS 16*, with additional information provided below. Measurement of the related right-of-use assets and lease liabilities is in progress.

Aircraft Leases

As of December 31, 2017, Air Canada had 111 aircraft under operating leases, and Air Canada expects to record such aircraft as right-of-use assets and lease liabilities of Air Canada in accordance with the requirements of the new standard. Additionally, Air Canada has identified that, under *IFRS 16*, Air Canada has leases in respect of aircraft used by regional carriers providing services under the respective capacity purchase agreements ("CPA"), and expects to record such aircraft as right-of-use assets and lease liabilities of Air Canada. As at December 31, 2017, there were 151 aircraft operating under these arrangements on behalf of Air Canada.

Property Leases

Air Canada has leases related to airport terminal operations space and other real estate leases. For leases related to terminal operations space, there are generally effective substitution rights in the hands of the lessor and therefore these are not considered lease contracts under the standard. Leases with reciprocal termination rights with a notice period of less than 12 months would be considered short-term leases and therefore would be excluded from balance sheet recognition under the practical expedient. Finally, those airport terminal contracts with variable lease payments will also be excluded since variable lease payments, other than those based on an index or rate, are excluded from the measurement of the lease liability. This results in a portfolio of property leases that are expected to be recorded as right-of-use assets and lease liabilities under the standard which relate to dedicated space in Air Canada's hub locations of Toronto, Montreal and Vancouver, lease contracts on building space dedicated to Air Canada for offices, airport and maintenance operations, Maple Leaf Lounges and land leases.

Accounting for Right-of-Use Assets

Right-of-use assets will be accounted for under *IAS 16 Property, Plant and Equipment*. Aircraft recorded as right-of-use assets will have the same accounting policies as directly owned aircraft, meaning the right-of-use assets will be componentized and depreciated over the lease term. Consistent with owned aircraft, any qualifying maintenance events will be capitalized and depreciated over the lesser of the lease term and expected maintenance life. Maintenance provisions will be recorded, as applicable, on aircraft leases as a maintenance expense over the term of the lease. Any changes to the provision for end-of-lease conditions will be recognized as an adjustment to the right-of-use asset and subsequently amortized to the income statement over the remaining term of the lease.

Income Statement Impacts

The impacts on the income statement will be an elimination of aircraft rent and building rent, which is recorded in other operating expenses, for those contracts which are recognized as leases, and instead will be replaced by an amortization of the right-of-use asset and interest costs on the lease liability. Maintenance expense is expected to decrease under the standard as qualifying maintenance events for the former operating leases will be capitalized and amortized over their expected maintenance life. This will be partially offset by higher maintenance provision expense recorded on all aircraft right-of-use assets which contain end of lease maintenance return conditions. Since all the aircraft lease contracts are denominated in U.S. dollars, there will be additional volatility in the foreign exchange recognized in the income statement due to the revaluation of the lease liabilities and maintenance provisions to the rate of exchange in effect at the date of the balance sheet.

10. OFF-BALANCE SHEET ARRANGEMENTS

Information on Air Canada's off-balance sheet arrangements is disclosed in section 15 "Off-Balance Sheet Arrangements" of Air Canada's 2017 MD&A. There have been no material changes to Air Canada's off-balance sheet arrangements from what was disclosed at that time.

11. RELATED PARTY TRANSACTIONS

At June 30, 2018, Air Canada had no transactions with related parties as defined in the CPA Handbook, except those pertaining to transactions with key management personnel in the ordinary course of their employment or directorship agreements.

12. RISK FACTORS

For a description of risk factors associated with Air Canada and its business, refer to section 18 "Risk Factors" of Air Canada's 2017 MD&A. There have been no material changes to Air Canada's risk factors from what was disclosed at that time.

13. 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 President and Chief Executive Officer ("CEO"), its Executive Vice President and Chief Financial Officer ("CFO") and its Disclosure Committee to ensure appropriate and timely decisions are made regarding public disclosure.

Internal controls over financial reporting have been designed by management, under the supervision of, and with the participation of the Corporation's CEO and 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.

In the Corporation's 2017 filings, the Corporation's CEO and CFO certified, 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.

In the Corporation's second quarter 2018 filings, the Corporation's CEO and CFO certified, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design of the Corporation's disclosure controls and procedures and the design of internal controls over financial reporting.

The Corporation's Audit, Finance and Risk Committee reviewed this MD&A and the interim unaudited condensed consolidated financial statements and notes, and the Corporation's Board of Directors approved these documents prior to their release.

