AIR CANADA

# 1997
## ANNUAL REPORT

The Annual General Meeting of Shareholders of Air Canada will be held at 9:30 a.m. on Wednesday, May 6, 1998 at the Saint John Trade and Convention Centre, (Loyalist Room), One Market Square, Saint John, New Brunswick.

**Shareholder Base**
Air Canada's shareholder base is comprised of the following: approximately, 78 per cent, Institutional; 18 per cent, Retail; and four per cent, Employees. Eighty-five per cent of the voting shares are held by Canadian residents and 15 per cent by non residents (as defined in the Air Canada Public Participation Act and Air Canada's Articles of Continuance).

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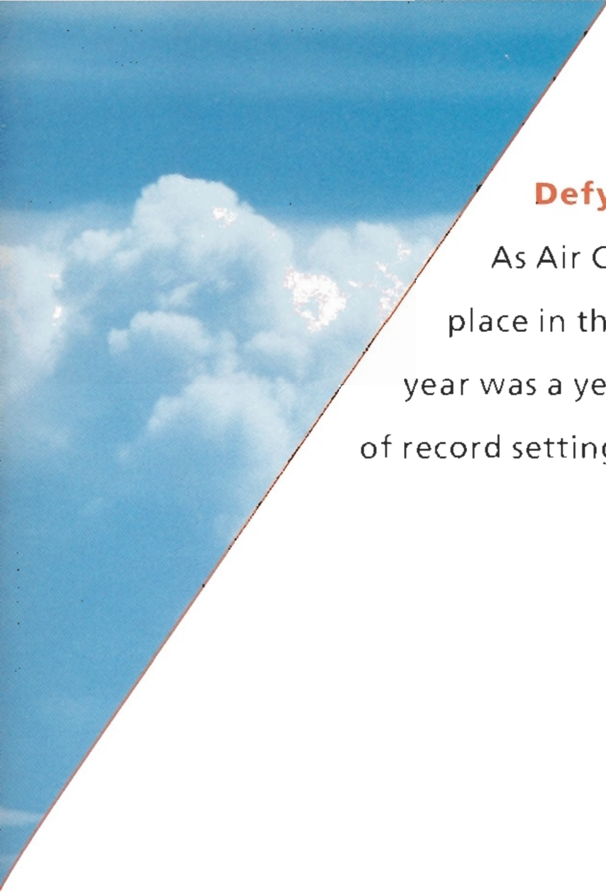
# Corporate profile

Air Canada is a Canadian-based international air carrier, providing scheduled and charter air transportation for passengers and cargo. The Corporation is Canada's largest air carrier and serves, together with its Regional Airlines, 118 destinations directly with a combined fleet of over 230 aircraft. In 1996, Air Canada (excluding its Regional Airlines) ranked as the 20th largest carrier in the world, as measured by revenue passenger miles (reported in Air Transport World). The Corporation's passenger route network offers scheduled services to 50 cities in Canada and 42 cities in the United States. Air Canada serves directly 26 cities in Europe, Asia, the Middle East and the Caribbean. Charter passenger services are also provided to 4 international destinations on a seasonal basis. The airline's cargo division serves numerous destinations in Canada and internationally, with sales representation in some 80 countries.

Air Canada's major strategic alliance partners under the *Star Alliance* are United Airlines, Inc., Deutsche Lufthansa AG, Scandinavian Airlines System, Thai Airways and Brazil's airline VARIG, S.A. Joint marketing, codeshare or commercial agreements are in place with 9 other international airlines. With its strategic alliance and commercial partners, the Corporation offers scheduled and charter air transportation to over 660 destinations in more than 110 countries.

Air Canada operates a large aircraft and engine maintenance business providing maintenance services to airlines and other customers. Ground handling, training and other services are also offered. The Corporation holds 100% interests, directly or indirectly, in four Canadian regional airlines, AirBC Limited, Air Ontario Inc., Air Alliance Inc. and Air Nova Inc., and in *Air Canada Vacations* (Touram Inc.), a major Canadian tour operator. In addition, the Corporation holds a 100% interest in Galileo Canada Distribution Systems Inc., a Canadian computer reservations system used by travel agents. The Corporation also holds minority interests in other travel and transportation-related businesses.



## Defying limits

As Air Canada continues to grow, we keep on redefining our place in the international aviation world. In that context, last year was a year quite unlike any other for Air Canada, a year full of record setting achievements.

### 1997 records

| | |
|---|---|
| Net profit: | $427 million |
| Operating profit: | $368 million |
| Operating revenues: | $5.6 billion |
| Flights/day*: | 665 |
| Passengers carried/year*: | 14 million |
| Passengers carried/day*: | 58,397 Sept. 26 |
| Destinations served: | 118 |
| Fleet: | 232 |

* Air Canada only, excludes Regional Airlines

### The Air Canada fleet

| | Boeing 747 | Boeing 767 | A340 | A330 | A320 | A319 | DC-9 | Canadair Regional Jet | Total |
|---|---|---|---|---|---|---|---|---|---|
| Owned | 6 | 13 | 0 | 0 | 21 | 5 | 28 | 0 | 73 |
| Op. Lease | 3 | 16 | 8 | 0 | 13 | 18 | 0 | 24 | 82 |
| In service | 9 | 29 | 8 | 0 | 34 | 23 | 28 | 24 | 155 |
| Orders | 0 | 0 | 3 | 5 | 0 | 12 | 0 | 0 | 20 |

### The Regional Airline Fleets – In Service*

| | Beech 1900D | BAe 146 | DHC-8-300 | DHC-8-100 | Total |
|---|---|---|---|---|---|
| Air Nova | 0 | 5 | 0 | 15 | 20 |
| Air Alliance | 5 | 0 | 0 | 6 | 11 |
| Air Ontario | 0 | 0 | 6 | 20 | 26 |
| AirBC | 0 | 5 | 6 | 9 | 20 |
| | 5 | 10 | 12 | 50 | 77 |

*Not included are 5 BAe J-31 aircraft for AirBC which have been leased to a third party

# Key Accomplishments

## Star Alliance launched

Welcome Star Alliance, the world's first global alliance and a cornerstone of Air Canada's international growth strategy. Drawing on the best of six premier airlines, Star Alliance extends Air Canada's reach to over 660 destinations on six continents.

## World seat sales

Canadians want the best value for money in leisure travel to more of the world and Air Canada is obliging with World Seat Sales. With our growing network, we're able to include many more destinations in our seat sales, places like Stockholm, Copenhagen, Berlin and Kiev.

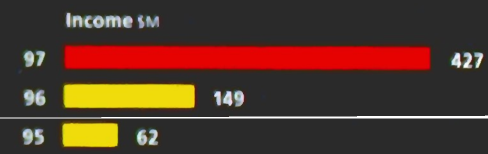
## Intercontinental fleet renewed

By 1999, new Airbus aircraft will begin replacing our older Boeing 747s. Air Canada's latest Airbus order includes A330-300 twin jets, more four engine A340-300s and – subject to confirmation – two larger A340 models, the A340-600 and ultra long range A340-500. The latter would be the longest range aircraft Air Canada has ever flown.



## Air Canada's 60th anniversary

## Biggest profit ever




## Building a global gateway

Toronto is Air Canada's world hub. With the start of non stops to Osaka and another ten US cities including Seattle and Phoenix, Air Canada continues building Toronto into a major gateway to all of North America. From Toronto, Air Canada and Air Ontario now fly nonstop to 38 cities in the United States, more than all other airlines combined.

## Year at a Glance

| Financial | 1997 | 1996 | Change |
|---|---|---|---|
| (Millions except per share figures) | | | |
| Operating revenues | $ 5,572 | $ 4,880 | 14% |
| Operating expenses | $ 5,204 | $ 4,665 | 12% |
| Operating income | $ 368 | $ 215 | |
| Income for the year | $ 427 | $ 149 | |
| Operating margin | 7% | 4% | |
| Cash flow from operations | $ 366 | $ 64 | |
| Cash and short-term investments | $ 650 | $ 455 | |
| Average common shares outstanding (fully diluted)* | 189.1 | 189.1 | |
| Income for the year per common share (fully diluted)* | $ 2.37 | $ 0.82 | |
| Cash flow from operations per common share (fully diluted)* | $ 2.04 | $ 0.41 | |
| Return on equity | 36% | 17% | |
| Common share, closing price (Toronto Stock Exchange) | $ 14.75 | $ 6.20 | |

*Per share amounts have been calculated using the weighted average number of common shares outstanding during the year.

| Operating Statistics | 1997 | 1996 | Change |
|---|---|---|---|
| (Scheduled and Charter – not consolidated) | | | |
| Revenue passengers carried (millions)* | 14.0 | 13.0 | 8% |
| Revenue passenger miles (millions)* | 22,788 | 20,596 | 11% |
| Available seat miles (millions) | 32,061 | 29,431 | 9% |
| Passenger load factor* | 71.1% | 70.0% | 1.1 pts. |
| Yield per revenue passenger mile (cents)* | 17.5 | 16.4 | 7% |
| Average number of employees | 21,215 | 19,868 | 7% |

*Includes frequent flyer redemptions (1996 restated).

# Chairman's Report to Shareholders

For many, the magic moment in Air Canada's 60th anniversary celebrations last September was the touchdown of a brand new Airbus A319 jetliner painted in the livery of Trans-Canada Air Lines, as Air Canada used to be known. For nostalgia buffs, this silver jet with familiar red and white stripes the length of the fuselage stirred fond memories, even a longing for those good old days.

Though my generation grew up with TCA, I believe Air Canada has known no better days than the present. Now larger, more productive and more profitable than ever, Air Canada is a $6 billion entity whose importance to Canada extends far beyond its far flung network. Literally hundreds of domestic suppliers are growing with us – from airports to caterers to the ingenious people who write our computer software. As it grows, Air Canada is hiring more young Canadians than almost any company I can think of.

While the silver A319 is meant to remind us of the past, for me it is a metaphor for what Air Canada has become: a company with a bold, entrepreneurial mindset that seizes opportunity. The decision to buy 35 A319s was made four years ago when times were tough and most airlines were not buying aircraft. It meant Air Canada got the planes at a great price. Now, with air travel markets booming, the A319s are being delivered at a rate of two a month. Perfect timing, I'd say, and president Lamar Durrett and his executive team are making the most of it.

Before it could enjoy such good fortune, Air Canada had to reinvent itself during the early part of the decade. That created the competitive costs and business culture suited to the era of deregulated air travel.

Two former chairmen spearheaded that transformation: my predecessor, Hollis Harris, and his predecessor, Claude Taylor. Claude is about to retire from the board of directors. That will end a formal association which began nearly a half century ago in 1949 when he joined TCA as a passenger agent in his native New Brunswick. Among his many major contributions from the executive suite, Claude was an early and forceful advocate of privatization. It is fitting, therefore, that he retire after the airline's most profitable year, with the prospect of more like it in the years to come. We thank him and Gordon MacFarlane, also retiring from the board, for their support and wish them the very best.

John F. Fraser
Chairman of the Board

# Report from the President and Chief Executive Officer

**Our success in 1997 was no accident. Improved economic conditions in Canada, the US and Europe were important factors. But much of what we achieved was a direct result of a busy year taking concrete actions to build durable value.**

President and Chief Executive Officer Lamar Durrett (seated, right) and three senior members of his executive management team – Robert Peterson, Senior Vice President, Finance and Chief Financial Officer, Jean-Jacques Bourgeault, Senior Executive Vice President, and Robert Milton, Executive Vice President and Chief Operating Officer.

It is with great pleasure and considerable pride that I report to you that 1997 was the best year ever in the history of Air Canada. Air Canada's performance was superior to any previous year by every significant financial, operational and technical yardstick. I take particular satisfaction that our record profit of $427 million, almost triple the previous best, confirms the merit of staying the course on the strategic plan we have carefully put in place over the previous five years. Gains on the sale of our remaining stake in Continental Airlines and certain other investments contributed $201 million to net earnings, proving once again the wisdom of our original decision to invest in Continental.

Operating earnings, perhaps the best measure of how well we are running the airline, also set an all-time record at $368 million. That's about one third better than Air Canada's previous best. Higher revenues across the system including a 25 per cent increase in premium class revenues, better yields and a further 11 per cent improvement in employee productivity all contributed to this outstanding result. Indeed operating earnings would have exceeded $400 million but for the impact of a six week work stoppage by pilots of our regional connector airlines.

It was also gratifying that the market took notice of Air Canada's progress. Our share price reached an all-time high of $15.40, closing the year at $14.75. Air Canada was back on the radar screens of market analysts and institutional investors who until recently had avoided Canadian airline stocks.

Our success in 1997 was no accident. Improved economic conditions in Canada, the US and Europe were important factors. But much of what we achieved was a direct result of a busy year taking concrete actions to build durable value. We launched more new Open Skies routes to the US increasing our market share to 41 per cent of all transborder scheduled air travel sold by Canadian travel agents, a far bigger share than any other airline. It's hard to believe Air Canada today operates 72 routes to 42 US destinations compared to only 28 routes and 14 destinations just three years ago. As a result transborder revenues more than doubled in the same period to over $1.2 billion.

Air Canada also flew more to Europe and Asia last year. Our new non-stop route from Toronto to Osaka is just the first of what should be many non-stop Toronto/Asia routes for Air Canada. The shift of international operations from Mirabel Airport to Dorval in 1997 created the necessary conditions for Air Canada to announce new non-stop routes from Montreal to Frankfurt and to Tel Aviv.

Nineteen ninety seven will be remembered as the year we cemented Air Canada's profitable partnership in the global **Star Alliance**. Integrating our services with those of quality airline partners like **United Airlines, Lufthansa, SAS, Thai Airways International and Varig** generated millions of dollars in new revenues for Air Canada as well as much improved services to our customers. And that is only the beginning.

We have made much of Air Canada having one of the youngest and most technically advanced and efficient fleets in the industry. Last October Air Canada took another important step with our decision to buy eight new wide body Airbus A330 and A340 aircraft. These aircraft will replace our venerable Boeing 747-100 and 200s that have performed yeoman service for Air Canada over the past quarter century. The new aircraft will begin to arrive next year with deliveries to be completed in the year 2000.

In March the Board will decide on whether to proceed on the second phase of our wide-body fleet renewal plan, acquisition of five new generation A340-500/600 aircraft. The A340-500 series will have the unique ability to fly non-stop from Toronto to Hong Kong without refueling. The stretched A340-600 series will carry about 20 per cent more passengers, ideal for high density international routes. Those aircraft would be delivered in 2002.

Last year also reminded us that we should always be ready for the unexpected. That was brought home by Flight 646's brush with tragedy in Fredericton on December 16, thankfully without loss of life. I am proud of the way Air Canada people responded to the incident. Our immediate priority was to take care of the needs of the passengers and their families. We continue to work closely with the Transportation Safety Board to support their investigation of the accident and to review Air Canada's internal procedures so that we can learn from that experience.

Looking ahead, it would be bravado to expect every year to be a record year. Nevertheless I am looking forward to another excellent year for Air Canada in 1998. Our basic plan is to do more of the things that worked well for us last year. Air Canada will continue to add new routes and capacity across the system with the main emphasis on the US and overseas markets. At the same time we will protect our 58 per cent share of the domestic market and increase further our preferred position among high yield business travelers.

Improving customer service is a key objective in 1998. Our aim is to recognize our customers as individuals and to do more to anticipate their individual preferences. New innovations like our Super Elite program that extends more and better privileges to our most valued frequent flyer customers, and new arrival lounges at international destinations so that Elite customers will be able to freshen up after a long trip, are examples of how Air Canada will go beyond the ordinary.

Introduction of Open Skies for US carriers at Toronto will increase competition in 1998. But Open Skies is about more than travel to the US. Canadians now have multiple airline choices, every day, to fly to every significant international destination via nearby US hubs. It remains a paradox in this new market environment that Canadian aviation policy persists in preventing Air Canada from competing fully with US and foreign airlines.

The price is that both Air Canada and Toronto are blocked from achieving their full potential. Hundreds of potential new jobs are not realized at Air Canada, together with even more spin-off jobs in the Greater Toronto Area. Restrictions on Air Canada, apparently motivated by a desire to protect unprotectable international routes from Vancouver, instead impose a harsh penalty on Toronto and shift business to American and other foreign airlines and to US airports.

The next section of this report sets out four main business goals for the airline. With the spirited dedication of all the good people at Air Canada who worked together to make 1997 such a remarkable year, I look forward with confidence that the good times have only just begun.

**We are challenging ourselves to aim higher. That's the thrust behind our new marketing vision: Defy Expectations. We can move Air Canada to a higher level of profitability. Skeptics point to the highly cyclical nature of our business, but I believe we can minimize the effects of recessions and produce sustained runs of superior results by building on four major goals.** Lamar Durrett

## 1

### Pursue profitable growth to meet the expectations of all stakeholders

No risk, no reward. Nothing ventured, nothing gained. These are articles of faith in the business world. But financial risk is relative and can be managed: Don't put all your eggs in one basket. Growth is one of the four building blocks for making a stronger and more profitable Air Canada, but growth on our terms – the Air Canada way. Our way reduces the business risk, shaves the cost and shortens the time frame required for new routes to make money.

Our challenge is to be the best airline value, with particular emphasis on the business traveller. Fewer than 100,000 customers generate 80 percent of Air Canada's profit. These are demanding customers. That's why we launched Executive First four years ago, and why last year we helped launch Star Alliance, the most ambitious alliance in the history of aviation that extends Air Canada's brand to hundreds of new destinations around the world.

Given that Canadians account for only 1.5 percent of the world's airline traffic, we have no illusion about becoming a mega-carrier. Our vision is to be a strong, mid-sized carrier with a solid international system, strong alliances, and to be world class in every respect. We will have a world class global hub at Toronto and strong international gateways at Montreal and Vancouver. Our 50 percent share of all airline sales in Toronto means Air Canada now has the critical mass to support the transborder services we need to attract a larger share of traffic between the US and Europe, Asia or Africa. Air Canada now flies nonstop to 38 US cities from Toronto. As the maps on pages 68 and 69 indicate, that's 25 more US destinations than before Canada-US Open Skies, and more than all other airlines combined.

Last year's consolidation of domestic and international passenger flights in Montreal at one airport – Dorval – produced an immediate surge in connecting traffic. Dorval is restoring Montreal's historic position as an international gateway. People from Atlantic Canada who had shunned international connections in Montreal because it meant shuttling between two airports, are rediscovering the convenience of transferring at Dorval, where domestic and international gates are just steps apart. We're building on that in 1998 by launching daily nonstop Montreal-Frankfurt service, along with twice weekly nonstop service to Tel Aviv.

With the redevelopment of Toronto's Pearson International Airport finally under way, its easy to get excited about Toronto's potential. Pearson is one of the few major airports anywhere adding both runways and terminal capacity. Although we are still concerned about cost, we're confident that the giant terminal scheduled to replace Terminal 2 will provide Air Canada with ample room to keep on growing as well as the customer friendly intransit facilities Toronto must have to become a leading North American airport for international connections. In the meantime, we're not waiting, adding more US destinations from Pearson using both jets and turboprops.

Air Canada has grown faster than most other carriers: from 99 aircraft only five years ago, to 169 aircraft in 1998. To grow so much so fast, we have focussed on launching new or unique routes, creating a nonstop or direct service where there was none previously, or creating competition where there is pent-up demand. **That's the common denominator in most of the 44 US routes we're flying today that were inaugurated since 1994.** It's a major reason why passenger traffic last year grew faster than capacity for the second straight year.

Air Canada pioneered the hub busting concept, using small Canadair jets to launch short haul routes under Open Skies. Wherever that happens, passengers prefer our nonstops over the connecting services of our competitors. Now we use our newest fleet addition – the A319s – to launch new hub busting transcontinental routes like Toronto-Phoenix. With its coast to coast range, the 112 seat A319 is cheaper to operate than larger aircraft, and offers just the right amount of capacity for developmental routes. And to enhance customer service and comfort we're refurbishing 25 of our DC-9s. These Energizer aircraft as we've nicknamed them will take over maturing US routes from Canadair jets, freeing the smaller aircraft to launch others. The DC-9s are fully depreciated. If market conditions deteriorate, they can be parked without idling capital, another way to mitigate the risk of expansion.

Air Canada's expanding network is a strategic advantage, providing customers with one stop shopping wherever they want to fly in the world.

When surveyed, customers cite our unrivalled network coverage as a leading reason for choosing Air Canada. It's not just the number of US cities we now serve, it's also greater flexibility. From Toronto, only Air Canada flies to two New York airports and all three airports in the Baltimore-Washington area. Chicago? We fly there daily from four cities in Canada.

Building the network and especially a powerful Toronto hub also requires that Air Canada serve the hubs of our US competitors, like Cleveland and Pittsburgh, two of ten US destinations added last year. Our record of success in head to head competition with large US hub airlines stems from flying smaller aircraft against their larger ones with enough frequency to give our customers a good choice of flights throughout the day. (Domestically, the reverse applies. Putting more widebody aircraft on transcontinental routes is attracting more business travellers to Air Canada. For many, it's simply no contest choosing between an Air Canada 767 or A340 and other airlines' 737 and 757s for a five hour flight. With demand booming, we're adding Executive Class and Executive First seating on A340s, domestic 767s, also the DC-9s.)

Now, we are putting more clout behind our transborder product. Air Canada and partner United Airlines are assembling the largest code sharing pact on earth. Obtaining US government anti-trust immunity last year permits us to coordinate schedules, plan joint fares and jointly promote new destinations. United now is code sharing Air Canada's entire transborder system, including all Toronto departures, bringing its 23 million frequent flyers to the party. This intensifying relationship between two Star Alliance members will mean more and more revenues for each. Last year saw our revenues from code sharing with United more than double.

Customer surveys cite the clear lead Aeroplan enjoys over rival frequent flyer programs among Canadian travellers. Enabling our frequent flyers to earn and redeem points on a worldwide basis on Star Alliance carriers is a clear enhancement. So is giving our customers one stop shopping for all their global travel needs.