Changes in Internal Controls over Financial Reporting

There have been no changes to the Corporation's internal controls over financial reporting during the quarter ended June 30, 2018 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

14. NON-GAAP FINANCIAL MEASURES

Below is a description of certain non-GAAP financial measures used by Air Canada in an effort to provide readers with additional information on its financial and operating performance. Such measures are not recognized measures for financial statement presentation under GAAP, do not have standardized meanings, may not be comparable to similar measures presented by other entities and should not be considered a substitute for or superior to GAAP results.

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is commonly used in the airline industry and is used by Air Canada as a means to view operating results before interest, taxes, depreciation, amortization, impairment and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Air Canada excludes special items from EBITDAR as such items would distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

EBITDAR is reconciled to operating loss as follows:

	Second Quarter			First Six Months		
(Canadian dollars in millions)	**2018**	**2017 (1)**	**$ Change**	**2018**	**2017 (1)**	**$ Change**
Operating income – GAAP	**$ 226**	**$ 292**	**$ (66)**	**$ 212**	**$ 262**	**$ (50)**
Add back (as reflected on Air Canada's consolidated statement of operations):						
Depreciation, amortization and impairment	278	242	36	545	470	75
Aircraft rent	123	130	(7)	248	252	(4)
Add back (included in Regional airlines expense):						
Depreciation, amortization and impairment	9	7	2	18	13	5
Aircraft rent	10	10	-	20	20	-
EBITDAR (including special items)	**$ 646**	**$ 681**	**$ (35)**	**$ 1,043**	**$ 1,017**	**$ 26**
Remove effect of special items (2)	-	-	-	-	30	(30)
EBITDAR (excluding special items)	**$ 646**	**$ 681**	**$ (35)**	**$ 1,043**	**$ 1,047**	**$ (4)**

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

(2) In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.

Adjusted CASM

Air Canada uses adjusted CASM as a means to assess the operating and cost performance of its ongoing airline business without the effects of aircraft fuel expense, the cost of ground packages at Air Canada Vacations and special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

In calculating adjusted CASM, aircraft fuel expense is excluded from operating expense results as it fluctuates widely depending on many factors, including international market conditions, geopolitical events, jet fuel refining costs and Canada/U.S. currency exchange rates. Air Canada also incurs expenses related to ground packages at Air Canada Vacations which some airlines, without comparable tour operator businesses, may not incur. In addition, these costs do not generate ASMs and therefore excluding these costs from operating expense results provides for a more meaningful comparison across periods when such costs may vary.

Excluding aircraft fuel expense, the cost of ground packages at Air Canada Vacations and special items from operating expenses generally allows for more meaningful analysis of Air Canada's operating expense performance and a more meaningful comparison to those of other airlines.

Adjusted CASM is reconciled to GAAP operating expense as follows:

	Second Quarter			First Six Months		
(Canadian dollars in millions, except where indicated)	**2018**	**2017 (1)**	**$ Change**	**2018**	**2017 (1)**	**$ Change**
Operating expense – GAAP	**$ 4,107**	**$ 3,618**	**$ 489**	**$ 8,192**	**$ 7,290**	**$ 902**
Adjusted for:						
Aircraft fuel expense (as reflected on Air Canada's consolidated statement of operations)	(964)	(701)	(263)	(1,789)	(1,360)	(429)
Aircraft fuel expense (included in Regional airlines expense)	(135)	(96)	(39)	(249)	(191)	(58)
Ground package costs	(114)	(103)	(11)	(390)	(359)	(31)
Special items (2)	-	-	-	-	(30)	30
Operating expense, adjusted for the above-noted items	**$ 2,894**	**$ 2,718**	**$ 176**	**$ 5,764**	**$ 5,350**	**$ 414**
ASMs (millions)	**27,269**	**25,357**	**7.5%**	**52,131**	**48,251**	**8.0%**
Adjusted CASM (cents)	**¢ 10.61**	**¢ 10.72**	**(1.0)%**	**¢ 11.06**	**¢ 11.09**	**(0.3)%**

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts. Refer to section 9 "Accounting Policies" of this MD&A for additional information.

(2) In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.

Adjusted Pre-tax Income

Adjusted pre-tax income is used by Air Canada to assess the overall pre-tax financial performance of its business without the effects of foreign exchange gains or losses, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications, gains or losses on disposal of assets, and special items. Air Canada uses adjusted pre-tax income to determine return on invested capital.