## Star Alliance

The founding of Star Alliance last May was a landmark achievement for Air Canada and a seminal event for the airline industry. It will change how customers relate to international air travel and how major carriers deploy their resources. The world's first truly global airline alliance, Star Alliance is six formidable airlines: Canada's largest (Air Canada), the world's largest (United), European powers Lufthansa and SAS, south-east Asia's Thai Airways International and Brazil's Varig. More and more, travellers want one stop shopping for global travel. Star Alliance serves over 660 destinations on six continents, more than any other airline alliance. All members of the alliance keep their own brand and identity, as well as their own frequent flyer program. At the same time, the six airlines are providing common services and benefits so that customers can expect the same uniformly high standards wherever they fly on the Star system.

Everyone is a winner with Star Alliance. All customers enjoy one stop check-in wherever they fly on the worldwide network. Air Canada's best customers – those who travel often or pay premium fares – gain worldwide recognition. Each Star carrier is equipped to recognize them and grant them the same benefits they do their own top customers, like priority services or access to airport lounges. The six carriers' 31 million frequent flyers can collect and redeem mileage points on any Star carrier. Our Aeroplan members now earn Qualifying miles for Prestige, Elite and new Super Elite status on a worldwide basis.

Twenty cities in Europe, from Athens to Stockholm to Berlin, were added to the Air Canada network last year through codesharing on SAS and Lufthansa aircraft. More will be added soon. To facilitate connections, Star Alliance members are sharing airport facilities, wherever possible, and providing each other with ground services.

Star will be a tool for profitable growth. Besides providing customers with good reasons to select Star Alliance carriers wherever they fly, the alliance offers many opportunities for substantial cost savings for the airlines. The opening of a Star Alliance ticket office in London has freed member airlines from operating separate ticket offices in one of the world's priciest real estate markets. Joint tenders for supplies and services are attracting lower bids than any of the six airlines could have negotiated individually on everything from blankets to stereo headsets. Other synergies are being explored.

No Star member owns equity in another. This partnership is made up of like minded corporate cultures with a strong buy-in from the six chief executives. That, in turn, fosters a strong collegial spirit. Twenty-three working groups are developing more customer benefits, like improved connections and baggage transfers, products for cargo as well as mutual accountability procedures so customers won't have to trek from airline to airline for help when something goes awry. Many airline alliances claim to deliver convenient connecting services. No group is working harder to bring about true, hassle free seamless service on a global basis than Star Alliance.

**Be the best at understanding customer needs and meeting them**

All the self styled gurus on the business seminar circuit agree on one thing: Corporate success today depends on being resolutely customer focussed. To that, we'd add being customer intuitive – understanding how trends in society are changing the motivation to travel and people's expectations of a trip. We know, and surveys confirm, that our customers believe there's an Air Canada way to travel: the best aircraft, the best network, schedules, lounges and airport gates. It's also a reflection of how we balance six decades of tradition with a commitment to continual improvement.

No airline can afford everything on travellers' wish list for new or improved services. For us to be customer intuitive means understanding what each segment of Air Canada's customer base would value most in enhancements. That was the impetus last year for CRM, the most extensive survey of the travel preferences and habits of full fare customers Air Canada has ever conducted. Thousands of regular Air Canada customers as well as customers who fly mainly on other airlines filled out the exhaustive questionnaire which furthered our understanding of why our regular customers choose Air Canada and what it will take for others to switch to us. The data also enables us to measure the market share gain we can expect for implementing specific enhancements.

Many factors help shape customer preferences. Age and gender enter the equation. So do economics, demographics, even geography. Responding to different wants can be as obvious as giving men and women in Executive First gender specific amenities kits, or as subtle as catering to the palate of American passengers. Meals or snack plates are standard fare on many

Opening a new transborder lounge at Montreal's Dorval Airport is one of the ways Air Canada is providing even more value to premium customers like James Stapleton.

transborder flights over 90 minutes, also some shorter ones. Breakfast is served on every single early morning transborder departure. Americans are agreeably surprised when they fly us for the first time and have food put in front of them. It's one way we are building our brand identity below the 49th parallel. And as A319s enter service, they are being deployed on prime routes to Chicago, New York, Boston and Atlanta so discerning US customers will associate flying on new jets with Air Canada.

In the early days of Trans-Canada Airlines, aircraft weren't even pressurized. Today's traveller has a much more refined sense of what constitutes a good travel experience. That will differ according to where and how often they fly. One growing segment flies almost exclusively internationally, a need hardly diminished by faxes and e-mail because there's nothing better than face to face meetings to cement a business deal halfway around the world. These international high flyers want more recognition and civility. Star Alliance gives them the former. Launching Executive First four years ago gave them more of the latter: wider seat and more legroom. Still, these are people who often have trouble sleeping on any aircraft. Now we can say to them, dream on: The introduction shortly of new noise suppression technology piped into their headsets through the Executive First sound system will lessen the ambient noise.

These globe trotters rate Air Canada's lounge product high on their list of reasons for choosing us. We're building on that. Opening this spring and summer in Toronto, Vancouver and London, our new international arrivals lounges will be an oasis where Executive First and other qualifying passengers can shower and unwind. Three years of work has gone into upgrading and expanding our Maple Leaf departure lounges. Several have received complete makeovers. That, plus the addition of Xerox business centres and now Sony entertainment centres with TV, CDs and video are keeping our Maple Leaf lounges a cut above the competition.

And what of other groups? The very frequent flyer wants more status. Fly hundreds of thousands of miles as some customers do, and it's easy to become jaded about accumulating Aeroplan miles. Aeroplan's new Super Elite level provides these people with additional perks and privileges that reward their outstanding patronage, like 24 hour telephone concierge service, priority standby listing, unlimited lounge access and guaranteed reservations even when a flight is oversold.

Waiting in lineups or telephone queues is the bane of business travellers in a hurry, which includes most short haul flyers. To the extent we can reduce or eliminate waiting, we raise their satisfaction level. Those comfortable with new technology will gravitate towards our three step electronic ticketing and check-in program: 1) Cyber Ticket Office at <www.aircanada.ca> on the Internet; 2) electronic ticketing, and 3) self-service check-in machines at major airports. Separately, each can be a time saver. Together, they form an electronic corridor that will speed passengers through airports. Launched last October, Cyber Ticket Office is open 24 hours a day for point to point bookings, and will eventually process flight changes, interline itineraries, Aeroplan reward travel and much more. Users of Cyber Ticket Office can order a traditional paper ticket from the airline or their travel agent. Or they can use electronic ticketing. Also known as paperless ticketing, electronic ticketing was introduced in 1996, and now accounts for almost a third of all domestic bookings made through the airline. As 1998 progresses,e-ticketing will be rolled out on most transborder routes. It will be available for some overseas travel by year-end.

Cyber Ticket Office isn't for everyone. Our call centres and travel agent partners will continue to process the bulk of our reservations. But technophiles will embrace Cyber Ticket Office and e-ticketing, particularly after self service check-in is introduced at major airports across Canada this year and next. Passengers with electronic tickets will use these dispensers to get bar coded boarding passes that can be scanned electronically at the gate.

None of this is to suggest that Air Canada only thinks about premium customers. Innovations like Cyber Ticket Office and self-service check-in are for all. The progressive rollout of new features last year made <www.aircanada.ca> one of the most fully featured airline Internet sites, providing up to the minute arrival and departure information, and weekend Websaver fare specials updated every Wednesday. Cargo customers can track their shipments and check which international flights for the week ahead have space available. It's no wonder that <www.aircanada.ca> receives over 3.2 million "hits" a week.

With network expansion and fleet renewal, every customer wins. So, too, with Star Alliance. And everyone loves Aeroplan. Independent surveys say it's Canada's favorite frequent flyer plan. With almost 3.5 million members, it continues to grow at a double digit pace, and last year's addition of Delta Hotels & Resorts – with strong presence from coast to coast – added to an already formidable lineup of partners that includes the top three car rental companies, and several of the world's leading hotel chains.

The leisure market wants top value, which prompted last year's launch of Websavers and World Seat Sales, the latter extending discounts to more US and overseas destinations than ever. Many business travellers also fly Air Canada on vacation, and they expect to travel the Air Canada Way even with kids in tow. Our policy lets families pre-book seats together, even on discount fares, while saving prime seats for full fare travellers. That way, families don't have to come to the airport three or four hours before flight time to be seated together. That's easier on everyone's nerves. We also keep our young passengers well entertained. Skyriders®, Air Canada's industry leading program for young travellers, continues to win rave reviews and a growing following. The Canadian Direct Mail Association awarded its Gold RSVP award to Skygram, the Skyriders newsletter.

## Fleet Renewal

Today's quieter fleet: The Airbus A319/A320 family, which now makes up about 40 per cent of Air Canada's fleet, meets the stringent Stage 3 international noise standard with plenty to spare. Though significantly larger than a DC-9, the A319/A320 make only half as much noise, although hushkitting the DC-9s will make them a lot quieter, too.

# 3

## Be renowned for technical proficiency and superior performance

From the pioneering aviators and engineers of the early Trans-Canada Airlines to the consummate professionals of today, the Air Canada way has always meant maintaining standards in excess of regulatory minimums, and no compromising on safety. The Maple Leaf on the tail has always been, always will be a metaphor for reliability. Air Canada's technical proficiency adds lustre to our reputation and fosters great *esprit de corps* among our pilot group, which has enabled us to attract the cream of pilot applicants as the airline grows.

It's always been like that. Aircraft makers used to covet a TCA order because of the airline's reputation for technical excellence and innovation. The major vendors were British or American, TCA was neither. They reasoned that if TCA placed an order, other airlines would view it as an unbiased endorsement. As a result, TCA was known to win important concessions, even major engineering changes, in exchange for an order.

With two major manufacturers squaring off in most competitions today, similar dynamics apply. Air Canada has placed five aircraft orders in four years. Being ready to wheel and deal, especially when the manufacturers are hungry for orders, has produced huge discounts.

Our people, like mechanic Jean DuPont, uphold Air Canada's worldwide reputation for safety and reliability.

Last year's order of five A330-300s and three more A340-300s for delivery in 1999-2000 is typical. The new planes are so well priced, and so much cheaper to operate they will add $20 million to our operating net annually when they replace our six Boeing 747 classics, even with the higher ownership cost of flying brand new planes. After we began flying A340-300s rather than 747s to Seoul and Hong Kong last summer, the financial performance of those routes improved significantly.

Air Canada was the North American launch customer for three Airbus models – the A319, A320 and A340-300. In late March, Air Canada will decide on Phase 2 of the long haul fleet renewal plan that will make the airline the global launch customer for the ultra long range A340-500 and one of the carriers to fly the high capacity A340-600. Each new aircraft type has brought added functionality. The extended range A340-300 which joined the fleet during the 1996-97 winter schedule gave the airline a plane with sufficient range to launch nonstop Toronto-Osaka service last July. And with its 16 hour range, the A340-500 will be the first aircraft capable of flying routes like Toronto-Hong Kong or Vancouver-Singapore nonstop in both directions.

Constantly renewing the fleet even as we expand makes a strong statement to our customers and alliance partners about the quality we put behind our brand. Customers are swayed by the intrinsic appeal of new aircraft. New aircraft, like new cars, spend less time in the shop. They have the latest in entertainment systems. They are more fuel efficient. An A319 is 32 percent more fuel efficient than a DC-9 on a seat mile basis. New aircraft are dramatically quieter, as anyone living near a major airport can attest. They fall well below the pending international Stage 3 noise cap.

Ongoing renewal allows the airline to progressively introduce new technology by installing it at the factory. When new A330-300s and A340-300s are added in 1999, they will include many outstanding new features in passenger comfort and in-seat entertainment. They will be among the first to incorporate FANS technology. FANS, the acronym for Future Air Navigation System, will employ satellite navigation for greater safety and shorter routings. The safety investment doesn't end at the factory. The Boeing 747-400s will get a version of FANS, the Energizer DC-9s are getting new colour weather radar and the regional jets are being upgraded with GPS, global satellite navigation.

Nine years of flying Airbus aircraft has built up a vast repository of experience and an exemplary record with the glass cockpit and fly by wire technology introduced by the European manufacturer. The similarity of the A319/320 and A340 cockpits reduces the amount of training pilots must go through when they graduate to the larger aircraft from 54 to 13 days, all of which are paid days. By June, the airline will have 69 A319/320s – including 35 new A319s.

Some of the world's leading airlines also rely on the Air Canada's reputation for technical proficiency. The Winnipeg base now performs heavy maintenance on America West Airlines' entire fleet of A320s. The Dorval base does engine overhauls for several other carriers, including United Parcel Service.

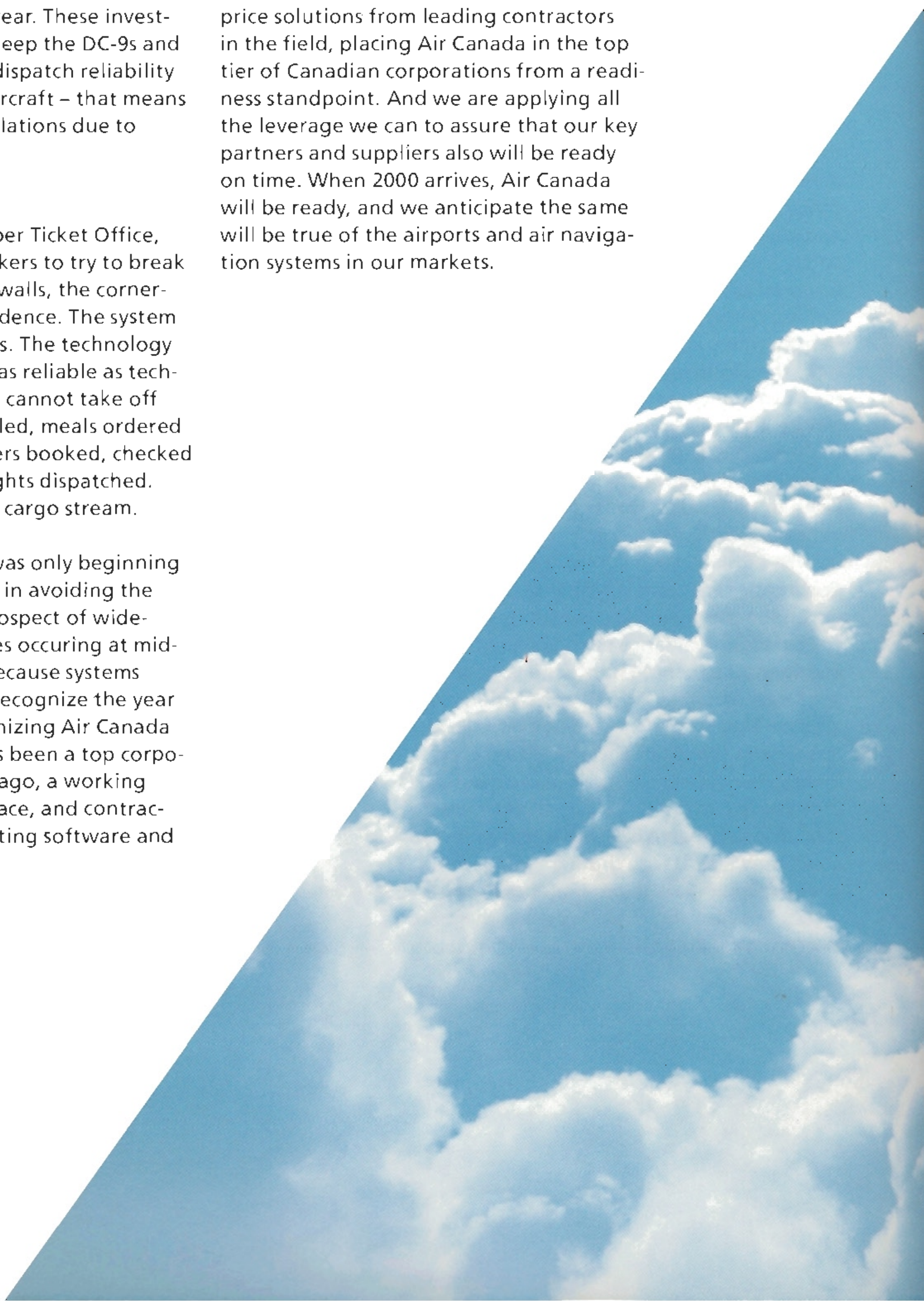
Progressively renewing the fleet challenges us to maintain the appeal of older aircraft that still have many good years ahead of them. The Energizer DC-9s will be easier on the ear and the eye. Each is to get a new pressurization system along with an interior refit. By hushkitting the engines and reducing interior noise, they will be quieter for passengers, also for people living near runways who won't miss the mighty roar of a DC-9 in full acceleration. The 747 classics were given a $5 million rehabilitation late last year. These investments are designed to keep the DC-9s and classic 747s flying with dispatch reliability comparable to newer aircraft – that means fewer delays and cancellations due to "technicals".

### Year 2000

Before we launched Cyber Ticket Office, we asked computer hackers to try to break through its security firewalls, the cornerstone of customer confidence. The system passed with flying colors. The technology on the ground must be as reliable as technology in the air. Planes cannot take off unless crews are scheduled, meals ordered and delivered, passengers booked, checked in and boarded, and flights dispatched. The same applies to the cargo stream.

A year ago, the public was only beginning to grasp what's at stake in avoiding the millennium bug. The prospect of widespread computer failures occuring at midnight January 1, 2000 because systems aren't programmed to recognize the year is mindboggling. Immunizing Air Canada against the problem has been a top corporate priority. Two years ago, a working group was already in place, and contractors signed up. By rewriting software and undertaking the normal course replacement of some systems, our Year 2000 update should be substantially complete by the end of 1998. Testing of new or upgraded systems should be completed no later than the summer of 1999, leaving ample time to cope with any unforeseen issues.

We have made prudent investments of time and resources. By acting early and decisively, we've been able to secure fixed price solutions from leading contractors in the field, placing Air Canada in the top tier of Canadian corporations from a readiness standpoint. And we are applying all the leverage we can to assure that our key partners and suppliers also will be ready on time. When 2000 arrives, Air Canada will be ready, and we anticipate the same will be true of the airports and air navigation systems in our markets.



# Corporate citizenship

Canadians look to large corporations to provide leadership on major social and environmental issues and support for sports and cultural endeavors, especially in this era of reduced government involvement in arts funding. Air Canada has always responded – it's the Air Canada way. So it was in 1991 when Air Canada took the calculated risk of being the first major airline to ban smoking on all flights. Non-smokers applauded the ban, but so did many smokers, showing the way for most of the world's airlines to butt out as well.

Today, many Canadians are concerned about the prospect of global warming. As the only airline participating in the federal government's Voluntary Challenge and Registry, Air Canada now reports annually on the prior year's progress on containing greenhouse gas emissions. Between 1990 and 1996, the fleet grew by 27 percent, while total aircraft emissions rose by just six percent. The influx of new aircraft – some as replacements for older ones – produced a 14 percent improvement in fuel efficiency. Over the same period, fossil fuel emissions from ground vehicles were reduced by 44 percent.

Air Canada takes pride in building a strong partnership with the community. Some of the organizations we are proud to partner with include the Canadian Youth Business Foundation, Mission Air Transportation Network, the RCMP Missing Children's Registry and Starlight Foundation Canada.

Combatting the high unemployment rates for young Canadians and aboriginal peoples is one of the greatest challenges facing Canada. By expanding as rapidly as it has, the airline is providing thousands of first time job seekers with good career opportunities. That should include more aboriginal people. By agreement with the Assembly of Manitoba Chiefs, the airline has stepped up efforts to attract qualified aboriginal candidates. Since the usual media channels often don't reach native communities, special one day recruiting drives are taking the message to them.

Without corporate sponsorship, it's doubtful many major sporting and cultural institutions would exist. Air Canada has been a sponsor of Canada's two National Basketball Association teams since their inception, also the Greater Vancouver Open golf tournament. Air Canada has a long association with professional hockey. We are the airline sponsor of four of the six Canadian based National Hockey League teams. With the decision to house both Toronto's pro hockey and basketball teams in the new Air Canada Centre, we are looking forward to once again being a sponsor of the NHL Maple Leafs. Just as importantly, we support Canadian amateur sport at several levels. As a sponsor of Canada's Olympic team, we're proud to have contributed in a small way to the team's great success at the recent Nagano Winter Games. As a patron of the arts, our sponsorships include Canada's acclaimed Cirque du Soleil, the country's three best known international film festivals, jazz and comedy festivals, the Royal Winnipeg Ballet and Canadian Native Arts Foundation.

### Make every employee a customer advocate

If we talk of heroics and Herculean efforts by our employees it's more than hyperbole. Team work and community service are deeply rooted in the Air Canada way. There was a great deal of both last year, from the enormous volunteer effort made by many thousands of employees so that Dreams Take Flight could make dreams come true for thousands of special needs children, to the heartfelt 'How can I help' reaction to Manitoba's devastating flood that moved employees from Quebec to fly there on their own time to help rebuild the Taras Shevchenko Community Hall at St. Norbert, south of Winnipeg. On board international flights, flight attendants collected leftover foreign currency from returning Canadians for the Children's Miracle Network. By giving so much to the community, our employees are great ambassadors for the airline. People advocates make the best customer advocates.

The same Air Canada spirit was exhibited on the job as well. Despite exceedingly tight deadlines, the consolidation of Montreal's international flights at Dorval Airport came off without a serious hitch. In Air Canada's case, that was the reward from many weeks of meticulous planning and preparation, including transition training for employees shifting over from Mirabel Airport. At midnight on September 14, a truck convoy left Mirabel with equipment to be redeployed the next day at Dorval. Every deadline was met because Air Canada people pulled together, and because the move was prepared with sensitivity for the disruption being caused to the lives of our transferring Mirabel staff.

It was teamwork again – this time by virtually all front line employees – that helped raise system on-time performance during the peak summer months by nine points even though it was the airline's busiest summer ever. Each station took up the "72 percent Challenge", joining in friendly competition to see which could achieve the best on time ratio based on live at zero, which means departing exactly as scheduled, with no grace period. Cash prizes were awarded to stations for spending at their discretion on group activities or charitable endeavors.

Then there is the High Performance Work Organization (HPWO) initiative, improving productivity of maintenance operations through the reorganization of the work force into self directed teams. Proposed by the International Association of Machinists and Aerospace Workers, HPWO is making labor and management partners in progress. Both union and management join forces to bid on third party contracts, an approach instrumental in landing the contract to maintain America West's A320 fleet. Improving work force productivity makes jobs more satisfying and secure. As team leaders develop confidence, the benefits are bound to grow.

With their skills, professionalism and cool under pressure, Air Canada's people always have been a huge asset, never more so than during our current expansion. In the last three years of growth, every measure of employee productivity has shot up dramatically. Only a few years ago, it was a rare day that Air Canada handled 50,000 passengers. Now, it's a commonplace. In fact, if you compare us with the Air Canada of 15 years ago, you find that staff levels are about the same, but we now carry 40 percent more passengers.

Members of our in-flight team, like in-charge flight attendant Heidi Grace, are dedicated to making customers like Cynthia Farrell feel at ease on every flight.

Our job is to give Air Canada people the tools and training to help foster a culture of top flight customer care, and particularly to maintain an environment where the customer feels at ease. Employing new technology like our electronic corridor for reservations, ticketing and check-in will reduce the mundane and repetitive aspects of jobs, freeing customer service employees so they can offer more personalized service. That's the principle behind Qik-Chek, a user friendly computer interface for passenger agents that drastically reduces the number of computer key strokes required to check in passengers. Qik-Chek is up and running in call centres and is being rolled out at airports across the system this year and next. It will reduce training on computer hardware from weeks to days, because new employees won't have to learn as many codes and commands.

That being said, our plan is to do more training, not less, including more recurrent training for ground staff related to new products and service delivery. We also want employees to have clear guidelines for dealing with the unforeseen. Problems happen at all airlines. Luggage can be misdirected, and flights overbooked. While investing to minimize those occurrences, we are also developing improved recovery procedures so that our front line staff will be able to respond on the spot, either solving the problem or offering immediate compensation on Air Canada's behalf.

## Dream Flights

Nine years ago, a group of Air Canada employees came up with the idea of raising money to bus a group of special needs children to a local theme park. Things took off from there. Instead of a bus trip, they ended up persuading the Corporation to provide a DC-9 for a day to fly 70 physically challenged and underprivileged children to Disney World. Soon, other stations were imitating what Toronto had done. Dream flights to Disney had become a movement within Air Canada.

Today, the various ad hoc efforts have been brought together under a national, non-profit corporation called Dreams Take Flight. That's partly to take advantage of the increasing interest from external sources – both individuals and corporations – impressed by the good being done and wanting to help.

That being said, Dreams Take Flight remains very much an Air Canada employee initiative. Virtually every employee has volunteered at some time or made a cash contribution or bought a pin or T-shirt. For that reason, and for the enormous good will these flights generate, it's the Corporation's favorite philanthropy. Air Canada contributes the aircraft. Depending on the station's size, it could be a DC-9, an A320, even a Boeing 747.

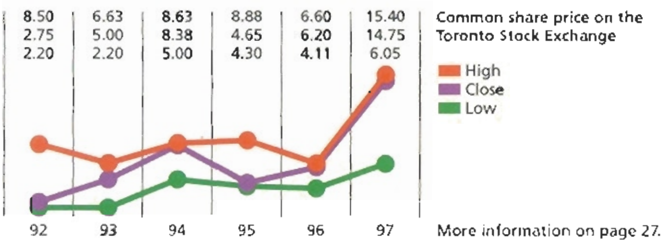
Each of the eight participating stations organizes one flight a year for children aged 6-12. Local volunteer committees administer the program and organize fund-raising activities like bake sales and T-shirt drives.

Pilot volunteers fly the planes. Other employees serve as chaperones. Staff in Los Angeles and Tampa handle arrangements at the receiving end and liaise with the Disney people. While social agencies put forward the names of children, their parents must sign consent forms. At the pre-flight party, each child is photographed and fingerprinted for security reasons and given identical caps and T-shirts so they can be readily spotted in a crowd.

Since the program was launched, over 4,000 special needs children from across Canada have been flown to Florida's Walt Disney World or Disneyland in California for a day they'll never forget. Dreams Take Flight is about volunteering at its best and Air Canada people at their best. It's about people giving time – and lots of it – in a gesture of compassion, amply repaid by the beaming faces on those children.

# Air Canada Performance at a Glance

Share price ($) – December 31

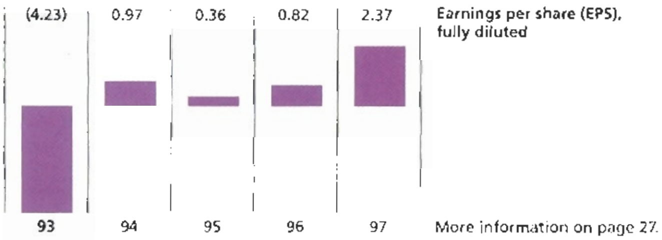



More information on page 27.

## Shareholder Value

- Common share price increased 138 per cent in 1997.
- Closing price of $14.75 per common share in 1997 versus $6.20 in 1996 reflected improved earnings and cash flow.
- Class A Non-Voting shares closed at $13.65 in 1997 versus $5.45 in 1996.
- December 31, 1997 market capitalization valued at $2.3 billion versus $0.9 billion at December 31, 1996.

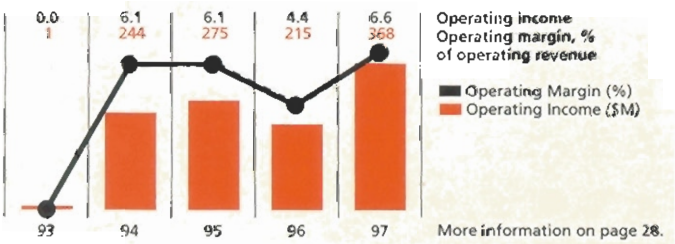
EPS ($)




More information on page 27.

## Earnings Growth

- Fully diluted earnings per share of $2.37 almost triple that of 1996.
- Excluding gains on sales of investments, EPS of $1.31 versus $0.04 in 1996.
- Gains on sales of investments amounted to $201 million in 1997 versus $129 million in 1996.
- 1997 Regional Airline strike adversely affected income by an estimated $32 million (after-tax) or $0.17 per share fully diluted.
- Repayment of fuel excise rebate and reinstatement of tax losses allowed for additional recovery of prior years' income tax benefits in 1997.



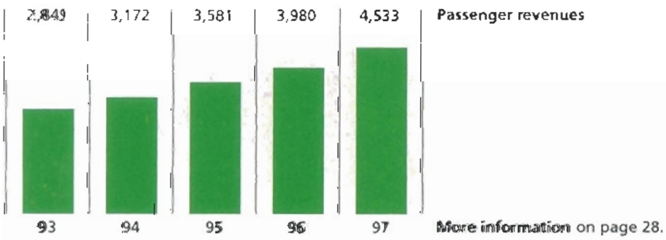

More information on page 28.

## Operating Income ($) and Margin (%)

- Operating income improved $153 million or 71 per cent in 1997.
- Operating margin rose 2.2 percentage points to 6.6 per cent.
- EBITDAR* up $217 million producing an EBITDAR margin of 18.1 per cent.

*Earnings (operating income) before interest, taxes, depreciation, amortization and aircraft rent

$M

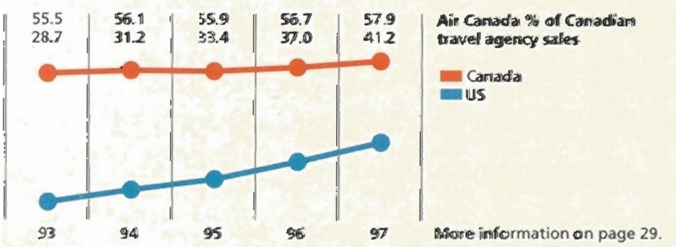



More information on page 28.

## Operating Revenue Growth

- Total passenger revenues grew by 14 per cent or $553 million in 1997.
- Domestic passenger revenues increased $108 million or 6 per cent.
- International revenues, fueled mainly by strong US transborder growth, rose $445 million or 22 per cent.

% Market share

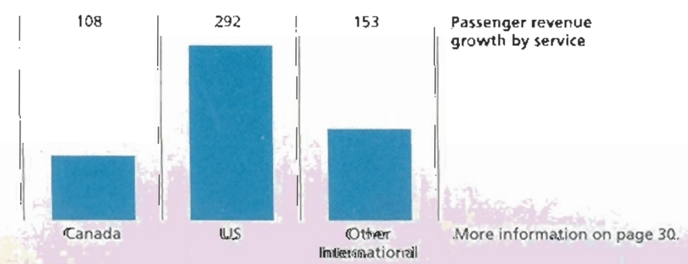



More information on page 29.

## Market Share

- Major growth in US transborder market share.
- US transborder market share, measured by Canadian travel agency sales, up 4 percentage points in 1997 to 41 per cent.
- For December 1997, transborder market share, up 5 percentage points to 44 per cent.
- Canada market share was 58 per cent for 1997, up 1 percentage point from 1996.
- For December 1997, Canada market share rose 3 percentage points to 61 per cent.

$M Growth 1997 vs 1996



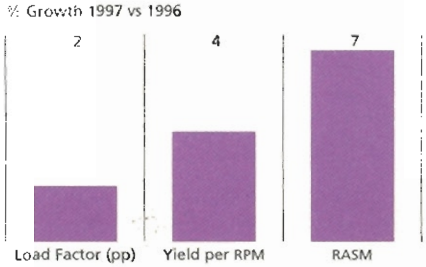

More information on page 30.

## Passenger Revenue Performance

- Strong performance of Canada-US transborder routes with passenger revenue up 30 per cent or $292 million.
- Canada passenger revenue up 6 per cent versus only 1 per cent growth in 1996.
- Other international revenue up 14 per cent with increased Atlantic and Pacific operations.

**Passenger Revenue Performance (cont'd)**

- Total passenger load factor improved 2 percentage points (pp), with revenue passenger miles (RPMs) up 9 per cent and available seat mile (ASM) capacity up 7 per cent.
- Passenger yield per revenue passenger mile rose 4 per cent.
- RASM up 7 per cent due mainly to strong US transborder performance and improved Canada operations.

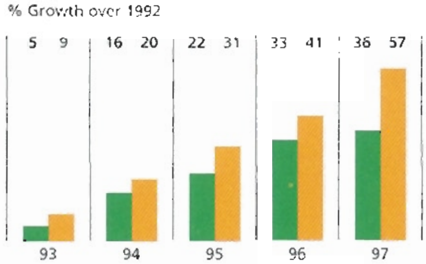



Passenger revenue per available seat mile (RASM)

More information on page 32.

**Productivity**

- Significant productivity improvements since 1992.
- Operating revenue per employee up 11 per cent in 1997 from 1996 and 57 per cent above 1992 level.
- Available seat miles per employee up 2 per cent in 1997 and 36 per cent above 1992 level.

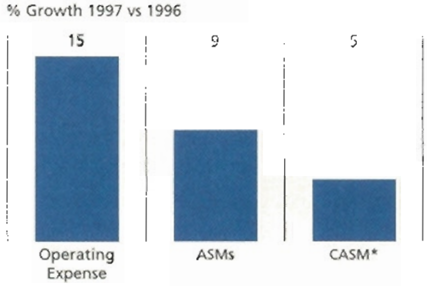



ASMs and operating revenue per employee (excluding subsidiaries)

More information on page 33.

**Operating Cost Performance**

- CASM or operating expense per ASM, adjusted for non-ASM producing revenues, up 5 per cent over 1996.
- Fuel tax reinstatement charge of $43 million, higher aircraft maintenance, aircraft rent, information technology and project costs accounted for most of the unit cost increase.
- Many flight-related expenses increased in greater proportion than the capacity offered, including the effect of price increases.
- Growth in revenue and traffic-related costs outpaced capacity, leading to higher unit costs.



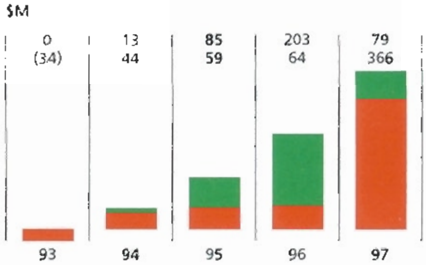

Operating expense* per available seat mile (CASM) (excluding subsidiaries)

*net of non-ASM producing revenues (cargo and other revenues).

More information on page 34.

**Financial Management**

- Major improvement to cash provided by operations, $302 million above 1996.
- Cash flow from operations of $2.04 per share – fully diluted in 1997, up $1.63.
- Excluding scheduled lease payments in excess of aircraft rent, cash from operations was $445 million in 1997, $178 million above 1996.

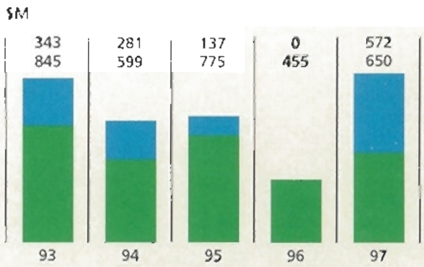



Cash generation

More information on page 35.

**Liquidity**

- Cash and available credit lines amounted to $1.2 billion at December 31, 1997.
- Continuing strong cash position: $650 million.
- Long-term strategy is to maintain cash and available credit of over $1 billion.

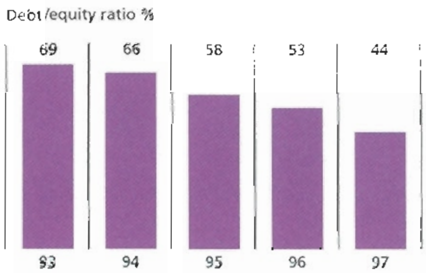



**Cash & unused lines of credit**

More information on page 36.

**Debt (excluding perpetual debt) / Debt plus Equity**

- Debt/equity ratio continued to improve to 44 per cent at year-end 1997.
- Growth in shareholders' equity with reduced debt.
- 1997 debt repayments of $482 million with new debt issued of $235 million.
- Most new aircraft deliveries financed under operating leases.
- Perpetual debt viewed as permanent capital.




Long-term debt* (excluding perpetual debt) as a % of long-term debt*, subordinated perpetual debt and shareholders' equity

*includes current portion.

More information on page 39.

# Management Discussion and Analysis of Results

## Overview of 1997

In 1997, Air Canada recorded its highest operating income and net income in the Corporation's 60 year history.

Operating income for the year was an unprecedented $368 million, representing a $153 million or 71 per cent improvement over 1996. Operating margin rose to 6.6 per cent, 2.2 percentage points above the 1996 level. Strong performance from the Canada-US transborder market was the key factor in the improved operating results. Air Canada's domestic and other international operations also contributed to the improvement. The record operating income was achieved in spite of two events which adversely affected 1997. The first was a labour disruption by Regional Airline pilots early in the year, which had an estimated $57 million unfavourable impact on operating income. The second was the Corporation's decision to reinstate tax losses through the repayment of fuel excise tax rebates from prior years, resulting in a $43 million charge to fuel expense in 1997 (plus $13 million of interest that did not impact operating income). At the same time, pension expense was $39 million lower than the previous year reflecting pension fund growth and a re-assessment of management assumptions.

Pre-tax income at $466 million was more than triple the 1996 result. Net income was $427 million in 1997 representing a $278 million improvement over 1996. Gains on sales of investments in 1997 were $201 million, $72 million higher than in 1996. On a fully-diluted basis, earnings per share rose to $2.37 versus $0.82 per share in 1996. Excluding gains on sales of investments, earnings per share amounted to $1.31 as compared to $0.04 in the prior year. Net income tax provision was $39 million in 1997 as compared to $4 million in 1996.

Cash provided by operations, at $366 million, rose $302 million over the prior year. Cash flow from operations amounted to $2.04 per share on a fully-diluted basis, compared to $0.41 in the prior year.

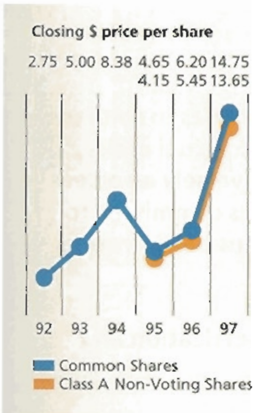
In 1997, Air Canada continued its strategy to diversify its transportation revenue base by expanding services in selected international markets while moderating the growth in domestic capacity. In the year, the Corporation capitalized on its successful US transborder expansion strategy by adding 10 new routes to the United States and expanding its codeshare operations with United Airlines. Since the February 1995 implementation of the Canada-US "Open Skies" agreement, Air Canada and its Regional Airlines have added and currently operate 44 new scheduled US services. Air Canada's US transborder services generated significantly greater contribution to profit in 1997 and were the major factor in the improved operating results. With a growing Canadian economy, strong business demand and capacity reductions by Air Canada's main competitor in Canada, the contribution to profit of Air Canada's domestic operations also improved.

In concert with the May 1997 formation of the Star Alliance, the most extensive airline alliance in the world, Air Canada continued to expand in international markets with increased direct services and codeshare operations with its Star Alliance partners. Both Atlantic and Pacific operations produced a higher contribution to profit in 1997.

Non-operating activities recorded income of $98 million, an improvement of $160 million from 1996. Of this improvement, $72 million resulted from higher gains from the sale of investments. In 1997, the Corporation recorded pre-tax gains of $201 million on the sales of investments, comprised of $171 million from the sale of its remaining common shareholding of Continental Airlines, Inc. and a $30 million gain from the sale of most of its equity interest in Galileo International and all of its equity interest in the Apollo Travel Service Partnership. This compared to a $129 million gain on the sale of Continental Airlines shares in 1996. Gain on sale of other assets of $35 million in 1997 resulted principally from the sale of long-term bonds and seven DC-9 aircraft. Net interest expense and amortization of deferred foreign exchange losses on long-term debt declined $49 million due to lower average debt balances, more favourable European and Japanese foreign exchange rates and higher capitalized interest.

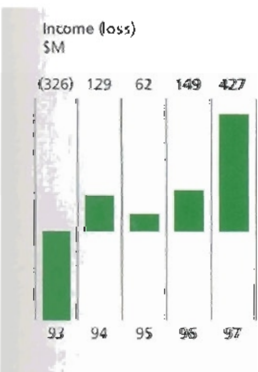
In 1997, Air Canada added 27 new jet aircraft to its fleet, comprised of four Airbus A340 aircraft, 22 Airbus A319 aircraft and one Canadair Regional Jet while seven DC-9 aircraft were sold.

## Shareholder Value




The price of Air Canada's common shares closed on the Toronto Stock Exchange (TSE) at the end of 1997 at $14.75 per share, up 138 per cent from its 1996 close. Since December 1992, the common share price has escalated from $2.75 per share to an all-time high of $15.40 in late 1997. The annualized return on Air Canada common shares from December 1992 to December 1997 was 40 per cent as compared to the TSE 300 index return of 17 per cent, measured on an annual compounded basis. Class A non-voting shares, traded on Canadian exchanges (and The Nasdaq Stock Market in US dollars) improved to $13.65 per share from $5.45 at the end of 1996. As at February 16, 1998, Air Canada's common shares closed on the TSE at $14.00.

## Earnings Growth




Air Canada's goal is to generate improved earnings from airline operations on a long-term basis. To accomplish this goal, the Corporation has focused on revenue growth from international markets, together with a continued emphasis on improving productivity and cost performance. Over the past year, earnings from airline operations reached record levels, as Air Canada increased revenue and productivity, operated a more diversified network and participated in the establishment of the Star Alliance. Over the past several years, gains from the sale of investments have also provided a significant contribution to the earnings growth.

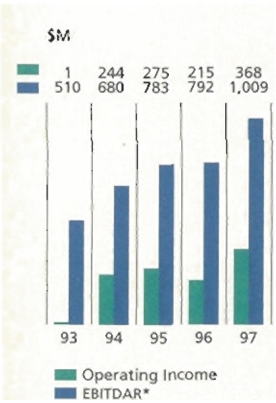
For 1998, Air Canada is investing in the future through selective expansion, a strong focus on delivering a superior product and customer service improvements, particularly geared to high value customers.

### Income Taxes

The Corporation recorded a $207 million income tax provision related to 1997 earnings. This was reduced by $168 million by applying a portion of unrecognized income tax benefits from losses in 1992 and 1993. As at December 31, 1997, the remaining unrecognized potential benefit of future income tax savings amounted to $14 million.

In 1993, under the December 1991 Federal Government Excise Tax Transportation Rebate Program, Air Canada exchanged income tax losses on a ratio of 10 to 1 for a cash rebate of fuel excise taxes paid in 1991 and 1992. In November 1997, Air Canada reinstated $429 million of federal income tax losses, representing $167 million of income tax benefits, by repaying to the Canadian government the net balance of the fuel excise tax rebate received in 1993 in the amount of $43 million plus $13 million of accrued interest. The transaction was recorded in the fourth quarter 1997 and the result was to increase recorded and unrecorded income tax benefits by $167 million, increase 1997 fuel expense by $43 million and reduce the net 1997 accounting tax provision by $141 million. Income taxes for the first three quarters of 1997 were not reduced by the reinstated income tax benefits until the fourth quarter. The net impact of the transaction on 1997 earnings was an improvement of $98 million or $0.51 per share on a fully-diluted basis.

## Operating Income and EBITDAR*



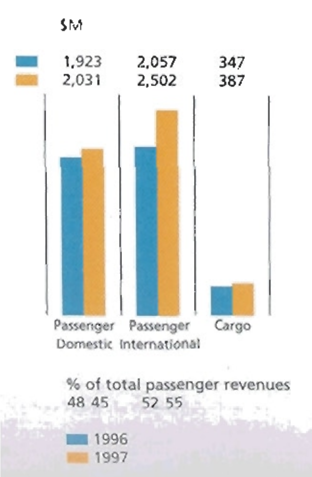

Operating income rose $153 million or 71 per cent in 1997, fueled by significant transborder growth. EBITDAR grew $217 million to $1,009 million. This was in spite of significant one-time items (estimated impact of Regional Airlines strike, fuel excise tax reinstatement and pension expense reduction) which, in total, adversely affected both of the above measures by an estimated $61 million. Air Canada is committed to improving the profitability of its airline operations, with a strong focus on operating income performance.

*Earnings (operating income) before interest, taxes, depreciation, amortization and aircraft rent.