Adjusted pre-tax income is reconciled to GAAP income (loss) before income taxes as follows:

	Second Quarter			First Six Months		
(Canadian dollars in millions)	2018	2017 [(1)]	$ Change	2018	2017 [(1)]	$ Change
Income (loss) before income taxes	**$ (71)**	**$ 314**	**$ (385)**	**$ (255)**	**$ 301**	**$ (556)**
Adjusted for:						
Special items [(2)]	-	-	-	-	30	(30)
Foreign exchange (gain) loss	25	(68)	93	137	(138)	275
Net financing expense relating to employee benefits	13	16	(3)	25	32	(7)
(Gain) loss on financial instruments recorded at fair value	9	(7)	16	8	(7)	15
(Gain) on sale and leaseback of assets	-	(26)	26	-	(52)	52
(Gain) loss on debt settlements and modifications	1	-	1	(10)	-	(10)
Loss on disposal of assets [(3)]	186	-	186	186	-	186
Adjusted pre-tax income	**$ 163**	**$ 229**	**$ (66)**	**$ 91**	**$ 166**	**$ (75)**

(1) *Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.*

(2) *In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.*

(3) *In the second quarter of 2018, Air Canada recorded a loss on disposal of assets of $186 million related to the expected sale of 25 Embraer 190 aircraft.*

Adjusted Net Income and Adjusted Earnings per Share – Diluted

Air Canada uses adjusted net income and adjusted earnings per share – diluted as a means to assess the overall financial performance of its business without the after-tax effects of foreign exchange gains or losses, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications, gains or losses on disposal of assets, and special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful. Starting as of and including the fourth quarter of 2017, adjusted net income is determined net of tax. Accordingly, the 2018 and 2017 information in the table below is not directly comparable.

Adjusted net income is reconciled to GAAP net income (loss) as follows:

	Second Quarter			First Six Months		
(Canadian dollars in millions, except where indicated)	**2018**	**2017 (1)**	**$ Change**	**2018**	**2017 (1)**	**$ Change**
Net income (loss)	**$ (77)**	**$ 311**	**$ (388)**	**$ (247)**	**$ 298**	**$ (545)**
Adjusted for:						
Special items (2)	-	-	-	-	30	(30)
Foreign exchange (gain) loss	45	(68)	113	156	(138)	294
Net financing expense relating to employee benefits	9	16	(7)	18	32	(14)
(Gain) loss on financial instruments recorded at fair value	6	(7)	13	5	(7)	12
(Gain) on sale and leaseback of assets	-	(26)	26	-	(52)	52
Loss on debt settlements and modifications	1	-	1	-	-	-
Loss on disposal of assets (3)	130	-	130	130	-	130
Adjusted net income	**$ 114**	**$ 226**	**$ (112)**	**$ 62**	**$ 163**	**$ (101)**
Weighted average number of outstanding shares used in computing diluted income per share (in millions)	277	277	-	277	278	(1)
Adjusted earnings per share – diluted	**$ 0.41**	**$ 0.82**	**$ (0.41)**	**$ 0.22**	**$ 0.59**	**$ (0.37)**

(1) *Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts. Refer to section 9 "Accounting Policies" of this MD&A for additional information.*

(2) *In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.*

(3) *In the second quarter of 2018, Air Canada recorded a loss on disposal of assets of $186 million related to the expected sale of 25 Embraer 190 aircraft.*

The following reflects the share amounts used in the computation of basic and diluted earnings per share on an adjusted earnings per share basis:

	Second Quarter		First Six Months	
(in millions)	**2018**	**2017**	**2018**	**2017**
Weighted average number of shares outstanding – basic	**273**	**271**	**273**	**272**
Effect of dilution	4	6	4	6
Weighted average number of shares outstanding – diluted	**277**	**277**	**277**	**278**

Return on Invested Capital

Air Canada uses return on invested capital ("ROIC") as a means to assess the efficiency with which it allocates its capital to generate returns. Return is based on adjusted pre-tax income (or loss, as applicable), excluding interest expense and implicit interest on operating leases. Invested capital includes (i) average year-over-year long-term debt, average year-over-year finance lease obligations, average year-over-year shareholders' equity and (ii) the value of capitalized operating leases (calculated by multiplying annualized aircraft rent by 7). Air Canada calculates invested capital based on a book value-based method of calculating ROIC, as described above. Following an increase in Air Canada's total cash, cash equivalents and short-term investments, Air Canada has decided to revise its methodology to reduce the average year-over-year book value of shareholders' equity by excess cash not required to run its core business operations. Air Canada has used average year-over-year advance ticket sales as a proxy for the minimum cash required for ongoing core business operations. This change would result in invested capital more closely reflecting operating capital. Refer to the definition of adjusted pre-tax income (loss) for a discussion as to why Air Canada uses this measure to assess the overall pre-tax financial performance of its business.