## Operating Revenue Growth

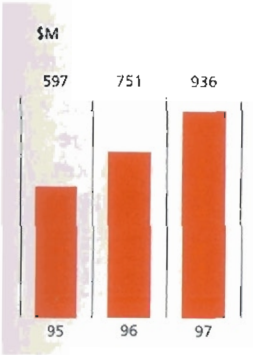
Operating revenues increased $692 million or 14 per cent in 1997, continuing the positive trend established over the past four years, described below:

| ($ millions) | 1993 | 1994 | 1995 | 1996 | **1997** |
|---|---|---|---|---|---|
| **Domestic Routes** | | | | | |
| Passenger | 1,691 | 1,814 | 1,898 | 1,923 | **2,031** |
| Cargo | 191 | 151 | 101 | 110 | **116** |
| Total | 1,882 | 1,965 | 1,999 | 2,033 | **2,147** |
| **International Routes** | | | | | |
| Passenger | 1,158 | 1,358 | 1,683 | 2,057 | **2,502** |
| Cargo | 144 | 183 | 222 | 237 | **271** |
| Total | 1,302 | 1,541 | 1,905 | 2,294 | **2,773** |
| Other | 414 | 518 | 603 | 553 | **652** |
| **Total Operating Revenues** | 3,598 | 4,024 | 4,507 | 4,880 | **5,572** |
| % Growth | 3% | 12% | 12% | 8% | **14%** |




### Transportation Revenues

In 1997, international passenger revenues accounted for 55 per cent of total passenger revenues, up from 52 per cent in 1996 and significantly above the 41 per cent level recorded in 1993. This reflected Air Canada's ongoing strategy to diversify its revenue sources by expanding into key international markets in order to reduce its dependence and exposure to the Canadian economy.



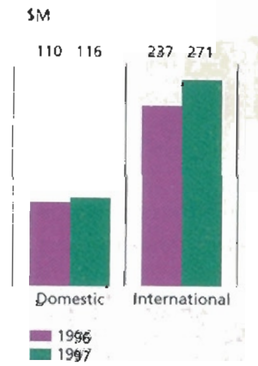

## Premium Class* revenues

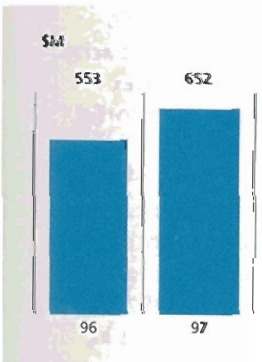
Within passenger revenues, Premium Class revenues rose $185 million or 25 per cent in 1997 continuing the significant, steady growth since 1995.

*Includes Executive Class and Executive First.

## Cargo

Cargo revenues rose $40 million or 12 per cent in 1997. International revenue growth on Atlantic routes was the main factor, accounting for $31 million of the increase.

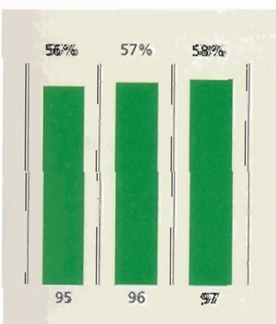



## Other Revenues

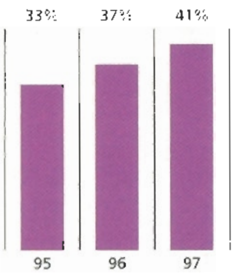
In 1997, other non-transportation revenues increased $99 million or 18 per cent. Third party maintenance revenues rose 28 per cent due to additional contracted maintenance services to other airlines. Revenues from Aeroplan partners rose 29 per cent. Ground handling, aircraft leasing and subsidiary revenues also increased over 1996.

# Passenger Market Share




## Domestic Market Share

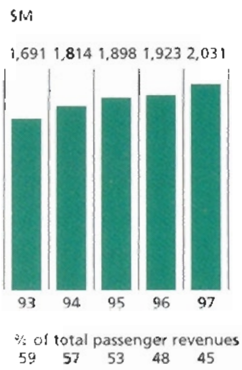
Domestic market share rose by 1 percentage point for the year 1997 to 58 per cent, as measured by the dollar value of passenger sales by travel agencies in Canada. In the month of December 1997, Air Canada's domestic market share reached 61 per cent, up 3 percentage points from December 1996. Air Canada believes that the increased market share reflects greater demand for Air Canada services due to a high quality product, a superior schedule and other factors.




### Canada-US Transborder Market Share

For the year 1997, Air Canada's US transborder market share, measured by the dollar value of transborder passenger sales by travel agencies in Canada, rose 4 percentage points to 41 per cent. For the year 1997, Air Canada had an almost 52 per cent market share of Canadian travel agency transborder sales at Toronto, its principal hub, up from 46 per cent in 1996. Over the past years, Air Canada has gained a considerable share of this important market.

## Passenger Revenue Performance




### Domestic Passenger Revenues

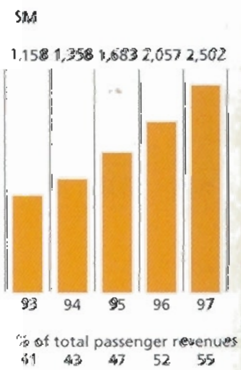
Domestic passenger revenues, which accounted for approximately 45 per cent of total passenger revenues, experienced marked growth of $108 million or 6 per cent in 1997. Air Canada's domestic revenues increased 13 per cent, excluding subsidiaries. This was due to a growing domestic economy, strong business travel demand and capacity reductions by Air Canada's main domestic competitor. Regional Airlines revenues declined 13 per cent due to a labour disruption and the sale of Northwest Territorial Airways in 1997.

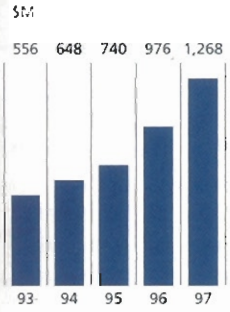
Excluding subsidiaries, the strongest revenue growth in Canada was recorded on the short haul Commuter routes, including the main Rapidair routes linking Toronto and Montréal/Ottawa which grew 19 per cent. These Commuter routes accounted for approximately 20 per cent of consolidated domestic passenger revenues in 1997. The transcontinental routes, linking Toronto, Montréal and Ottawa with major cities in western Canada, recorded 10 per cent revenue growth in 1997 and represented approximately 40 per cent of domestic passenger revenues. Growth on Regional routes, which include operations within eastern and western Canada, amounted to 13 per cent, excluding subsidiaries, with stronger growth recorded on the eastern Canada routes.

A labour disruption at Air Canada's Regional Airlines had an estimated unfavourable impact of $70 million on the Corporation's passenger revenues in early 1997. For the year, Regional Airlines' total passenger revenues declined $52 million of which $16 million was due to the sale of Northwest Territorial Airways in mid-1997.

### International Passenger Revenues

Passenger revenues from international services, including US transborder services, rose $445 million or 22 per cent and accounted for 55 per cent of Air Canada's passenger revenues, up from 52 per cent in 1996. Since 1993, passenger revenues from international services have more than doubled.

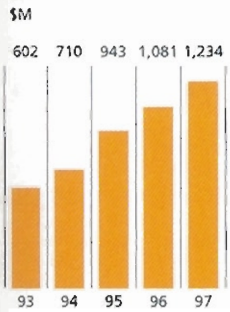





## Canada-US Transborder Passenger Revenues

US transborder passenger revenues showed continued strong growth of 30 per cent over 1996 and accounted for more than half of international passenger revenues. Since the introduction of "Open Skies" in February 1995, US revenues have nearly doubled, reflecting Air Canada's aggressive strategy of expanding direct Canada-US services. This revenue growth was the result of the strong performance of both new and existing transborder routes.

Executive Class premium revenues on transborder services grew by over 40 per cent in 1997 reflecting strong business demand for Air Canada services.




## Other International Passenger Revenues

Passenger revenues from other international routes rose 14 per cent in 1997. Other international routes are comprised of Atlantic, Pacific and Caribbean services representing, respectively, 37 per cent, 7 per cent and 5 per cent of total international passenger revenues.

In 1997, Atlantic passenger revenues grew by 15 per cent, with approximately half of the growth occurring on United Kingdom routes. Pacific routes recorded 14 per cent revenue growth with Osaka, Hong Kong and Seoul all showing increases. Caribbean revenues were up 7 per cent over 1996.

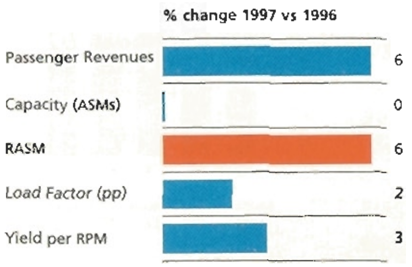
Premium revenues on these international services rose 30 per cent on the basis of strong traffic growth from 1996.

## Regional Airlines

Regional Airline (Air Nova, Air Ontario, AirBC and Air Alliance) revenues are included in the above consolidated revenues as well as Northwest Territorial Airways until its sale in June 1997. From early January to March 1997, the four Regional Airlines were involved in a pilot labour disruption which adversely affected their operations. Following this disruption, passenger revenues returned to expected levels and showed growth over the prior year. For 1997, the four Regional Airlines recorded a passenger revenue decline of 6 per cent from 1996 (excluding Northwest Territorial Airways). Operating expenses also declined, but by a lesser amount. As a result, operating income of the Regional Airlines for the year was slightly below 1996 levels.

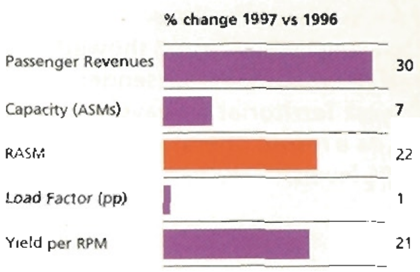
# Key Components of Passenger Revenue

The major components relating to passenger revenue growth in Air Canada's key markets are described below. Passenger revenue per available seat mile (RASM) is one of the best industry measures of passenger revenue performance as it provides a yardstick of revenue generation per unit of capacity offered. The key ingredients include passenger traffic, expressed in relation to the capacity offered, through the passenger load factor (i.e. revenue passenger miles (RPMs) to available seat miles). The second component is the yield per revenue passenger mile (or average fare paid per occupied seat mile flown). For example, if an airline can improve its load factor (i.e. the number of revenue passengers travelling on a particular flight) and its yield per revenue passenger mile (i.e. the average fare paid by each passenger on that flight) then the passenger revenue per available seat mile (RASM) will increase leading to greater operating profitability on that flight. The higher the RASM, the more revenue is generated by the airline per unit of capacity offered.



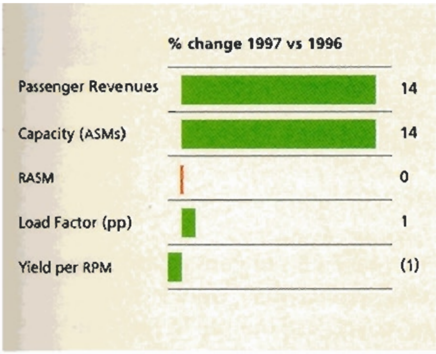

## Domestic Performance

In the domestic market, passenger revenue increased 6 per cent with ASM capacity unchanged from 1996. Domestic RASM increased 6 per cent as a result of load factor growth of 2 percentage points (pp) and a passenger yield per RPM increase of 3 per cent. The increase in passenger yield was due to greater use by the business community of higher fare products and fare increases implemented in late 1996 as well as moderate increases introduced in 1997. Excluding subsidiaries, Air Canada's domestic passenger revenues increased 13 per cent on 4 per cent ASM capacity growth. Domestic RASM improved 8 per cent on a one percentage point improvement in load factor and a 7 per cent increase in passenger yield per RPM.




## Canada-US Transborder Performance

In the US transborder market, passenger revenues increased 30 per cent on ASM capacity growth of 7 per cent. Transborder RASM improved 22 per cent, due to a passenger yield per RPM increase of 21 per cent and a load factor improvement of 1 percentage point. Passenger yield per RPM improved due to fare increases introduced in late 1996 and a significant increase in the proportion of Executive Class and business travellers, as well as Air Canada's focus on shorter haul, direct service routes which cater to business travellers and generally have a higher yield due to shorter stage lengths.




### Other International Market Performance

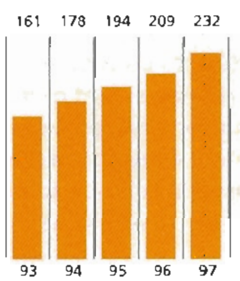
Passenger revenues from other international services, which include Atlantic, Pacific and Caribbean markets, increased 14 per cent in 1997 on a 14 per cent ASM capacity growth. RASM was unchanged due to a 1 percentage point increase in load factor offset by a 1 per cent decline in yield per RPM from 1996.

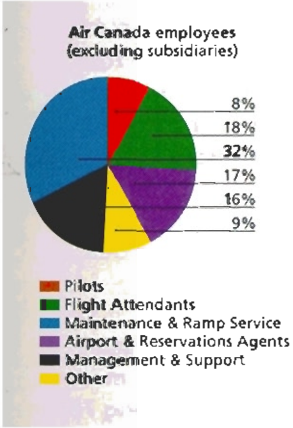
In Atlantic markets, RASM was 1 per cent higher with a 15 per cent increase in ASM capacity. Both load factor and yield improved marginally from 1996. In Pacific markets, which accounted for 7 per cent of international revenues (4 per cent of total passenger revenues), RASM declined 5 per cent. While load factor showed a significant growth of 5 percentage points, yield per RPM declined 11 per cent due, in part, to weaker Asian currencies and, in latter 1997, economic uncertainty in many Asian countries.

## Productivity

Employee productivity, as measured by operating revenue per employee, improved 11 per cent over 1996. ASMs per employee improved 2 per cent. Since 1992, operating revenue per employee has improved 57 per cent, on a cumulative basis and ASMs per employee has improved 36 per cent.

Operating revenue per employee (excluding subsidiaries) $000s

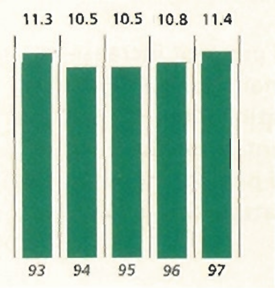



In 1997, Air Canada had an average of 21,215 employees, measured on a full-time equivalent basis, excluding subsidiaries. This represents an increase of 7 per cent over 1996. Air Canada increased employees in 1997 mainly in relation to the 9 per cent growth in ASM capacity, excluding subsidiaries. Customer service personnel, including pilots, flight attendants, reservations and customer handling staff were added, together with maintenance employees, in order to improve the delivery of key services. Focus on improved customer service, particularly with respect to high value customers, is an important 1998 objective.

# Operating Cost Performance

Operating cost per ASM
Net of non-ASM producing revenues
(excluding subsidiaries)
cents per ASM




Operating expense rose $539 million or 12 per cent in 1997.

Unit costs, as measured by operating expense per ASM, increased 5 per cent, excluding subsidiaries. Excluding non-ASM producing revenues (Cargo and Other), operating expense per ASM also increased 5 per cent over 1996. Unit costs rose mainly in relation to the fuel excise tax reinstatement, aircraft materials, aircraft rent, information technology and project costs and one-time provisions, partially offset by reduced benefits expenses.

The following describes major cost changes in 1997:

Salaries and wages increased $84 million or 7 per cent due primarily to increase in the number of employees related to flight operations, maintenance and customer service functions. Excluding subsidiaries, average salaries increased 3 per cent over 1996 and average full-time employees increased 7 per cent.

Employee benefit expense declined $26 million. This was due to a $39 million reduction to pension expense reflecting favourable pension fund performance and a re-assessment of management assumptions which resulted in the elimination and recovery of prior years' charges for amounts in excess of the maximum allowable deferred pension expense. Other employee benefits increased in relation to higher employee levels.

1997 Consolidated operating expenses
% of Total


Aircraft fuel expense rose $72 million. Included in fuel expense is a charge of $43 million relating to the repayment of fuel excise tax rebates and reinstatement of tax losses from prior years. Excluding this charge, fuel expense rose $29 million or 5 per cent. In 1997, fuel hedging contributed to a reduction of $4 million in overall fuel expense, compared to an unhedged position. The average fuel cost per litre, excluding subsidiaries, increased 2 per cent with more favourable fuel prices offset by lower gains from fuel hedging and, to a lesser extent, by the impact of a weaker Canadian dollar. Average available seat miles per litre of fuel consumed improved 2 per cent reflecting greater fuel productivity mainly as a result of Air Canada's fleet modernization program.

Commission expense increased 11 per cent on passenger and cargo revenue growth of 14 per cent. Commission expense as a proportion of passenger revenue declined due largely to commission caps introduced in 1996 and in late 1997.

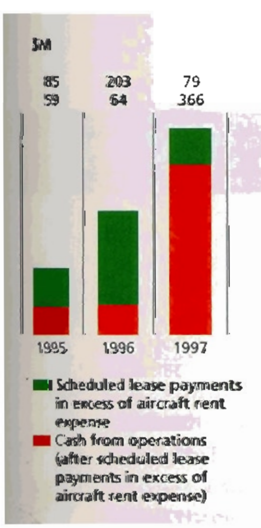
Aircraft maintenance, materials and supplies expense rose $38 million or 18 per cent. Excluding subsidiaries, Air Canada's aircraft maintenance expense increased $58 million due to additional maintenance work on Boeing 747, Canadair Regional Jet, Boeing 767 and Airbus A320 aircraft. Subsidiary maintenance materials expense declined 27 per cent due to reduced flying activity in 1997.

Aircraft rent increased $64 million or 20 per cent mainly as a result of 1997 aircraft leases on four Airbus A340s and 17 new Airbus A319s as well as the full year impact of aircraft leases which commenced in 1996. Rent expense for Airbus A320 aircraft declined in 1997 due to the ownership of two A320s in 1997 and the refinancing of most A320 aircraft leases in 1996 at more favourable lease rates.

Customer maintenance materials expense rose 25 per cent and reflected greater third party maintenance work.

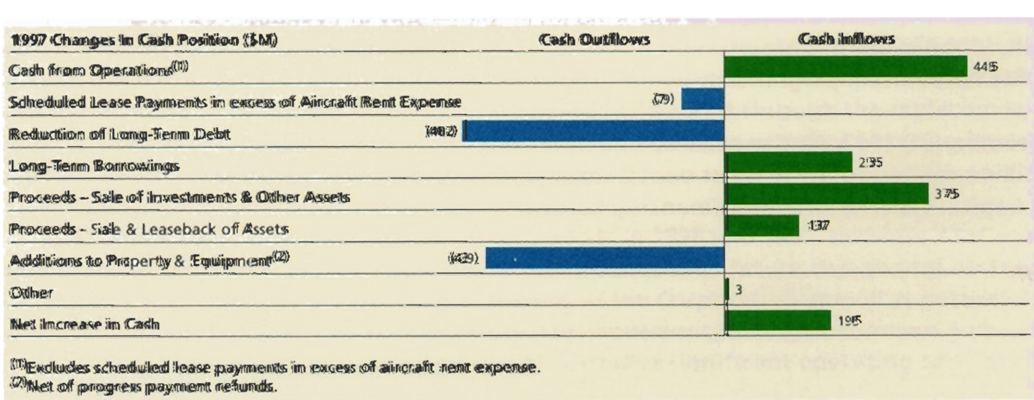
The "Other" expense category increased $187 million or 18 per cent. Within this category are flying and revenue-related expenses including airport terminal handling costs, computer reservations charges, credit card fees, flight/cabin crew lodging expense, equipment rentals and advertising. These expenses rose due to increased capacity and greater passenger volumes as well as higher prices for many expense elements. Other major increases included information technology projects and services and computer network expenses. Higher provisions and legal settlements were also recorded in 1997. Subsidiaries' other expenses increased largely due to additional costs associated with the first quarter 1997 labour disruption.

## Financial Management




### Cash Generation

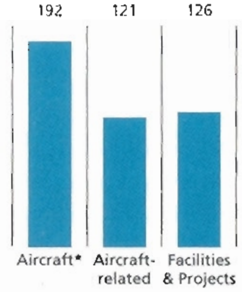
With improved operating earnings, 1997 cash provided by operations increased to $366 million, a $302 million improvement from 1996. Scheduled lease payments in excess of aircraft rent represent a negotiated outflow of operating cash used for aircraft leases, either at the inception or in the course of the lease when cash payments are in excess of the amounts recorded for aircraft lease expense. Excluding these amounts, cash from operations amounted to $445 million in 1997 or $2.46 per share – fully diluted.



In the course of 1997, Air Canada repaid $482 million of long-term debt and borrowed $235 million of new debt, as described below, for a net debt repayment of $247 million.

Concurrent with Air Canada's improved operating performance and earnings profile, new financing markets became more accessible to the Corporation. As a result, Air Canada issued, for the first time in the Canadian public bond market, $230 million of 10 year senior unsecured debentures in September at a coupon rate of 7.25 per cent. Proceeds from this transaction were mainly used to acquire five Airbus A319 aircraft. Sale and leaseback transactions accounted for cash inflows of $137 million for two Airbus A320 aircraft and two Canadair Regional Jet aircraft. Sale of investments and other assets provided $375 million, of which the sale of Continental Airlines shares represented $207 million, the sale of long-term bond investments provided $77 million and the sale of Galileo International and Apollo Travel Service Partnership represented $44 million.

1997 Capital expenditures
$M




*net of progress payment refunds

Additions to property and equipment of $439 million included $192 million for the acquisition of five Airbus A319 aircraft, two previously leased Boeing 767-200 aircraft, one previously leased Boeing 747-200 aircraft and progress payments for Airbus A319 and A330/A340 aircraft. Aircraft-related expenditures for inventory, spare engines, betterments and capitalized interest were $121 million. Refunds of progress payments on aircraft amounting to $286 million were netted against additions to aircraft expenditures. This represented, effectively, cash proceeds from the return of progress payments made in prior years, upon completion of the lease financing of new aircraft. Facilities, ground equipment, computer systems and project development expenditures accounted for $126 million.

## Liquidity

As at December 31, 1997, the Corporation had $650 million of cash and short-term investments, up $195 million from 1996. Together with available and undrawn lines of credit, this amounted to a liquidity position of $1.2 billion. Over the past several years, Air Canada has maintained a policy of ensuring an ample supply of available cash and credit, in the event of unforeseen circumstances. For future years, Air Canada plans to continue to maintain a significant liquidity position.

As at December 31, 1997, Air Canada also had other financing commitments amounting to $1.2 billion related to the lease or debt financing of future aircraft deliveries (see Planned Capital Expenditures and Financing below).

# Planned Capital Expenditures and Financing

The table below outlines Air Canada's 1997 deliveries of new aircraft and planned deliveries in the 1998 to 2000 period:

| **Aircraft Type** | **1997** | 1998 | 1999 | 2000 |
|---|---|---|---|---|
| Airbus A340 | **4** | 1(1) | 2 | 1 |
| Airbus A330 | – | – | 2 | 3 |
| Airbus A319 | **22** | 12 | – | – |
| Canadair Regional Jet (CRJ) | **1**(2) | 1(2) | – | – |
| Total | **27** | 14 | 4 | 4 |

(1)One Airbus A340 aircraft will be delivered in the spring of 1998 under a short-term operating lease.
(2)Air Canada has exercised an option to purchase two CRJ aircraft. One CRJ aircraft, which was leased and in the operating fleet in 1997, was purchased in January 1998. The second CRJ aircraft is planned to be purchased in June 1998.

### Airbus A340 and A330 Acquisitions

In October 1997, Air Canada signed a purchase agreement with Airbus Industrie for the acquisition, on a phased basis, of a number of Airbus A340 and A330 aircraft to replace older Boeing 747 aircraft and to provide for international growth opportunities as they arise. Air Canada has committed to the first phase of the program of the delivery of five Airbus A330-300 aircraft and three Airbus A340-300 aircraft in 1999 and 2000. The Corporation intends to use the aircraft as replacement capacity for six Boeing 747-100 and 200 aircraft as well as two Airbus A340 aircraft currently on short-term operating lease. Leases on these latter two have been extended until 2000 corresponding to the delivery dates of the new Airbus aircraft. The Airbus A340 is a 284-seat technologically-advanced, four engined long range aircraft with low operating costs. The Airbus A330-300 is essentially the same airframe as an A340-300 but with two engines and seats 292 passengers with one of the lowest operating costs per cycle and per seat mile of any commercial aircraft in its class. Air Canada has received commitments for financing covering 85 per cent of the purchase price of the five Airbus A330-300 aircraft and three A340-300 aircraft on order. In addition, Air Canada has options for 20 additional Airbus A340 and A330 aircraft in the 2002-2006 timeframe.

The second phase of the program, which is not committed, involves the addition of up to five new generation A340-500/600 aircraft in 2002 and relates primarily to growth opportunities being pursued in key international markets. The decision on whether or not to proceed with this phase will be taken by March 1998. The third phase, which is also not committed, relates to the acquisition of up to eight Airbus A340-300 and A330-300 aircraft of which three are planned to be used to phase out all remaining Boeing 747 aircraft through the replacement of three Boeing 747-400 aircraft in the 2000-2001 timeframe. Air Canada's decision whether or not to implement this phase will be taken in 1999.

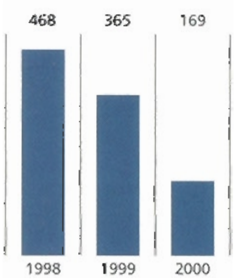
This phased approach, with specific decision and re-confirmation points in 1998 and 1999, provides Air Canada with significant flexibility to structure its core widebody fleet in accordance with future demand for air travel taking into account economic conditions, the financial performance of the Corporation as well as potential new destinations allowed for under Canada's international air policy. The movement towards a common Airbus fleet for all widebody aircraft seating more than 225 passengers will also achieve significant operating cost savings compared to the aircraft being replaced.

## DC-9 Aircraft

As at December 31, 1997, Air Canada had 28 DC-9 aircraft. Current plans call for the retention of 25 of these aircraft, in order to take advantage of market opportunities on US transborder and domestic routes. While ongoing maintenance expenses will be higher, retention of DC-9 aircraft reduces Air Canada's overall capital expenditure requirements as compared to new aircraft acquisitions. This provides added flexibility, in the event of an economic downturn or other situation requiring reduced capacity, as these aircraft could be retired or parked with very low carrying expense. Air Canada plans to complete aircraft and cabin system upgrades on its DC-9 fleet. As well, installation of DC-9 engine hushkits are planned on a progressive basis, to meet Stage 3 noise regulations which require all aircraft to be Stage 3 compliant by December 31, 1999 in the United States and by April 1, 2002 in Canada. The estimated cost of the planned DC-9 aircraft upgrades and hushkit installation is approximately $145 million, with most funds planned to be spent in 1999.

As at December 31, 1997, Air Canada's entire operating fleet, except for DC-9 aircraft, met Stage 3 noise regulations being implemented progressively in the US and Canada. The average age of Air Canada's aircraft fleet was 9.9 years at December 1997 (5.9 years excluding DC-9 aircraft).

**Planned capital expenditures**
(net of financing)
$M




## 1998 to 2000 Capital Expenditures and Financing

The table below summarizes the Corporation's planned capital expenditures, net of committed aircraft financing for the 1998 to 2000 period. Total planned and committed expenditures, after committed aircraft financing, amount to $468 million in 1998, $365 million in 1999 and $169 million in 2000.

| | | Planned(1) | |
|---|---|---|---|
| ($ millions) | 1998 | 1999 | 2000 |
| Committed aircraft expenditures before financing | 595(2) | 408 | 346 |
| Committed aircraft financing | (445) | (423) | (411) |
| Net committed aircraft expenditures (proceeds) after committed financing | 150 | (15) | (65) |
| Planned expenditures for aircraft, engines, engine hushkits, inventory, spare parts, modifications and refurbishments | 117 | 245 | 115 |
| Other planned property and equipment | 201 | 135 | 119 |
| Planned and committed capital expenditures, after committed financing | 468 | 365 | 169 |

(1) Planned US dollar amounts are converted at the rate of CDN $1.43 per US dollar.
(2) Includes progress payments to be repaid to other parties. Previously, these amounts were netted against committed aircraft financing.

Committed aircraft expenditures before financing represent projected payments for committed 1998 to 2000 aircraft purchases of Airbus A319, A340, A330 and Canadair Regional Jet aircraft assuming that Air Canada acquires all aircraft prior to any lease financing arrangement.

Committed aircraft financing represents financing commitments for the 1998 to 2000 Airbus A319 and A340/A330 aircraft deliveries. Formal commitments for 100 per cent lease financing have been received covering the 1998 Airbus A319 aircraft deliveries. In 1997, Air Canada purchased five Airbus A319 aircraft and plans to purchase up to an additional eight Airbus A319 aircraft in 1998. Two Airbus A319 aircraft were purchased in early 1998, without utilizing the committed lease financing facilities. The 1998 financing amounts are shown assuming that the remaining Airbus A319 financing facilities are fully utilized under sale and leaseback arrangements. The amounts shown for the Airbus A340/A330 deliveries in 1999 and 2000 represent financing commitments covering 85 per cent of the purchase price of the aircraft. Subject to final decisions regarding the purchase or lease of up to six Airbus A319 deliveries, net 1998 capital expenditures, after financing, may be up to $268 million higher, in the event Air Canada does not utilize committed financing on these aircraft. Proceeds from the Deutsche mark 200 million Eurobond issue, completed in January 1998 (not included in the above table) are being used to acquire certain Airbus A319 aircraft.

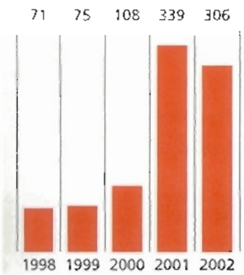
Net committed aircraft expenditures (proceeds) after financing amount to $150 million in 1998 with planned cash inflows of $15 million and $65 million in 1999 and 2000 respectively. These cash inflows represent, effectively, the return of a portion of aircraft progress payments made by Air Canada in prior years.

Planned expenditures for aircraft, engines, engine hushkits, inventory and refurbishments include $145 million for improvements and hushkitting of DC-9 aircraft of which most of these funds are planned to be spent in 1999.

Other planned property and equipment is for committed as well as planned and projected capital spending on information technology projects, airport improvements, ground equipment, facilities, buildings and expenditures by subsidiaries.

All uncommitted capital expenditures will be subject to management's assessment of future market and financial conditions prior to final commitment.

Mandatory debt repayments
$M

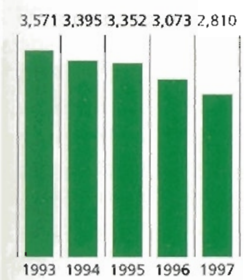



The accompanying graph describes Air Canada's mandatory debt repayments for the years 1998 to 2002 at December 31, 1997.

During 1997, Air Canada arranged the following unsecured, revolving credit facility which, at December 31, 1997, was undrawn:

US$400 million reducing revolving term credit facility with a three and one half year maturity from a group of financial institutions in Canada, extendible by one year on each anniversary date by mutual consent of the parties. If not extended, the availability of funds declines until maturity. This facility replaced a previous US$207 million bank facility which was repaid in mid-1997.

Long-term debt*
(including subordinated perpetual debt)
$M




*Includes current portion of long-term debt

In early 1998, Air Canada completed a Deutsche mark Eurobond financing of DM200 million, 6 5/8 per cent unsecured bonds due in 2005. In late February 1998, the Corporation announced that it would redeem the $250 million principal amount of the convertible unsecured subordinated debentures in April 1998, through the issuance of Class A non-voting shares. See Note 8 of the Notes to Consolidated Financial Statements.

At year-end 1997, 47 per cent of Air Canada's fleet by number (excluding subsidiary aircraft) or 27 per cent by fair market value were owned and unencumbered. These aircraft represent a potential future source of financing through sale and leaseback arrangements.

A major priority of the Corporation is to generate improved cash from operations in 1998 and subsequent years. Cash from operations is expected to play an increasing role in providing funds to repay debt and fund capital expenditures in the coming years.

In addition to the long-term debt and subordinated perpetual debt described above, Air Canada has the obligation to make lease payments under operating leases relating to aircraft and other property. As disclosed in Note 11 to the 1997 Financial Statements, the future minimum lease payments under these operating leases amount to $3,966 million, of which $3,486 million relates to operating leases of aircraft. These contracts constitute operating leases and not capital leases in accordance with generally accepted accounting principles in Canada, as they meet the conditions and criteria of the CICA Handbook applicable to operating leases. The amount of lease payments made under these operating leases constitute operating expenses for Air Canada. The operation of assets under the operating leases is consistent with the commercial practice of airlines within the industry.

## Risk Management

The Corporation enters into interest rate hedging agreements on an ongoing basis to minimize the impact of changes in interest rates. At December 31, 1997, US$406 million or some 21 per cent of the Corporation's total debt was in US dollars, on a floating rate basis. Approximately 45 per cent of the planned 1998 interest rate exposure on this floating rate debt was hedged with short-term interest rate contracts placed with major credit worthy financial institutions. Longer term interest rate agreements were also in place effectively converting the fixed interest rate exposure to floating for a small portion of US dollar long-term debt.

Air Canada has borrowed in a number of low interest rate currencies such as the Swiss franc, the Japanese yen and, to a lesser extent, the Deutsche mark. In 1997, the Corporation entered into swap agreements to effectively convert the 250 million Deutsche mark debt into floating rate Canadian dollar debt for both principal and interest obligations. Also, Air Canada entered into interest rate swaps effectively fixing the next interest rate reset for half of the principal of the yen perpetual debt at interest rates less than currently being paid.

Depending on market conditions and the Corporation's view of interest rate movements, a portion or up to all of the floating rate interest exposure could be fixed in the short-term or swapped to fixed rate for terms up to maturity. The Corporation's cash position, which is invested in highly rated interest bearing instruments, provides a partial hedge against interest rate movements on the floating rate debt to the extent short-term US and Canadian interest rates move in tandem. Short-term interest rates on cash balances may be periodically hedged depending upon market conditions.

Movements in short-term interest rates can affect financial results due to Air Canada's floating rate debt position and short-term investment portfolio. Taking into account interest rate hedging at December 31, 1997, projected short-term investments and planned debt repayments, a one percentage point increase in short-term interest rates would have an estimated $1.0 million impact on planned net interest expense in 1998.

Based on book value, the weighted average cost of Air Canada's long-term debt, subordinated perpetual debt and convertible debentures was 7.7 per cent in 1997, down from 7.9 per cent in 1996. The lower weighted average cost of debt reflects primarily reduced interest expense caused by a stronger average Canadian dollar against Swiss, German and Japanese currencies partially offset by a weaker average Canadian dollar against the US dollar.

The Corporation also manages foreign exchange exposure through the use of options, forward contracts and cross currency swaps. At December 31, 1997, no foreign exchange contracts were in place covering the principal amount of US and other foreign currency debt. Aircraft assets, recorded on the balance sheet at historical exchange rates at the time of acquisition, are essentially US dollar-based assets which can provide a longer term economic hedge against currency movements. Longer term swap arrangements were in place effectively converting the 250 million Deutsche mark debt into Canadian dollar debt and certain US dollar debt into Japanese yen debt. At December 31, 1997, other than US dollar debt, only the principal amounts relating to 200 million of Swiss franc debt and 14 billion of Japanese yen notes were exposed to foreign exchange fluctuations. The principal amount of the subordinated perpetual debt is not considered to be subject to economic foreign exchange risk, since the requirement to repay the principal is only upon liquidation, if ever, of the Corporation.

Foreign exchange exposure on interest obligations in Swiss francs and Deutsche marks are covered by surplus cash flows in European currencies. With expanded operations to Japan, yen denominated cash flow surpluses provide a natural hedge, fully covering yen interest expense.

Air Canada has an ongoing operational requirement for US dollars to cover various expenses such as fuel, aircraft materials, debt repayment, interest and aircraft lease payments. The Corporation generally obtains US dollars by buying dollars on the spot and forward exchange markets and through the conversion of other foreign currency surpluses into US dollars. At December 31, 1997, none of the net projected operational requirements for US dollars in 1998 were covered by forward exchange contracts. With expanded operations to the United States, Air Canada is generating increasing US dollar cash flows to cover these operational requirements.

A one cent improvement in the value of the Canadian dollar (compared to one US dollar) is estimated to positively affect planned operating income by approximately $3 million and non-operating expense by $2 million in 1998. Conversely, a one cent deterioration would generally have the opposite effect. A weakening Canadian dollar can potentially stimulate foreign currency sales, reducing the expected negative impact on operating results.

Aircraft fuel is a major expense to the Corporation. Air Canada enters into fuel hedging contracts with credit worthy institutions to protect against increases in the price of fuel. As at December 31, 1997, the Corporation had effectively hedged 48 per cent of its anticipated 1998 equivalent fuel consumption through financial swap agreements at an average effective fixed price of US$19 per barrel for West Texas Intermediate crude oil. Approximately 8 per cent of 1998 consumption was covered under fixed price fuel purchase contracts with suppliers. For the portion of Air Canada's projected 1998 fuel consumption which was not hedged or under a fixed price agreement at December 31, 1997, a one US dollar per barrel movement in the price of crude oil could result in an approximate CDN$10 million change in annual operating expense.

## Year 2000

Air Canada is an extensive user of information technology and its operations and business processes are highly dependent on these systems. The Year 2000 problem refers to computer systems not being able to handle two digit year codes across the millenium change. As a result, Air Canada identified the critical nature of this issue and has been actively addressing it since 1996. Based on an applications inventory, completed in 1996, approximately one quarter of Air Canada systems were Year 2000 compliant, and another quarter were already scheduled to be replaced prior to any potential "failure" date. The remainder, representing approximately one-half of Air Canada systems, are part of our Destination 2000 project with the mission to repair these remaining systems well in advance of encountering Year 2000 problems. At the present time, this part of the project is approximately one-third complete as a number of computer applications have already been modified and plans are to conclude all modifications, including testing and implementation, by the first quarter of 1999. Compliance of computer hardware and operating system software, as well as voice and data telecommunications networks is being addressed by Air Canada under its technology outsourcing agreement. Other areas being addressed, include personal computers, properties and facilities as well as computer systems embedded within facilities and equipment. All electronic interfaces to external businesses are also being verified. This is targetted to be completed, including testing and implementation by the first quarter of 1999.

Air Canada is dependent on a number of business partners and suppliers in its ongoing operations. Air Canada, is in the process of communicating with its key partners and suppliers in order to assess their readiness. Alternatives and/or contingency plans will be elaborated in the event a partner or supplier is exposed with respect to solving its year 2000 problem and becomes a risk to Air Canada operations. In order to cover all key partners and suppliers in a timely and cost-efficient manner, Air Canada is working with numerous airline industry organizations (such as ATAC, ATA and IATA) to assess the Year 2000 readiness of common airline infrastructures and service providers.

As a result of this work, Air Canada incurred operating expenses of $5 million in 1997 for the Destination 2000 project. Based on current information, Air Canada estimates that additional costs to be charged to operating expense in 1998 and 1999 will amount to $15 to $20 million in total, with the larger part of these expenses in 1998. Equipment expenditures for the project are currently estimated to be an additional $5 million, mostly to be spent in 1999.

## Outlook

Since the introduction of the "Open Skies" agreement between Canada and the United States in February 1995, Air Canada has implemented a significant growth strategy in the US transborder market. For the first three years, this agreement contained restrictions governing the number of new US carrier operations at the major airports of Toronto, Montréal and Vancouver. In February 1997, these restrictions were removed at Montréal and Vancouver to allow for unlimited US carrier operations. Effective February 24, 1998, restrictions will be removed at Toronto, allowing unlimited US carrier operations between Toronto and the United States. At the same time, restrictions relating to codesharing between Toronto and US points will be eliminated. This will allow Air Canada to significantly expand its codeshare operations with United Airlines by adding over 200 flights per day to numerous US points, with further expansion planned for later in 1998.

Competition will be heightened on US transborder services as a result of the removal of airport restrictions and increased flights by US carriers to and from Toronto. Based on current published schedules, US carriers are planning to implement six new return flights at Toronto per day starting late February 1998. Over the past three years, the Corporation has built a strong transborder network, particularly from Toronto and operates over 125 transborder return flights per day from this city. Additionally, Air Canada and the US carriers have rationalized, to a certain extent, their transborder operations and eliminated services which did not meet financial expectations. With the planned major expansion of codeshare opportunities for Air Canada and United Airlines, the removal of restrictions at Toronto is not expected to have a significant impact on the operations of Air Canada.

The Canadian domestic market has seen a high degree of volatility and competition over the past several years. During 1997, two low cost airlines which operated within Canada ceased operations and Air Canada's main domestic competitor completed a major realignment of its operations together with a deferral of certain debt and lease obligations. This competitor's realignment of operations involved a 4 per cent reduction of domestic capacity together with selective expansion in US and Pacific markets. The domestic capacity reduction provided opportunities to the Corporation to benefit from a more rational capacity environment in Canada.

Air Canada's participation as a founding member of Star Alliance offers significant long-term potential to improve revenues and reduce costs. The Star Alliance carriers had combined revenues of some US$46 billion in 1996 and carried over 183 million passengers. Star Alliance carriers currently serve over 640 cities across the globe in 108 countries. The Alliance intends to facilitate travel connections and transfers by providing customers with a high level of service between network connection points together with mutual recognition of the status of the best customers, reciprocal participation in frequent flyer programs, use of airport lounges and other product enhancements which are forthcoming. Additionally, the carriers are expected to benefit from cost synergies through initiatives such as common utilization of airport terminal facilities, sales offices, establishment of common "hubs" and joint purchasing arrangements. In 1997, Air Canada's interline revenues from Star Alliance partners almost doubled and continued growth is expected in 1998.

For 1998, the Corporation plans to increase its total ASM capacity by approximately 11 per cent. This includes a planned 10 per cent increase to domestic capacity while International services are planned to grow by approximately 11 per cent with transborder, Pacific and Atlantic expansion being the main components. Expansion of US operations is expected to continue in 1998, particularly through additional deployment of new Airbus A319 aircraft and the full year effect of new routes introduced in 1997.

In the latter part of 1997, a number of Asian countries experienced economic difficulties resulting in reduced economic growth, reductions to the value of their currencies and in some cases, restructuring and loans from the International Monetary Fund. This "Asian Flu" has spilled over into the Canadian economy putting pressure on the Canadian dollar and potentially affecting the export industries who provide these countries primarily with raw materials. Air Canada has a limited exposure for its direct operations on the Pacific as this region represents 4 per cent of the Corporation's total passenger revenues. One key market has been impacted namely, South Korea, where Air Canada operates a core year round service of three flights per week. Air Canada is monitoring the situation and may adjust capacity based on economic conditions and the demand for travel services. Air Canada has aspirations to expand its operations in the major Pacific markets and believes that Asia has significant long-term profit potential. Air Canada continues to press the Canadian government for additional route designations to serve Pacific markets. In the event additional designations become available, Air Canada would likely revise its planned flying to expand Pacific operations mainly by re-deploying capacity from other markets depending upon economic conditions in the Pacific destination country at the time.

In late 1997 and early 1998, concurrent with the economic difficulties in Asia, the Canadian dollar lost value compared to the currency of its major trading partner, the US dollar, and traded in the range of $1.44 per US dollar on February 16, 1998. Should the Canadian dollar remain at this level throughout 1998, Air Canada will see an increase to expenses which are largely denominated in US dollars namely, fuel expense, aircraft lease expense and interest expense. This will however be offset, to a certain extent, by the higher value of US dollar revenues. The overall impact of an average $1.44 Canadian dollar to US exchange rate for the year 1998 (as compared to the 1997 average of $1.3844), is estimated to adversely affect planned 1998 pre-tax income by approximately $30 million. Due to changing market conditions, there is no certainty that this adverse currency impact will be realized.

Prices for West Texas Intermediate crude oil have fallen in late 1997 and early 1998 to the range of US$17-$18 a barrel, well below the average of US$21.21 experienced in 1997. Should fuel prices remain at these reduced levels for the year 1998, Air Canada could experience an approximate $40 million favourable effect on its fuel expense (compared to prices in effect during the prior year), taking into account hedge positions in early February 1998 but excluding foreign exchange. Due to changing market conditions however, there is no certainty that this level of saving will be realized.