Return on invested capital is reconciled to GAAP income before income taxes as follows:

(Canadian dollars in millions, except where indicated)	12 Months Ended		
	June 30, 2018	December 31, 2017 [1]	June 30, 2017 [1]
Income before income taxes	**$ 730**	**$ 1,286**	**$ 856**
Remove:			
Special items [2]	-	30	121
Foreign exchange loss	155	(120)	(67)
Net financing expense relating to employee benefits	58	65	73
Gain on financial instruments recorded at fair value	(8)	(23)	(22)
Gain on sale and leaseback of assets	-	(52)	(52)
(Gain) loss on debt settlements and modifications [3]	(31)	(21)	82
Loss on disposal of assets [4]	186	-	-
Adjusted pre-tax income	**$ 1,090**	**$ 1,165**	**$ 991**
Adjusted for:			
Interest expense	319	311	339
Implicit interest on operating leases [5]	264	266	258
Adjusted pre-tax income before interest	**$ 1,673**	**$ 1,742**	**$ 1,588**
Invested capital:			
Average long-term debt and finance lease obligations	6,887	6,369	6,858
Average shareholders' equity, net of excess cash	1,596	1,249	(422)
Capitalized operating leases [6]	3,773	3,801	3,682
Invested capital	**$ 12,256**	**$ 11,419**	**$ 10,118**
Return on invested capital (%)	**13.7%**	**15.3%**	**15.7%**

(1) *Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts. To provide a more meaningful comparison, ROIC as at June 30, 2017 is based on previously reported amounts as 2016 amounts have not been restated for the adoption of IFRS 15. Refer to section 9 "Accounting Policies" of this MD&A for additional information.*

(2) *Special items for the 12 months ended December 31, 2017 included a provision of $30 million related to cargo investigations.*

Special items for the 12 months ended June 30, 2017 included a provision of $30 million related to cargo investigations and a past service cost expense of $91 million related to the cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

(3) *Gain on debt settlements and modifications for the 12 months ended June 30, 2018 of $31 million included a gain of $38 million related to the repricing of its US$1.1 billion senior secured credit facility, a loss of $3 million related to the early exercise of a purchase option for an Airbus 330 aircraft and a loss of $3 million related to the prepayment of fixed rate debt.*

Gain on debt settlements and modifications for the 12 months ended December 31, 2017 of $21 million included a gain of $27 million related to the repricing of its US$1.1 billion senior secured credit facility, a loss of $3 million related to the early exercise of a purchase option for an Airbus 330 aircraft and a loss of $2 million related to the prepayment of fixed rate debt on four Embraer 190 aircraft.

Loss on debt settlements and modifications for the 12 months ended June 30, 2017 of $82 million was related to a $1.25 billion refinancing transaction.

(4) *In July 2018, the Corporation entered into final negotiations for the sale of 25 Embraer 190 aircraft. As such, these aircraft are presented as Assets held for sale and measured at expected sale proceeds less costs to sell. In connection with this remeasurement, a loss on disposal was recorded in the second quarter of 2018 for $186 million.*

(5) *Interest implicit on operating leases is equal to 7.0% of 7 times the trailing 12 months of aircraft rent. 7.0% is a proxy and does not necessarily represent the actual implicit interest on operating leases for any given period.*

(6) *Capitalized operating leases are calculated by multiplying the trailing 12 months of aircraft rent by 7. Aircraft rent totaled $539 million for the 12 months ended June 30, 2018, $543 million for the 12 months ended December 31, 2017 and $526 million for the 12 months ended June 30, 2017 (includes aircraft rent related to regional operations).*

Adjusted Net Debt to Trailing 12-Month EBITDAR (Leverage Ratio)

Adjusted net debt to trailing 12-month EBITDAR ratio (also referred to as "leverage ratio" in this MD&A) is commonly used in the airline industry and is used by Air Canada as a means to measure financial leverage. Leverage ratio is calculated by dividing adjusted net debt by trailing 12-month EBITDAR. As mentioned above, Air Canada excludes special items from EBITDAR results (which are used to determine leverage ratio) as such items would distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful. Refer to section 6.2 "Adjusted Net Debt" of this MD&A for a reconciliation of this non-GAAP financial measure to the nearest measure under GAAP.

Free Cash Flow

Free cash flow is commonly used in the airline industry and is used by Air Canada as an indicator of the financial strength and performance of its business, indicating the amount of cash Air Canada is able to generate from operations and after capital expenditures. Free cash flow is calculated as net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale and leaseback transactions. Refer to section 6.4 "Consolidated Cash Flow Movements" of this MD&A for a reconciliation of this non-GAAP financial measure to the nearest measure under GAAP.

15. GLOSSARY

Adjusted CASM – Refers to operating expense per ASM adjusted to remove the effects of aircraft fuel expense, ground packages costs at Air Canada Vacations, and special items. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

Adjusted net income (loss) – Refers to the consolidated net income (loss) of Air Canada adjusted to remove the after-tax effects of foreign exchange gains or losses, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications, gains or losses on disposal of assets, and special items. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

Adjusted pre-tax income (loss) – Refers to the consolidated income (loss) of Air Canada before income taxes and adjusted to remove the effects of foreign exchange gains or losses, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications, gains or losses on disposal of assets, and special items. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

Air Georgian – Refers to Air Georgian Limited.

Atlantic passenger and cargo revenues – Refer to revenues from flights that cross the Atlantic Ocean with origins and destinations principally in Europe, India, the Middle East and North Africa.

Available seat miles or ASMs – Refers to a measure of passenger capacity calculated by multiplying the total number of seats available for passengers by the miles flown.

Average stage length – Refers to the average mile per departure seat and is calculated by dividing total ASMs by total seats dispatched.

Boeing – Refers to The Boeing Company.

Bombardier – Refers to Bombardier Inc.

CASM – Refers to operating expense per ASM.

Domestic passenger and cargo revenues – Refer to revenues from flights within Canada.

EBITDAR – Refers to earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent. EBITDAR is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information. Air Canada excludes special items from EBITDAR.

EVAS – Refers to Exploits Valley Air Services Limited.

Free cash flow – Refers to net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale and leaseback transactions. Free cash flow is a non-GAAP financial measure. Refer to sections 6.4 and 14 of this MD&A for additional information.

Jazz – Refers to Jazz Aviation LP.

Leverage ratio – Refers to adjusted net debt to trailing 12-month EBITDAR ratio (calculated by dividing adjusted net debt by trailing 12-month EBITDAR). Leverage ratio is a non-GAAP financial measure. Refer to sections 6.2 and 14 of this MD&A for additional information.

Loss (gain) on debt settlements and modifications – Refer to gains or losses related to debt settlements and modifications that, in management's view, are to be separately disclosed by virtue of their size or incidence to enable a fuller understanding of Air Canada's financial performance.

Other passenger and cargo revenues – Refer to revenues from flights with origins and destinations principally in Central and South America, the Caribbean and Mexico.

Pacific passenger and cargo revenues – Refer to revenues from flights that cross the Pacific Ocean with origins and destinations principally in Asia and Australia.

Passenger load factor – Refers to 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 PRASM – Refers to average passenger revenue per ASM.

Percentage point (pp) – Refers to a measure for the arithmetic difference of two percentages.

Return on invested capital or ROIC – Refers to return on invested capital and is a measure used to assess the efficiency with which a company allocates its capital to generate returns. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

Revenue passenger carried – Refers to the International Air Transport Association's (IATA) definition of passenger carried whereby passengers are counted on a flight number basis rather than by journey/itinerary or by leg.

Revenue passenger miles or RPMs – Refers to a measure of passenger traffic calculated by multiplying the total number of revenue passengers carried by the miles they are carried.

Seats dispatched – Refers to the number of seats on non-stop flights. A non-stop flight refers to a single takeoff and landing.

Sky Regional – Refers to Sky Regional Airlines Inc.

Special items – Refer to those items that, in management's view, are to be separately disclosed by virtue of their significance to the financial statements, to enable a fuller understanding of Air Canada's financial performance.

Weighted average cost of capital or WACC – Refers to management's estimate of its cost of capital, in which each category of capital is proportionately weighted.

Yield – Refers to average passenger revenue per RPM.