In 1998, aircraft rent expense is projected to increase by approximately $100 million due to new aircraft deliveries and the full year impact of aircraft leases entered into in 1997. New generation aircraft have improved operating efficiencies in the form of reduced fuel consumption, lower maintenance expense and savings in other expense areas. The growing Airbus fleet is projected to provide savings compared to alternative fleet types through improved aircraft commonality which lowers pilot, maintenance, training, inventory and other costs as well as providing enhanced scheduling flexibility and revenue generation potential.

Two major Canadian labour agreements covering pilots (represented by the Air Canada Pilots Association (ACPA)) and flight attendants (represented by the Canadian Union of Public Employees (CUPE)) are scheduled for renegotiation in 1998. Negotiations are scheduled to begin shortly with the pilot group whose current contract expires in April 1998. Air Canada expects that, through the collective bargaining process, new labour agreements will be concluded with these employee groups. Labour agreements between three Regional Airlines (Air Nova, Air Alliance and AirBC) and their pilots (represented by the Air Line Pilots Association – Canada (ALPA)) are also up for renewal in the spring of 1998 and in December 1998. The parties will be working on concluding mutually beneficial agreements through the collective bargaining process. In late 1997, Air Ontario reached a tentative 4-year agreement to May 2002 with its pilots (represented by ALPA). This agreement is subject to ratification in the first quarter of 1998.

In 1997, Air Canada signed a letter of intent for the sale of its 100 per cent interest in Galileo Canada to Galileo International. Discussions regarding this sale are continuing.

With the privatization of the Canadian air navigation system under NAV CANADA, air navigation charges will become payable directly by all airlines operating to, from and within Canada to NAV CANADA on a phased basis commencing in March 1998. Effective March 1, 1998, the Air Transportation Tax ("ATT") used by the Government of Canada to fund a large portion of the operations of the air navigation system and which is collected by the airlines on behalf of the Government of Canada, will be reduced by approximately 50 per cent and new air navigation charges (at a level similar to the ATT reduction) will be instituted by NAV CANADA. On November 1, 1998, the ATT will be phased out completely and replaced by additional air navigation charges assessed by NAV CANADA to the airlines. Air Canada is planning to recover NAV CANADA fees through fare increases similar to the value of the ATT as it is phased out. In 1997, the Corporation collected on behalf of the Government of Canada, ATT valued at approximately $232 million. From a reporting standpoint, NAV CANADA fees will become a direct operating cost of the airlines and Air Canada's operating expenses, unit costs and revenues will be increased accordingly with the introduction of the new arrangements.

In 1997, the Federal Aviation Administration of the United States ("FAA") issued an interim final rule and commenced charging overflight fees for air navigation services for aircraft operating in US controlled domestic and oceanic airspace effective May 19, 1997. Air Canada's Asian, Caribbean and certain North Atlantic flights incurred charges starting on this date. The FAA deferred charging for Canadian domestic flights which fly in US airspace until March 1, 1998. Following unsatisfactory consultations with the FAA regarding the level of charges, the Canadian airline industry, through the Air Transport Association of Canada, filed a legal challenge of the Interim Final Rule.

On January 30, 1998, the United States Court of Appeal issued a ruling which struck down the charges set out in the FAA Interim Final Rule. The court ruling was made on the grounds that the FAA used inappropriate pricing methodology. At the same time, the Court confirmed the right of the FAA to impose overflight charges on airlines for air navigation services. At this time, the likely impact of the ruling is uncertain. The estimated cost to Air Canada of the Asian, Caribbean and North Atlantic overflight charges is approximately $8 million on an annual basis based on the fee schedule which was overturned by the Court. Discussions are continuing with respect to future US overflight charges for domestic Canada flights over US airspace.

Air Canada has entered into negotiations with the Greater Toronto Airport Authority ("GTAA") regarding the long-term lease of its Toronto airport terminal facilities. The GTAA is a corporation without share capital incorporated to operate and develop a regional network of airports in the Greater Toronto area. The GTAA commenced commercial operation in December 1995 with the acquisition of Toronto-Lester B. Pearson International Airport pursuant to a 60 year ground lease from the Government of Canada. In May 1997, the GTAA acquired Terminal 3 at the airport from Terminal 3 Development Corporation. The GTAA has adopted a comprehensive airport development program with the objective of providing sufficient airside, terminal and groundside capacity for the future and enhancing the airport's competitive position as a gateway airport to North America. The GTAA has proposed a significant long-term development plan which includes construction of additional runways as well as the planned replacement of existing facilities including Terminal 1 by year 2002 and subsequently Terminal 2, presently occupied by Air Canada, by the year 2005 with further expansion continuing until the year 2010. The phasing and staging of each component of the airport development program will be determined on the basis of demand. Air Canada is presently in discussions with the GTAA regarding the timing and content of the airport development program, particularly with respect to Terminal 2. Air Canada has a major interest in the future development of the airport and is working closely with the GTAA to ensure that it can continue to operate and expand this key hub airport for the future. The GTAA implemented significant landing fee and other surcharges in 1998 to fund terminal, runway and airside improvement projects. For the next several years, the GTAA is proposing to levy additional landing fee charges to fund both its current operations and the development plans with respect to the airport. The GTAA could also potentially introduce an airport improvement fee to support its long-term funding requirements.

For the past several years, the Corporation reduced its income tax provision related to the particular year's earnings by applying unrecognized income tax benefits from losses in 1992 and 1993. With the remaining unrecognized benefits, at December 31, 1997 amounting to $14 million, 1998 earnings will not be substantially affected by the application of prior years' income tax benefits. As a result, the net accounting income tax provision will increase in 1998, relative to 1997.

Over the next three years, Air Canada plans to invest in excess of $100 million in technology initiatives to improve customer service and operational/cost performance. These investments include product distribution initiatives (such as Internet and direct access booking improvements), airport processing and handling systems as well as improved yield management, scheduling, financial and human resources systems.

One of the Corporation's major priorities is to maintain a net unit cost profile which is competitive with major US air carriers. Air Canada will continue to focus on measures to improve productivity and on expense reduction initiatives including fleet modernization, reductions to distribution costs through direct access products, improved airport handling and customer service through technology and other initiatives. However, with the projected increase to user fees, including NAV CANADA charges and other expense areas, Air Canada expects a modest increase to its average unit cost per ASM for 1998.

The airline industry is subject to a number of influences over which it has limited or no control including economic conditions, interest rates, fuel prices, foreign exchange rates as well as regulatory and political events. Economic conditions in Canada are expected to remain favourable in 1998, however, there are many variables which cannot be predicted including foreign exchange rates, interest rates and other events such as the financial condition of Air Canada's main domestic competitor and the potential for new entrants in the domestic market.

The global airline industry is expected to remain highly competitive in 1998. Passenger traffic and yields have shown marked improvement in 1997, however they will continue to be under pressure as a result of the operation of low cost carriers and consumers demanding greater value for money. Air Canada has completed major structural changes over the past several years in order to improve its network, market position, products and operational efficiency.

The 1997 formation of the Star Alliance represents a milestone, which together with strong transborder market performance, an improved domestic environment and a sound product and expansion strategy, bode well for 1998. The Corporation will continue to work towards improving all aspects of its business including customer service, operational processes, products and fleet composition, with the objective of increasing operating profitability and cash flow to enhance shareholder value in 1998 and subsequent years.

This discussion contains certain forward-looking statements, which involve risks and uncertainties. As a result of a number of factors including fuel prices, the economic environment, interest rates, foreign exchange rates, the airline pricing environment and industry capacity decisions, actual results could differ from expected results and the differences could be material.

## Management's Report

The consolidated financial statements contained in this annual report have been prepared by management in accordance with generally accepted accounting principles and the integrity and objectivity of the data in these financial statements are management's responsibility. Management is also responsible for all other information in the annual report and for ensuring that this information is consistent, where appropriate, with the information and data contained in the financial statements.

In support of its responsibility, management maintains a system of internal control to provide reasonable assurance as to the reliability of financial information and the safeguarding of assets. The Corporation has an internal audit department whose functions include reviewing internal controls and their application, on an ongoing basis.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control and exercises this responsibility through the Audit Committee of the Board, which is composed of directors who are not employees of the Corporation. The Audit Committee meets with management, the internal auditors and the external auditors at least four times each year.

The external auditors, Price Waterhouse, conduct an independent audit, in accordance with generally accepted auditing standards, and express their opinion on the financial statements. Their audit includes a review and evaluation of the Corporation's system of internal control and appropriate tests and procedures to provide reasonable assurance that, in all material respects, the financial statements are presented fairly. The external auditors have full and free access to the Audit Committee of the Board and meet with it on a regular basis.

M. Robert Peterson
Senior Vice President, Finance
and Chief Financial Officer

R. Lamar Durrett
President and
Chief Executive Officer

## Auditors' Report

To the Shareholders of Air Canada:
We have audited the consolidated statement of financial position of Air Canada as at December 31, 1997 and 1996 and the consolidated statements of operations and retained earnings and changes in cash position for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 1997 and 1996 and the results of its operations and the changes in its cash position for the years then ended in accordance with generally accepted accounting principles.

Price Waterhouse

Chartered Accountants
Montréal, Québec
January 29, 1998

# Consolidated Statement of Operations and Retained Earnings

(in millions except per share figures)

| Year ended December 31 | 1997 | 1996 |
|---|---|---|
| **Operating revenues** | | |
| Passenger | $ 4,533 | $ 3,980 |
| Cargo | 387 | 347 |
| Other | 652 | 553 |
| | 5,572 | 4,880 |
| **Operating expenses** | | |
| Salaries and wages | 1,236 | 1,152 |
| Benefits | 153 | 179 |
| Aircraft fuel | 712 | 640 |
| Depreciation, amortization and obsolescence | 258 | 258 |
| Commissions | 438 | 395 |
| Food, beverages and supplies | 229 | 201 |
| Aircraft maintenance, materials and supplies | 248 | 210 |
| Airport user fees | 228 | 200 |
| Aircraft rent | 383 | 319 |
| Customer maintenance materials | 105 | 84 |
| Other (note 1j) | 1,214 | 1,027 |
| | 5,204 | 4,665 |
| **Operating income** | 368 | 215 |
| **Non-operating income (expense)** | | |
| Interest income | 26 | 50 |
| Interest expense | (203) | (239) |
| Interest capitalized | 43 | 32 |
| Amortization of deferred foreign exchange on long-term debt | (20) | (46) |
| Gain on sale of investments (note 4) | 201 | 129 |
| Gain on sale of other assets | 35 | 4 |
| Other | 16 | 8 |
| | 98 | (62) |
| **Income before income taxes** | 466 | 153 |
| **Income tax provision** (note 10) | (207) | (56) |
| **Recovery of prior years income tax benefits previously not recorded** | 168 | 52 |
| **Income for the year** | 427 | 149 |
| **Deficit, beginning of year** | (257) | (392) |
| **Charge relating to convertible debentures** (note 8) | 1 | (14) |
| **Retained earnings (deficit), end of year** | $ 171 | $ (257) |
| **Earnings per share** | | |
| – Basic | $ 2.74 | $ 0.86 |
| – Fully diluted | $ 2.37 | $ 0.82 |

See accompanying notes.

# Consolidated Statement of Financial Position

(in millions)

| December 31 | 1997 | 1996 |
|---|---|---|
| **Assets** | | |
| Current | | |
| Cash and short-term investments (note 1d) | $ 650 | $ 455 |
| Accounts receivable | 467 | 387 |
| Spare parts, materials and supplies | 225 | 197 |
| Prepaid expenses | 17 | 20 |
| Deferred income taxes | 35 | – |
| | 1,394 | 1,059 |
| **Property and equipment** (note 2) | 2,817 | 2,819 |
| **Deferred charges** (note 3) | 1,447 | 1,118 |
| **Investments and other assets** (note 4) | 333 | 445 |
| | $ 5,991 | $ 5,441 |
| **Liabilities** | | |
| Current | | |
| Accounts payable and accrued liabilities | $ 668 | $ 615 |
| Advance ticket sales | 400 | 270 |
| Current portion of long-term debt | 71 | 226 |
| | 1,139 | 1,111 |
| **Long-term and subordinated perpetual debt** (note 5) | 2,739 | 2,847 |
| **Other long-term liabilities** | 218 | 177 |
| **Deferred credits** (note 7) | 460 | 321 |
| | 4,556 | 4,456 |
| **Shareholders' Equity** | | |
| **Convertible debentures** (note 8) | 201 | 186 |
| **Share capital** (note 9) | 1,063 | 1,056 |
| **Retained earnings (deficit)** | 171 | (257) |
| | 1,435 | 985 |
| | $ 5,991 | $ 5,441 |

See accompanying notes.

On behalf of the Board:

R. Lamar Durrett
President and Chief Executive Officer

John F. Fraser, O.C.
Chairman of the Board

# Consolidated Statement of Changes in Cash Position

(in millions except per share figures)

| Year ended December 31 | 1997 | 1996 |
|---|---|---|
| **Cash provided by (used for)** | | |
| **Operating** | | |
| Income for the year | $ 427 | $ 149 |
| Adjustments to reconcile to net cash provided by operations | | |
| Depreciation, amortization and obsolescence | 258 | 258 |
| Gain on sale of investments (note 4) | (201) | (129) |
| Gain on sale of other assets | (35) | (4) |
| Deferred income taxes | 17 | (45) |
| Deferred pension expense | (38) | (24) |
| Amortization of deferred foreign exchange on long-term debt | 20 | 46 |
| Amortization of deferred gains | (20) | (24) |
| (Increase) decrease in accounts receivable | (80) | 21 |
| Increase in spare parts, materials and supplies | (38) | (32) |
| Increase in accounts payable and accrued liabilities | 53 | 17 |
| Increase in advance ticket sales | 130 | 55 |
| Scheduled lease payments in excess of aircraft rent expense | (79) | (203) |
| Other | (48) | (21) |
| | 366 | 64 |
| **Financing** | | |
| Issue of share capital | 7 | 2 |
| Long-term borrowings | 235 | 645 |
| Reduction of long-term debt | (482) | (848) |
| Other | (26) | (17) |
| | (266) | (218) |
| **Investing** | | |
| Proceeds from sale and leaseback of assets | 137 | 336 |
| Proceeds from sale of investments and other assets | 375 | 176 |
| Additions to property and equipment (net of recovered progress payments) | (439) | (607) |
| Investments and advances | 22 | (71) |
| | 95 | (166) |
| **Increase (decrease) in cash position** | 195 | (320) |
| **Cash position, beginning of year** | 455 | 775 |
| **Cash position, end of year** | $ 650 | $ 455 |
| **Cash flow per share from operations** | | |
| – Basic | $ 2.34 | $ 0.41 |
| – Fully diluted | $ 2.04 | $ 0.41 |

See accompanying notes.

# Notes to Consolidated Financial Statements

(currencies in millions)

## 1. Significant Accounting Policies

### Nature of Operations

Air Canada is a Canadian-based international air carrier providing scheduled and charter air transportation for passengers and cargo. The Corporation's airline route network, together with its regional airline subsidiaries, offer air transportation services over routes authorized by the Government of Canada and the foreign governments concerned. Those routes serve 92 communities in North America and 26 cities in Europe, the Middle East, Asia and the Caribbean. With Air Canada's alliance partners, scheduled and charter air transportation is offered to over 660 destinations in more than 110 countries. Air transportation and related revenues represent over 94% of consolidated operating revenues.

The Corporation provides aircraft and engine maintenance, and computer, ground handling, and other services to airlines and other customers.

### a) Principles of Consolidation

The consolidated financial statements are expressed in Canadian dollars and are prepared in accordance with accounting principles generally accepted in Canada. They include the accounts of Air Canada as well as regional airlines (AirBC Ltd., Air Ontario Inc., Air Alliance Inc., and Air Nova Inc.), a computerized reservation system, Galileo Canada Distribution Systems Inc., and a tour operator, Air Canada Vacations (Touram Inc.), all of which are wholly-owned operating subsidiaries. In 1997, the Corporation sold its 100% interest in the previously consolidated Northwest Territorial Airways Ltd.

The excess of the acquisition costs of investment in subsidiaries over the Corporation's proportionate share of the underlying value of the net assets at the date of acquisition represents goodwill, and is amortized over periods not exceeding 20 years (note 4). The value of goodwill, and any impairment of that value, is assessed by reference to cash flows, operating income and estimation of fair value.

Investments in companies in which Air Canada does not have significant influence over management are carried at cost.

### b) Use of Estimates

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

### c) Foreign Currency Translation

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at rates of exchange in effect at the date of the consolidated statement of financial position. Gains or losses are included in income of the year, except for the gains or losses relating to long-term receivables and debt which are deferred and amortized over the remaining term of the corresponding receivable or debt. Non-monetary assets, liabilities and other items recorded in income arising from transactions denominated in foreign currencies, are translated at rates of exchange in effect at the date of the transaction.

### d) Cash and Short-Term Investments

Cash and short-term investments include short-term investments of $611 (1996 $505). All short-term investments may be liquidated promptly and have maturities of less than one year.

### e) Spare Parts, Materials and Supplies

Spare parts, materials and supplies are valued at average cost. A provision for the obsolescence of flight equipment spare parts is accumulated over the estimated service lives of the related flight equipment to a 30% residual value.

## 1. Significant Accounting Policies (Cont'd)

**f) Air Transportation Revenue**
Airline passenger and cargo sales are recognized as operating revenues when the transportation is provided. The value of unused transportation is included in current liabilities.

**g) Post-Employment Benefits**
Pension expense, based on management's assumptions, consists of the actuarially computed costs of the pension benefits in respect of current year's service; imputed interest on plan assets and pension obligations; and straight-line amortization of experience gains or losses, assumption changes and plan amendments over the expected average remaining service life of the employee group.

Costs associated with post-employment health care and life insurance benefits are recognized as incurred.

**h) Depreciation and Amortization**
Operating property and equipment are depreciated or amortized to estimated residual values based on the straight-line method over their estimated service lives.

| | Estimated Residual Values | | Period of Amortization |
|---|---|---|---|
| | Aircraft | Engines/Rotable Inventory | |
| **Air Canada** | | | |
| Boeing 747-133/233B | 15% | 10% | 16 years |
| Boeing 767-233 | 15% | 15% | 20 years |
| A319-113 | 15% | 15% | 20 years |
| A320-211 | 15% | 15% | 20 years |
| DC-9-32 | 15% | 10% | 10 years |
| **Subsidiaries** | | | |
| Various | 15-20% | 15-20% | 12-20 years |

Significant aircraft reconfiguration costs are amortized over 3 years. Aircraft introduction costs are amortized over 4 years. Betterments to aircraft on operating leases are amortized over the term of the lease.

**i) Maintenance and Repairs**
Maintenance and repair costs are charged to operating expenses as incurred. Significant modification costs are capitalized and amortized over the remaining service lives of the assets.

**j) Other Operating Expenses**
Included in other operating expenses are expenses related to building rent and maintenance, advertising and promotion, computer reservation service charges, professional fees and services, terminal handling, crew meals and hotels, computer network and information technology costs, insurance costs and other expenses.

**k) Aeroplan**
The incremental cost of providing travel awards under the Corporation's frequent flyer program is charged to expense when reward levels are reached. Revenue from the sale of mileage credits to participating partners is included in other revenue during the period in which the credits are sold.

**l) Interest Capitalized**
Interest on funds used to finance the acquisition of new flight equipment and other property and equipment is capitalized for periods preceding the dates the assets are available for service.

1. Significant Accounting Policies (Cont'd)

**m) Gains on Sale and Leaseback of Assets**
Gains on sale and leaseback of assets are deferred and amortized to income over the terms of the leases as a reduction in rental expense.

**n) Income Tax**
Income taxes are provided using the deferred credit method.

**o) Financial Instruments**
The Corporation manages its foreign exchange exposure through the use of options, forward contracts and cross currency swaps. Resulting gains and losses are accrued as exchange rates change to offset gains and losses resulting from the underlying hedged transactions. Premiums and discounts are amortized over the term of the contracts.

The Corporation also enters into interest rate swap agreements to minimize the impact of changes in rates. Net receipts or payments under the Corporation's swap agreements are accrued as adjustments to interest expense.

The Corporation enters into fuel contracts to manage its exposure to jet fuel price volatility. Resulting gains and losses are recorded as adjustments to fuel expense as fuel is purchased. Premiums and discounts are recorded over the term of the contracts.

**p) Comparative Figures**
Certain comparative figures have been reclassified to conform with the financial statement presentation adopted in the current year.

**2. Property and Equipment**

| | 1997 | 1996 |
|---|---|---|
| Cost: | | |
| Flight equipment | $ 3,130 | $ 2,942 |
| Other property and equipment | 1,239 | 1,176 |
| | 4,369 | 4,118 |
| Accumulated depreciation and amortization: | | |
| Flight equipment | 1,071 | 1,034 |
| Other property and equipment | 774 | 724 |
| | 1,845 | 1,758 |
| | 2,524 | 2,360 |
| Progress payments | 293 | 459 |
| **Property and equipment at net book value** | $ 2,817 | $ 2,819 |

Interest capitalized during the year amounted to $43 using an average interest rate of 8.0% (1996 $32 at 8.0%).

In 1996, flight equipment included aircraft retired from active service with a net book value of $7.

## 3. Deferred Charges

| | 1997 | 1996 |
|---|---|---|
| Employer pension plan funding in excess of pension expense | $ 502 | $ 439 |
| Foreign currency exchange on long-term debt | 155 | 184 |
| Scheduled lease payments in excess of aircraft rent expense | 650 | 397 |
| Financing costs | 79 | 58 |
| Aircraft introduction costs | 41 | 22 |
| Other | 20 | 18 |
| **Deferred charges** | $ 1,447 | $ 1,118 |

## 4. Investments and Other Assets

| | 1997 | 1996 |
|---|---|---|
| Investments in companies accounted for on the cost basis | $ – | $ 162 |
| Security and other deposits | 183 | 154 |
| Notes receivable | 74 | 64 |
| Goodwill, net of amortization | 42 | 45 |
| Partnership interests in international computer reservation systems | 2 | 15 |
| Other | 32 | 5 |
| **Investments and other assets** | $ 333 | $ 445 |

At December 31, 1997, investments in companies accounted for on the cost basis include only the Corporation's 1.02% common share holding of GPA Group plc. which is carried at a nominal amount. During the year, the Corporation sold its remaining Class B common shares in Continental Airlines for proceeds of $207 (gain $171), and all remaining portfolio investments for proceeds of $77 (gain $14).

Notes receivable bear interest at a weighted average rate of 14.8% and mature 1998 through 2010. The carrying value of notes receivable approximates fair value.

In 1997, the Corporation sold most of its interest in Galileo International and all of its equity interest in Apollo Travel Service Partnership for aggregate proceeds of $44 and a pre-tax gain of $30. Earnings from partnership interests total $3 (1996 $5) and are included in other non-operating income.

## 5. Long-Term and Subordinated Perpetual Debt

| | Final Maturity | Interest Rate (%) | 1997 | 1996 |
|---|---|---|---|---|
| U.S. dollar debt (a) | 1998-2008 | 6.4 – 8.7 | $ 867 | $ 1,272 |
| Canadian dollar debt (b) | 1998-2011 | 7.25 – 12.8 | 422 | 220 |
| Swiss franc debt (c) | 2002 | 5.1 | 182 | 190 |
| Deutsche mark debt (d) | 2001 | 7.1 | 207 | 223 |
| Japanese yen notes (e) | 2007 | 5.8 | 156 | 177 |
| | | | 1,834 | 2,082 |
| Subordinated perpetual debt (Note 6) | | | 931 | 931 |
| Long-term debt portion of convertible debentures (Note 8) | | | 45 | 60 |
| | | | 2,810 | 3,073 |
| Current portion of long-term debt | | | (71) | (226) |
| **Long-term and subordinated perpetual debt** | | | $ 2,739 | $ 2,847 |

5. Long-Term and Subordinated Perpetual Debt (Cont'd)

All debt is unsecured by the assets of the Corporation with the exception of subsidiaries' debt totalling $192 (1996 $220) which is secured by certain of their assets.

Principal repayment requirements for the next five years are as follows:

| 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|
| $ 71 | $ 75 | $ 108 | $ 339 | $ 306 |

As at December 31, 1997, the Corporation had a U.S. $400 committed, unsecured and undrawn revolving credit facility with a group of financial institutions in Canada. The facility has a maturity ending in 2001 but may be extended by an additional year on each anniversary date. If the facility is not extended, the availability of funds declines until maturity.

a) As at December 31, 1997, U.S. dollar debt totalled U.S. $606, of which U.S. $406 is at floating interest rates based on U.S. dollar LIBOR. Approximately 45% of the 1998 interest rate exposure on the floating rate U.S. dollar debt is hedged by short-term interest rate contracts. Of the U.S. $606 debt:

- a U.S. $300 borrowing has a final maturity in 2005 and may be repaid at par any time until the year 2000 and on any interest payment date thereafter. The Corporation has repurchased but not cancelled U.S. $10 of this borrowing.
- a U.S. $235 borrowing has a final maturity in 2006 and may be repaid at par in whole or in part on any interest payment date, with an indemnity.
- a U.S. $81 borrowing has a final maturity in 2008 and may be repaid at par in whole or in part any time prior to maturity, with an indemnity.

The following hedges with credit worthy counterparties are related to the long-term debt above:

i) a swap where the Corporation owes, on a compounded basis, a fixed rate of interest on a notional amount of U.S. $165 until cash settlement no later than October 2000. This swap is completely offset by an equal and offsetting swap with another counterparty where the Corporation owes, on a compounded basis, a floating rate of interest.

ii) a swap where the Corporation pays a floating rate of interest on a notional amount of U.S. $165 until October 2000.

iii) a swap where the Corporation owes 20,010 Japanese yen with a floating interest rate until October 2002 and fixed thereafter until maturity in 2007, and the counterparty owes the Corporation U.S. $165 with a fixed rate of interest.

b) Canadian dollar debt is comprised of $230 debentures maturing in 2007 and various other subsidiary debt totalling $192. The debentures are redeemable by the Corporation in whole or in part at any time, with an indemnity.

c) Swiss franc debt is comprised of 200 Swiss francs maturing in 2002 that may be called by the Corporation at par on any interest payment date. Between 1991 and 1993 the Corporation repurchased but did not cancel 14 Swiss francs of this borrowing.

d) Deutsche mark debt is comprised of 250 Deutsche mark bonds maturing in 2001. The Corporation has entered into the following hedge agreements, with credit worthy counterparties, related to this debt:

5. Long-Term and Subordinated Perpetual Debt (Cont'd)

i) effectively converting 125 Deutsche mark 7.1% fixed rate debt into Deutsche mark floating rate debt until May 2001.
ii) effectively converting 125 Deutsche mark floating rate debt into $102 Canadian floating rate debt until May 2001.
iii) effectively converting 125 Deutsche mark 7.1% fixed rate debt into $105 Canadian floating rate debt until May 2001.

In January 1998 the Corporation issued 200 Deutsche mark 6.6% fixed rate Eurobonds which have a final maturity of 2005.

e) Japanese yen debt is comprised of 14,286 Japanese yen notes. These will be repaid in 20 equal semi-annual instalments ending October 2007. The interest rate on the notes will be reset in 2002 based on an interest rate index. These notes may be called by the Corporation at par on any interest payment date.

6. **Subordinated Perpetual Debt**

| | 1997 | 1996 |
|---|---|---|
| 60,000 Japanese yen at 5.30% until 1999 Callable in 1999 and every fifth year thereafter at par (a) | $ 657 | $ 710 |
| 300 Swiss francs at 6.25% Callable in 2001 and every fifth year thereafter at 102% of par | 293 | 307 |
| 200 Swiss francs at 5.75% Callable at 101.5% of par in 1999 and every fifth year thereafter at 102% of par | 196 | 204 |
| 200 Deutsche marks at 4.625% until 2000 Callable in 2000 and every third year thereafter at par (b) | 159 | 178 |
| Subordinated perpetual debt, at year-end foreign exchange rates | $ 1,305 | $ 1,399 |
| Less foreign exchange | (374) | (468) |
| **Subordinated perpetual debt** | $ 931 | $ 931 |

The maturity of this subordinated perpetual debt is only upon the liquidation, if ever, of the Corporation. Principal and interest payments on the debt are unsecured and are subordinated to the prior payment in full of all indebtedness for borrowed money, excluding convertible debentures (note 8). The effects of foreign exchange fluctuations since issuance have not been recorded in income since it is not probable that circumstances will arise requiring redemption of the debt and since, under present circumstances, it is not probable that the Corporation will call the debt. As at December 31, 1997 the foreign exchange fluctuation related to 60,000 Japanese yen is $159 (1996 $212), 500 Swiss francs is $153 (1996 $175), and 200 Deutsche marks is $62 (1996 $81).

a) The interest rate on the yen subordinated perpetual debt is 5.30% until 1999 and will be reset for each subsequent five-year reset period based upon a capped spread over the Japanese long-term prime lending rate. The Corporation has entered into interest rate swaps effectively fixing the next interest reset for one half of the principal at interest rates less than currently being paid.

b) The interest rate on the Deutsche mark subordinated perpetual bonds is 4.625% until 2000 and will be reset for each subsequent three-year reset period based upon an interest rate index.

## 7. Deferred Credits

| | 1997 | 1996 |
|---|---|---|
| Gain on sale and leaseback of assets | $ 156 | $ 164 |
| Aircraft rent expense in excess of scheduled lease payments | 220 | 110 |
| Income taxes | 71 | 34 |
| Other | 13 | 13 |
| **Deferred credits** | $ 460 | $ 321 |

## 8. Convertible Debentures

The convertible debentures are convertible at the holder's option at anytime up to and including the close of business on the business day immediately preceding maturity in April 2005 at a conversion price of $8.00 per Class A non-voting common share. This equals a rate of 12.5 Class A non-voting common shares per $100.00 principal amount of convertible debentures.

The convertible debentures are redeemable, for cash or Class A non-voting common shares, at the option of the Corporation beginning April 1998 and thereafter until April 2000 at par plus accrued and unpaid interest provided that the weighted average closing price of the Class A non-voting shares on the Montreal Exchange and on the Toronto Stock Exchange exceeds 125% of the conversion price. From April 2000, the convertible debentures will be redeemable at the option of the Corporation either for cash or for Class A non-voting shares based upon 95% of the weighted average closing price of the Class A non-voting shares in a specified time period prior to redemption.

A portion of convertible debentures, $45 (1996 $60) representing the present value of interest payments on convertible debentures to April 2000, is classified as long-term debt. This amount will decline to zero over the period to April 2000, and is offset by an increase in convertible debentures classified as Shareholders' Equity. The charge to Shareholders' Equity for 1997 was $15 less income taxes of $6 and recovery of prior years income tax benefits previously not recorded of $10 resulting in a net credit of $1. The charge to Shareholders' Equity in 1996 was $14.

## 9. Share Capital

The authorized capital of the Corporation consists of an unlimited number of common shares, Class A non-voting common shares, Class A preferred shares issuable in series and Class B preferred shares issuable in series. The Corporation's Articles of Continuance under provisions of the Canada Business Corporations Act include limits on individual and aggregate non-resident public ownership of common shares of 10% and 25% respectively, including associates of such shareholders.

The issued capital consists of common shares and Class A non-voting common shares, and the changes during 1996 and 1997 in the outstanding number of shares and their aggregate stated value during those years are as follows:

| | Common Shares | | Class A Non-Voting Shares | |
|---|---|---|---|---|
| | *Number* | *Amount* | *Number* | *Amount* |
| December 31, 1995 | 119,375,613 | $ 814 | 35,714,400 | $ 240 |
| Share purchase options exercised | 47,692 | – | 64,427 | – |
| Share Appreciation Rights Plan | 379,437 | 2 | – | – |
| December 31, 1996 | 119,802,742 | $ 816 | 35,778,827 | $ 240 |
| Share purchase options exercised | 260,276 | 2 | 879,558 | 5 |
| Debenture Conversions | – | – | 17,375 | – |
| December 31, 1997 | 120,063,018 | $ 818 | 36,675,760 | $ 245 |

## 9. Share Capital (Cont'd)

The details of the Corporation's share option plan, under which eligible employees are granted options to purchase common shares and Class A non-voting common shares, at a price not less than the market value of the shares at the date of granting, are as follows:

| | Options Outstanding Common Shares | Option Price Per Common Share | Options Outstanding Class A Non-Voting Shares | Option Price Per Class A Non-Voting Share |
|---|---|---|---|---|
| 1988 | 21,460 | $8.00 | – | – |
| 1990 | 1,013 | $9.75 | – | – |
| 1991 | 3,112 | $9.13 | – | – |
| 1992 | 2,889 | $5.55 | – | – |
| 1993 | 59,530 | $2.79 | 9,795 | $2.79 |
| 1994 | 114,942 | $6.42-$6.56 | 62,365 | $6.42-$6.70 |
| 1995 | 152,235 | $5.05-$7.89 | 42,118 | $7.89 |
| 1996 | 411,366 | $4.73-$4.94 | 320,600 | $4.17-$4.64 |
| 1997 | 405,276 | $7.77 | 185,553 | $7.32 |
| | 1,171,823 | | 620,431 | |

The options granted in 1988 are exercisable in the amount of 33⅓% of the shares per year on a cumulative basis. All other options are exercisable on the basis of 25% of the options per year on a cumulative basis, beginning after one year and expiring after ten years.

On May 10, 1995, the Board of Directors approved a resolution providing for an amendment to the Corporation's share option plan pursuant to which the holders of common share options were offered an opportunity to convert such options to Class A non-voting common share options on a one-for-one basis with the same vesting schedule and subject to the same terms and conditions governing the common share options.

## 10. Income Taxes

Income taxes differ from the amount which would be obtained based on the combined basic Canadian federal and provincial income tax rate. The difference results from the following items:

| | **1997** | 1996 |
|---|---|---|
| Provision based on combined federal and provincial tax rates | **$ 189** | $ 62 |
| Non-taxable portion of capital gains | **(19)** | (11) |
| Large corporations tax | **6** | 6 |
| Non-deductible expenses | **29** | 7 |
| Other | **2** | (8) |
| | **$ 207** | $ 56 |
| Current | **$ 205** | $ 55 |
| Deferred | **2** | 1 |
| **Income tax provision** | **$ 207** | $ 56 |

10. Income Taxes (Cont'd)

In 1993, under the December 1991 Federal Government Excise Tax Transportation Rebate Program, the Corporation exchanged income tax losses on a ratio of 10 to 1 for a $46 cash rebate of fuel excise taxes paid in 1991 and 1992. As a result, 1993 unrecorded income tax benefits were reduced by $175.

In 1997, the Corporation reinstated $429 of federal income tax losses, representing $167 of income tax benefits, by repaying the Canadian government the net balance of fuel tax rebates received in 1993 in the amount of $43 plus $13 of accrued interest.

As at December 31, 1997, accumulated unrecognized income tax benefits amount to $14.

**11. Commitments**

The Corporation has commitments to purchase twelve Airbus A319, three Airbus A340, five Airbus A330 and two Canadair Regional Jet aircraft for U.S. $943 which are payable as follows:

| | U.S. |
|---|---|
| 1998 | $ 416 |
| 1999 | $ 285 |
| 2000 | $ 242 |

The Corporation has received financing commitments for substantially all Airbus deliveries.

Other commitments for property, ground equipment and spare parts, amount to approximately $279.

Future minimum lease payments under operating leases of aircraft and other property total $3,966 and are payable as follows:

| | Operating Leases of Aircraft | Operating Leases of Other Property |
|---|---|---|
| 1998 | $ 549 | $ 68 |
| 1999 | 556 | 57 |
| 2000 | 513 | 46 |
| 2001 | 484 | 37 |
| 2002 | 447 | 36 |
| Remaining years | 937 | 236 |
| | $ 3,486 | $ 480 |

Operating lease commitments include currency swaps to convert a significant portion of U.S. dollar lease rentals into Canadian dollar lease rentals for five Canadair Regional Jet operating leases until lease terminations in 2007. These currency swaps, with a credit worthy counterparty, were put in place at the time the leases were concluded and have a fair value at December 31, 1997 of $7 (1996 $8) in favour of the counterparty, taking into account foreign exchange rates in effect at that time.

## 12. Pension Plans

The Corporation and its subsidiaries maintain several defined benefit pension plans. Based on the latest actuarial reports prepared as at December 31, 1996 using management's assumptions, the estimated present value of the accrued pension benefits as at December 31, 1997 amounted to $4,088 and the net assets available to provide these benefits were $4,430 calculated on a four year moving average market value basis.

## 13. Financial Instruments and Risk Management

The Corporation manages its exposure to changes in interest rates, foreign exchange rates, and jet fuel prices through the use of various derivative financial instruments. Senior management is responsible for setting acceptable levels of risk and reviewing risk management activities as necessary. The Corporation uses derivative financial instruments only for the purpose of hedging existing commitments or obligations, not for generating trading profits.

### Credit Exposure of Derivatives

The Corporation's theoretical risk in the derivative financial instruments described below is the cost of replacing the contracts at current market rates in the event of default by any of the counterparties. However, the Corporation does not anticipate such default as it only transacts with credit worthy counterparties, and the relative market positions with each counterparty are monitored to ensure an adequate diversification of risk.

### Interest Rate Risk Management

The Corporation has entered into interest rate swap agreements in order to manage the interest rate exposure associated with certain long-term debt obligations. The notional amounts of the swaps do not represent amounts exchanged between parties and are not a measure of the Corporation's exposure resulting from the use of swaps. The amounts exchanged are based on interest rates applied to the notional amounts. The fair value of interest rate swap agreements as at December 31, 1997 was $76 (1996 $39) in favour of counterparties, taking into account interest rates in effect at the time.

The Corporation has also entered into various forward interest rate agreements, with maturities of less than one year, to manage the risks associated with interest rate movement on the short-term investment portfolio and U.S. and Canadian floating rate debt. The notional amounts of the agreements do not represent amounts exchanged between parties and are not a measure of the Corporation's exposure resulting from the use of the agreements. The amounts exchanged are based on interest rates applied to the notional amounts. The aggregate fair value of contracts outstanding at December 31, 1997 was not material for either year presented.

### Foreign Exchange Risk Management

The Corporation has entered into certain foreign exchange contracts, with maturities of less than one year, to manage risks associated with foreign currency exchange rates. As at December 31, 1997 the aggregate face amount of such contracts was approximately $161 (1996 $703). The related realized and unrealized gains and losses for such contracts at December 31, 1997 were not material for either year presented.

The Corporation has also entered into cross currency swap agreements. The fair value of these agreements at December 31, 1997 was $13 (1996 $0) in favour of the Corporation.

## 13. Financial Instruments and Risk Management (Cont'd)

### Fuel Price Risk Management

The Corporation enters into contracts with certain financial intermediaries, not exceeding two years, to manage its exposure to jet fuel price volatility. Gains and losses resulting from fuel hedging transactions are recognized as a component of fuel expense. As at December 31, 1997 the Corporation had effectively hedged approximately 48% of its projected 1998 fuel requirements and approximately 17% of its projected 1999 fuel requirements. As at December 31, 1997 the fair value of fuel contracts was $10 in favour of the counterparties (1996 $31 in favour of the Corporation).

### Concentration of Credit Risk

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

### Statement of Financial Position Financial Instruments – Fair Values

The carrying amounts reported in the consolidated statement of financial position for cash and short-term investments, accounts receivable, and accounts payable approximate fair values due to the immediate or short-term maturities of these financial instruments.

The fair value of long-term and subordinated perpetual debt, including current portion of long-term debt, is based on rates currently available to the Corporation for debt with similar terms and maturities. The fair value of long-term and subordinated perpetual debt as at December 31, 1997 was $3,165 (1996 $3,363) compared with carrying values, net of deferred foreign currency exchange, of $2,655 (1996 $2,889).

## 14. Contingencies

Various lawsuits and claims are pending by and against the Corporation. It is the opinion of management supported by counsel that final determination of these claims will not have a material adverse effect on the financial position or the results of the Corporation.

Under aircraft lease agreements, the Corporation may be required to provide residual value support not exceeding $107. Independent appraisals as at December 31, 1997 have indicated it is very unlikely the Corporation will be required to provide this support. The Corporation retains a residual value interest in these leased aircraft through purchase options.

In 1990 and 1989, the Corporation concluded agreements with a substantial U.S. financial institution where, upon payment by the Corporation, the financial institution assumed liability for scheduled payments relating to certain long-term obligations in amounts of $98 in 1990 and $107 in 1989 and interest thereon. These obligations (which amount to $77 and $86 respectively at December 31, 1997) are extinguished for financial reporting purposes and have been removed from the Corporation's statement of financial position. Until the assumed liabilities have been fully discharged by the financial institution, the Corporation remains contingently liable for such obligations in the remote event that the counterparty fails to perform.

## 15. United States Generally Accepted Accounting Principles

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada (Canadian GAAP) which conform in all material respects with generally accepted accounting principles in the United States (U.S. GAAP) except as set forth below.

| | 1997 | 1996 |
|---|---|---|
| **Income Adjustments** | | |
| Income for the year in accordance with Canadian GAAP | $ 427 | $ 149 |
| Convertible debentures (1) | (15) | (14) |
| Unrealized foreign exchange gain on translation of: | | |
| Long-term debt with principal repayment requirements (2) | 29 | 105 |
| Subordinated perpetual debt (3) | 94 | 176 |
| Pension costs (4) | (22) | 20 |
| Post-retirement benefit costs other than pension (5) | (17) | (12) |
| Income tax provision (6) | (51) | 125 |
| Current year income adjustments | 18 | 400 |
| Income for the year before U.S. GAAP accounting change | 445 | 549 |
| Cumulative effect of U.S. GAAP accounting change for subordinated perpetual debt, net of income tax (3) | – | (448) |
| Income for the year in accordance with U.S. GAAP | $ 445 | $ 101 |
| **Financial Position Adjustments** | | |
| Cash and short-term investments: | | |
| Balance under Canadian GAAP | $ 650 | $ 455 |
| Reclassification of short-term investments with maturities greater than three months (8) | – | (8) |
| Balance under U.S. GAAP | $ 650 | $ 447 |
| Short-term investments: | | |
| Balance under Canadian GAAP | $ – | $ – |
| Reclassification of short-term investments with maturities greater than three months (8) | – | 8 |
| Balance under U.S. GAAP | $ – | $ 8 |
| Investments and other assets: | | |
| Balance under Canadian GAAP | $ 333 | $ 445 |
| Adjustment for available-for-sale securities (9) | – | 171 |
| Adjustment for tax effect of available-for-sale securities (9) | – | (52) |
| Deferred income taxes (6) | 261 | 321 |
| Balance under U.S. GAAP | $ 594 | $ 885 |

15. United States Generally Accepted Accounting Principles (Cont'd)

| | 1997 | 1996 |
|---|---|---|
| Deferred charges: | | |
| Balance under Canadian GAAP | $ 1,447 | $ 1,118 |
| Adjustment for foreign currency exchange on long-term debt (2) | (155) | (184) |
| Adjustment for pension costs (4) | 92 | 99 |
| Balance under U.S. GAAP | $ 1,384 | $ 1,033 |
| Long-term and subordinated perpetual debt: | | |
| Balance under Canadian GAAP | $ 2,739 | $ 2,847 |
| Reclassification of convertible debentures (1) | 201 | 186 |
| Foreign exchange on subordinated perpetual debt (3) | 374 | 468 |
| Balance under U.S. GAAP | $ 3,314 | $ 3,501 |
| Other long-term liabilities: | | |
| Balance under Canadian GAAP | $ 218 | $ 177 |
| Adjustment for pension costs (4) | 119 | 89 |
| Adjustment for post-retirement benefit costs (5) | 265 | 248 |
| Balance under U.S. GAAP | $ 602 | $ 514 |
| Shareholders' equity: | | |
| Balance under Canadian GAAP | $ 1,435 | $ 985 |
| Reclassification of convertible debentures | (201) | (186) |
| Charge relating to convertible debentures | 15 | 14 |
| Tax effect of charge relating to convertible debentures | (16) | – |
| Current year income adjustments | 18 | 400 |
| Current year adjustment for available-for-sale securities | (119) | (8) |
| Current year retained earnings adjustments for pension costs | (8) | – |
| Cumulative effect of U.S. GAAP accounting change for subordinated perpetual debt | – | (448) |
| Cumulative prior year adjustments for: | | |
| U.S. GAAP accounting change for subordinated perpetual debt | (468) | – |
| Foreign currency exchange | (184) | (290) |
| Pension costs | 10 | (9) |
| Post-retirement costs | (248) | (236) |
| Post-employment costs | – | – |
| Available-for-sale securities | 119 | 127 |
| Deferred income tax | 321 | – |
| Balance under U.S. GAAP | $ 674 | $ 349 |

1) Under Canadian GAAP, convertible securities are split for accounting purposes between long-term debt and shareholders' equity with interest expense related to the equity portion recorded as a charge to retained earnings. Under U.S. GAAP, convertible debentures are recorded as long-term debt with interest expense charged to earnings.

2) Under Canadian GAAP, unrealized exchange gains and losses arising on the translation, at exchange rates prevailing on the balance sheet date, of long-term debt repayable in a foreign currency are deferred and amortized to income over the remaining life of the related debt. Under U.S. GAAP, such exchange gains and losses are included in income in the period in which occurred.

## 15. United States Generally Accepted Accounting Principles (Cont'd)

3) Under Canadian GAAP, unrealized exchange gains and losses arising on the translation, at exchange rates prevailing on the balance sheet date, of subordinated perpetual debt repayable in a foreign currency are deferred. Under U.S. GAAP, such exchange gains and losses are included in income in the period in which occurred. In 1996, the Corporation changed its accounting policy for U.S. GAAP to the method noted above. Previously this debt was translated using historical rates of exchange.

4) The determination of net pension costs in accordance with Canadian and U.S. GAAP differs with respect to the valuation of assets at January 1, 1987, the basis used to determine the benefit obligation and the expected return on plan assets, and the amortization of changes in assumptions and experience gains and losses. Under U.S. GAAP, changes in assumptions and experience gains and losses may remain unamortized until they exceed ten per cent of the projected benefit obligation or market related value of plan assets. For Canadian GAAP all changes in assumptions and experience gains and losses are amortized.

5) Under Canadian GAAP, the cost of providing post-retirement and post-employment benefits other than pensions can either be charged against income as funding payments are made or provided for on an accrual basis. As allowed by Canadian GAAP, the Corporation is accounting for post-retirement and post-employment benefit costs other than pensions on a cash basis. Under U.S. GAAP, post-retirement and post-employment benefits other than pensions are charged against income on an accrual basis.

6) Under Canadian GAAP, the income tax provision is calculated using the deferred credit method and previously unrecognized income tax benefits are recognized as realized. Under U.S. GAAP, the income tax provision is calculated using the liability method and a valuation allowance is provided against any deferred tax asset if it is more likely than not that a portion of the asset will not be realized.

7) Under U.S. GAAP, the calculation of income per share is based on basic common share equivalents of 156,030,221 (1996 155,364,363) and fully diluted common share equivalents of 188,326,269 (1996 186,917,544).

| Earnings per common share | 1997 | 1996 |
|---|---|---|
| Income for the year before U.S. GAAP accounting change | $ 2.85 | $ 3.53 |
| Cumulative effect of U.S. GAAP accounting change | – | (2.88) |
| Income for the year | $ 2.85 | $ 0.65 |

| Earnings per common share assuming dilution | 1997 | 1996 |
|---|---|---|
| Income for the year before U.S. GAAP accounting change | $ 2.47 | $ 3.05 |
| Cumulative effect of U.S. GAAP accounting change | – | (2.40) |
| Income for the year | $ 2.47 | $ 0.65 |

8) Under Canadian GAAP, short-term investments with maturities less than one year are included in cash and short-term investments. Under U.S. GAAP short-term investments with maturities greater than three months are recorded as short term investments and as a result the statement of changes in cash position would be adjusted to reflect cash provided by investing activities of $8 (1996 $347).

9) Under Canadian GAAP, portfolio investments are accounted for using the cost method. Under U.S. GAAP portfolio investments classified as available-for-sale securities are carried at market values with unrealized gains or losses reflected as a component of shareholders' equity.

# Ten Year Comparative Review

| | 1997 | 1996 | 1995 | 1994 | 1993 | 1992 | 1991 | 1990 | 1989 | 1988 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Financial Data – consolidated** ($ millions) | | | | | | | | | | |
| **Operating revenues:** | | | | | | | | | | |
| Passenger | 4,533 | 3,980 | 3,581 | 3,172 | 2,849 | 2,813 | 2,815 | 3,103 | 2,884 | 2,602 |
| Cargo | 387 | 347 | 323 | 334 | 335 | 342 | 354 | 413 | 398 | 503 |
| Other | 652 | 553 | 603 | 518 | 414 | 346 | 316 | 383 | 336 | 299 |
| | 5,572 | 4,880 | 4,507 | 4,024 | 3,598 | 3,501 | 3,485 | 3,899 | 3,618 | 3,404 |
| **Operating expenses:** | | | | | | | | | | |
| Salaries, wages and benefits | 1,389 | 1,331 | 1,252 | 1,167 | 1,122 | 1,188 | 1,199 | 1,230 | 1,131 | 1,096 |
| Aircraft fuel (1) | 712 | 640 | 527 | 474 | 397 | 472 | 515 | 637 | 539 | 494 |
| Depreciation, amortization and obsolescence | 258 | 258 | 216 | 206 | 219 | 206 | 190 | 170 | 150 | 148 |
| Aircraft rent | 383 | 319 | 292 | 230 | 214 | 164 | 156 | 136 | 120 | 63 |
| Other | 2,462 | 2,117 | 1,945 | 1,703 | 1,569 | 1,616 | 1,589 | 1,676 | 1,559 | 1,499 |
| | 5,204 | 4,665 | 4,232 | 3,780 | 3,521 | 3,646 | 3,649 | 3,849 | 3,499 | 3,300 |
| **Operating income (loss) before the undernoted item** | 368 | 215 | 275 | 244 | 77 | (145) | (164) | 50 | 119 | 104 |
| **Staff reduction and retirement costs** | – | – | – | – | (76) | (52) | (36) | (61) | (16) | (6) |
| **Operating income (loss)** | 368 | 215 | 275 | 244 | 1 | (197) | (200) | (11) | 103 | 98 |
| **Non-operating income (expense):** | | | | | | | | | | |
| Net interest expense | (134) | (157) | (201) | (185) | (191) | (190) | (126) | (49) | (52) | (87) |
| Amortization of deferred foreign exchange | (20) | (46) | (69) | (67) | (34) | (17) | (5) | (6) | (3) | (7) |
| Gain on sale of investments | 201 | 129 | 57 | 66 | – | – | – | 7 | 193 | 15 |
| Provision for investments and writedown of goodwill | – | – | – | – | (111) | (15) | (17) | (11) | (57) | – |
| Gain (loss) on sale of other assets | 35 | 4 | 17 | 67 | 33 | (29) | (5) | 15 | 27 | 64 |
| Other | 16 | 8 | 3 | 32 | (14) | – | (1) | 12 | 27 | 32 |
| **Total non-operating income (expense)** | 98 | (62) | (193) | (87) | (317) | (251) | (154) | (32) | 135 | 17 |
| **Income (loss) before income taxes and minority interest** | 466 | 153 | 82 | 157 | (316) | (448) | (354) | (43) | 238 | 115 |
| **(Provision for) recovery of income taxes** | (39) | (4) | (20) | (25) | (9) | (4) | 142 | 18 | (85) | (29) |
| **Minority interest** | – | – | – | (3) | (1) | (2) | 1 | (1) | – | 1 |
| **Income (loss) from continuing operations** | 427 | 149 | 62 | 129 | (326) | (454) | (211) | (26) | 153 | 87 |
| **enRoute Card discontinued operations** | – | – | – | – | – | – | (7) | (48) | (4) | 2 |
| **Income (loss) for the year** | 427 | 149 | 62 | 129 | (326) | (454) | (218) | (74) | 149 | 89 |
| **Cash provided by (used for):** | | | | | | | | | | |
| Operating | 366 | 64 | 59 | 44 | (34) | (243) | (221) | 60 | 149 | 6 |
| Financing | (266) | (218) | 380 | (359) | 335 | 246 | 742 | 402 | 427 | 133 |
| Investing | 95 | (166) | (263) | 69 | 126 | 287 | (829) | (583) | (375) | (6) |
| **Increase (decrease) in cash position** | 195 | (320) | 176 | (246) | 427 | 290 | (308) | (121) | 201 | 133 |
| **Cash position, end of year** | 650 | 455 | 775 | 599 | 845 | 418 | 128 | 436 | 557 | 356 |
| Operating margin before provision for staff reduction and retirement costs | 6.6% | 4.4% | 6.1% | 6.1% | 2.1% | (4.1)% | (4.7)% | 1.3% | 3.3% | 3.1% |
| EBITDAR (2) | 1,009 | 792 | 783 | 680 | 510 | 225 | 182 | 356 | 389 | 315 |
| EBITDAR margin | 18.1% | 16.2% | 17.4% | 16.9% | 14.2% | 6.4% | 5.2% | 9.1% | 10.8% | 9.3% |
| Current ratio | 1.22 | 0.95 | 0.91 | 1.34 | 1.36 | 1.09 | 1.15 | 1.47 | 1.79 | 1.56 |
| Total assets | 5,991 | 5,441 | 5,397 | 4,997 | 5,039 | 4,810 | 4,921 | 4,579 | 4,121 | 3,437 |
| Long-term debt (including current portion) | 1,879 | 2,142 | 2,421 | 2,464 | 2,640 | 2,492 | 2,183 | 1,384 | 973 | 1,100 |
| Subordinated perpetual debt | 931 | 931 | 931 | 931 | 931 | 883 | 834 | 834 | 834 | 336 |
| Shareholders' equity | 1,435 | 985 | 833 | 365 | 230 | 316 | 770 | 988 | 1,062 | 913 |
| Debt (excluding perpetual debt) to debt plus equity | 44% | 53% | 58% | 66% | 69% | 68% | 58% | 43% | 34% | 47% |
| Earnings (loss) per share (3) | $ 2.37 | $ 0.82 | $ 0.36 | $ 0.97 | $ (4.23) | $ (6.13) | $ (2.94) | $ (1.01) | $ 1.99 | $ 1.64 |
| Cash flow from operations per share (3) | $ 2.04 | $ 0.41 | $ 0.41 | $ 0.37 | $ (0.44) | $ (3.28) | $ (2.99) | $ 0.80 | $ 1.99 | $ 0.12 |
| Book value per share | $ 9.15 | $ 6.33 | $ 5.37 | $ 3.08 | $ 1.96 | $ 4.27 | $ 10.40 | $ 13.35 | $ 14.55 | $ 12.70 |
| Average common shares outstanding (millions) (3) | 189.1 | 189.1 | 168.7 | 143.5 | 80.7 | 75.9 | 75.1 | 74.9 | 74.8 | 48.5 |
| Return on equity | 35.7% | 16.9% | 10.1% | 46.7% | (237.6)% | (86.2)% | (25.0)% | (7.0)% | 15.4% | 13.5% |

(1) Includes a fuel excise tax rebate in 1993 of $46 million (consolidated) and a repayment of fuel excise tax rebate in 1997 of $43 million.

(2) Earnings (operating income) before interest, taxes, depreciation, amortization and aircraft rent.

(3) Fully diluted.

| Ten Year Comparative Review (cont'd) | 1997 | 1996 | 1995 | 1994 | 1993 | 1992 | 1991 | 1990 | 1989 | 1988 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Operating statistics – not consolidated** | | | | | | | | | | |
| **Passenger – scheduled and charter:** | | | | | | | | | | |
| Revenue passengers carried (millions) (1) | **14.0** | 13.0 | 10.8 | 9.9 | 9.5 | 9.9 | 9.9 | 11.8 | 12.0 | 11.9 |
| Revenue passenger miles (millions) (1) | **22,788** | 20,596 | 16,747 | 14,995 | 13,768 | 14,391 | 13,658 | 16,577 | 16,278 | 15,553 |
| Available seat miles (millions) | **32,061** | 29,431 | 26,578 | 23,730 | 21,157 | 21,628 | 19,953 | 23,233 | 23,348 | 21,778 |
| Passenger load factor (1) | **71.1%** | 70.0% | 63.0% | 63.2% | 65.1% | 66.5% | 68.4% | 71.4% | 69.7% | 71.4% |
| Yield per revenue passenger mile (cents) (1) | **17.5** | 16.4 | 18.0 | 17.7 | 17.1 | 16.3 | 17.3 | 16.7 | 16.3 | 15.7 |
| Yield per available seat mile (cents) | **12.5** | 11.5 | 11.4 | 11.2 | 11.1 | 10.8 | 11.9 | 11.9 | 11.4 | 11.2 |
| **Cargo – scheduled and charter:** | | | | | | | | | | |
| Revenue ton miles (millions) | **895** | 783 | 707 | 633 | 586 | 532 | 549 | 645 | 595 | 605 |
| Yield per revenue ton mile (cents) | **41.1** | 41.6 | 43.3 | 43.5 | 47.6 | 53.1 | 53.1 | 53.2 | 53.5 | 56.6 |
| **All operations:** | | | | | | | | | | |
| Operating expense per available seat mile (cents) (2) | **14.2** | 13.4 | 13.4 | 13.2 | 13.8 | 14.2 | 15.6 | 14.8 | 13.4 | 13.3 |
| Operating expense (net of non-ASM producing revenue) per available seat mile (cents) (2)(3) | **11.4** | 10.8 | 10.5 | 10.5 | 11.1 | 11.7 | 12.9 | 12.1 | 10.9 | 10.7 |
| Average number of employees (thousands) | **21.2** | 19.9 | 19.6 | 18.4 | 18.2 | 19.4 | 20.6 | 23.1 | 23.2 | 22.6 |
| Available seat miles per employee (thousands) | **1,516** | 1,481 | 1,359 | 1,288 | 1,166 | 1,112 | 969 | 1,005 | 1,005 | 962 |
| Revenue per employee ($ thousands) | **232** | 209 | 194 | 178 | 161 | 148 | 141 | 148 | 139 | 134 |
| Average aircraft utilization (hours per day) (4) | **10.4** | 10.7 | 10.6 | 10.3 | 9.6 | 9.6 | 9.8 | 9.5 | 9.3 | 9.7 |
| Average aircraft flight length (miles) | **944** | 957 | 958 | 946 | 907 | 925 | 898 | 900 | 850 | 814 |
| Fuel price per litre (cents) | **26.8** | 26.3 | 23.5 | 23.8 | 24.4 | 24.6 | 26.6 | 28.9 | 24.3 | 23.6 |
| Fuel litres (millions) | **2,235** | 2,080 | 1,910 | 1,707 | 1,529 | 1,609 | 1,627 | 1,965 | 1,991 | 1,905 |
| **Operating statistics – consolidated** | | | | | | | | | | |
| Revenue passenger miles (millions) (1) | **23,896** | 21,894 | 17,905 | 16,143 | 14,820 | 15,519 | 14,642 | 17,271 | 16,868 | 15,938 |
| Available seat miles (millions) | **34,117** | 31,988 | 28,968 | 25,991 | 23,341 | 23,886 | 22,031 | 24,630 | 24,562 | 22,525 |
| Passenger load factor (1) | **70.0%** | 68.4% | 61.8% | 62.1% | 63.5% | 65.0% | 66.5% | 70.1% | 68.7% | 70.8% |
| Yield per revenue passenger mile (cents) (1) | **18.9** | 18.1 | 20.0 | 19.6 | 19.2 | 18.1 | 19.2 | 18.0 | 17.1 | 16.3 |

## Quarterly Financial and Operating Data

(unaudited)

| | 1997 | | | | | 1996 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Year | Q4 | Q3 | Q2 | Q1 | Year | Q4 | Q3 | Q2 | Q1 |
| **Financial data – consolidated ($ millions)** | | | | | | | | | | |
| Operating revenues | **5,572** | 1,396 | 1,623 | 1,415 | 1,138 | 4,880 | 1,205 | 1,391 | 1,212 | 1,072 |
| Operating income (loss) | **368** | 16 | 284 | 135 | (67) | 215 | 10 | 208 | 37 | (40) |
| Income (loss) for the period | **427** | 94 | 181 | 71 | 81 | 149 | (18) | 149 | 110 | (92) |
| Cash flow from operations | **366** | (2) | 318 | 66 | (16) | 64 | (151) | 152 | 130 | (67) |
| **Operating statistics – not consolidated** | | | | | | | | | | |
| Revenue passenger miles (millions) (1) | **22,788** | 5,132 | 7,127 | 5,701 | 4,828 | 20,596 | 4,638 | 6,346 | 5,184 | 4,428 |
| Domestic | **7,739** | 1,878 | 2,269 | 1,971 | 1,621 | 7,299 | 1,700 | 2,142 | 1,879 | 1,578 |
| International | **15,049** | 3,254 | 4,858 | 3,730 | 3,207 | 13,297 | 2,938 | 4,204 | 3,305 | 2,850 |
| Available seat miles (millions) | **32,061** | 7,801 | 9,453 | 7,822 | 6,985 | 29,431 | 7,053 | 8,409 | 7,345 | 6,624 |
| Domestic | **10,760** | 2,712 | 2,979 | 2,638 | 2,431 | 10,309 | 2,531 | 2,920 | 2,559 | 2,299 |
| International | **21,301** | 5,089 | 6,474 | 5,184 | 4,554 | 19,122 | 4,522 | 5,489 | 4,786 | 4,325 |
| Passenger load factor (1) | **71.1%** | 65.8% | 75.4% | 72.9% | 69.1% | 70.0% | 65.8% | 75.5% | 70.6% | 66.9% |
| Domestic | **71.9%** | 69.3% | 76.2% | 74.7% | 66.7% | 70.8% | 67.2% | 73.3% | 73.4% | 68.6% |
| International | **70.6%** | 63.9% | 75.0% | 72.0% | 70.4% | 69.5% | 65.0% | 76.6% | 69.1% | 65.9% |
| Yield per revenue passenger mile (cents) (1) | **17.5** | 19.0 | 16.9 | 17.6 | 16.8 | 16.4 | 17.6 | 15.9 | 16.2 | 16.1 |

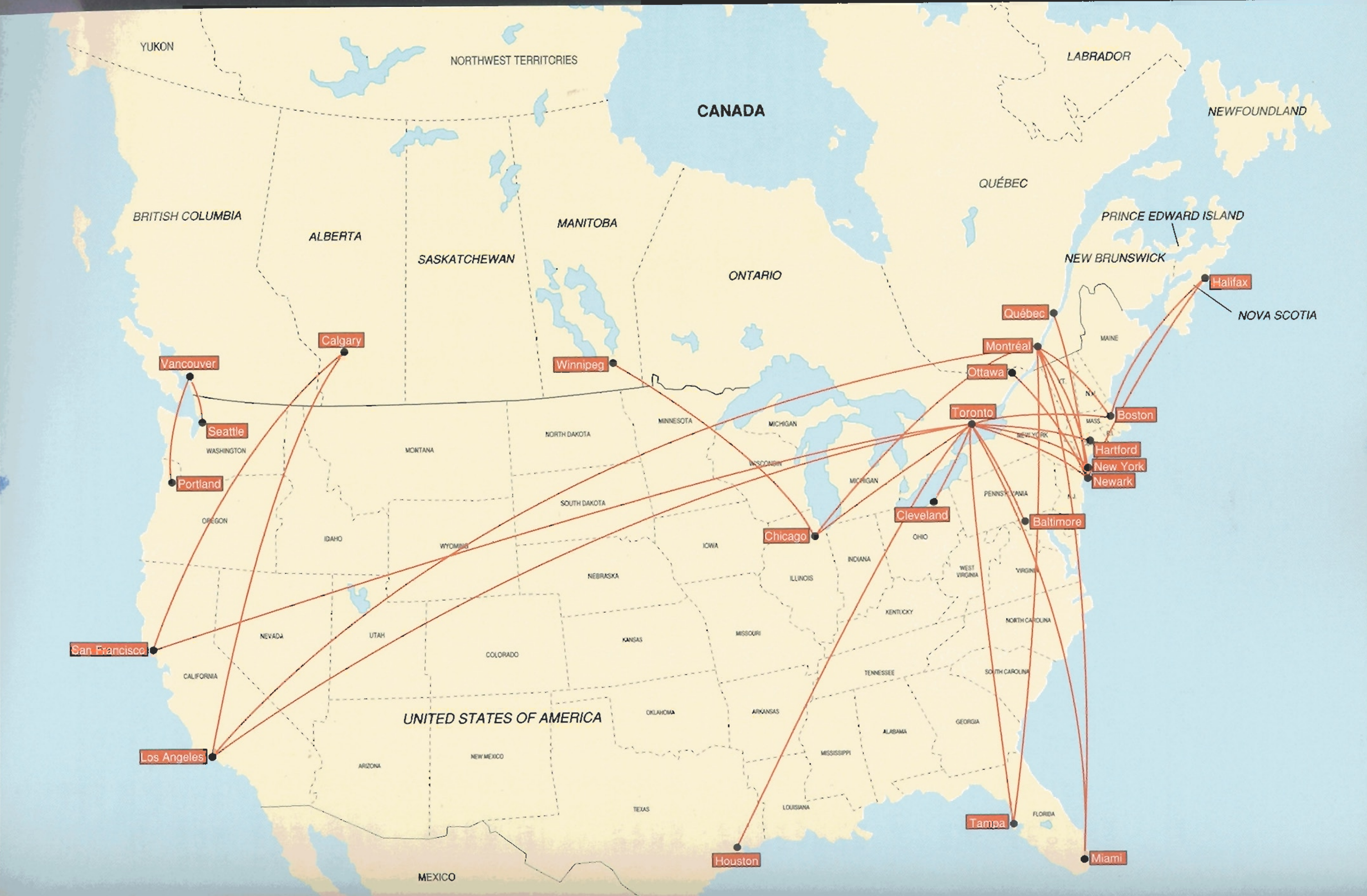
(1) Includes frequent flyer redemptions for 1997 and 1996 (restated).

(2) Includes a fuel excise tax rebate in 1993 of $45 million (not consolidated) and a repayment of fuel excise tax rebate in 1997 of $43 million.

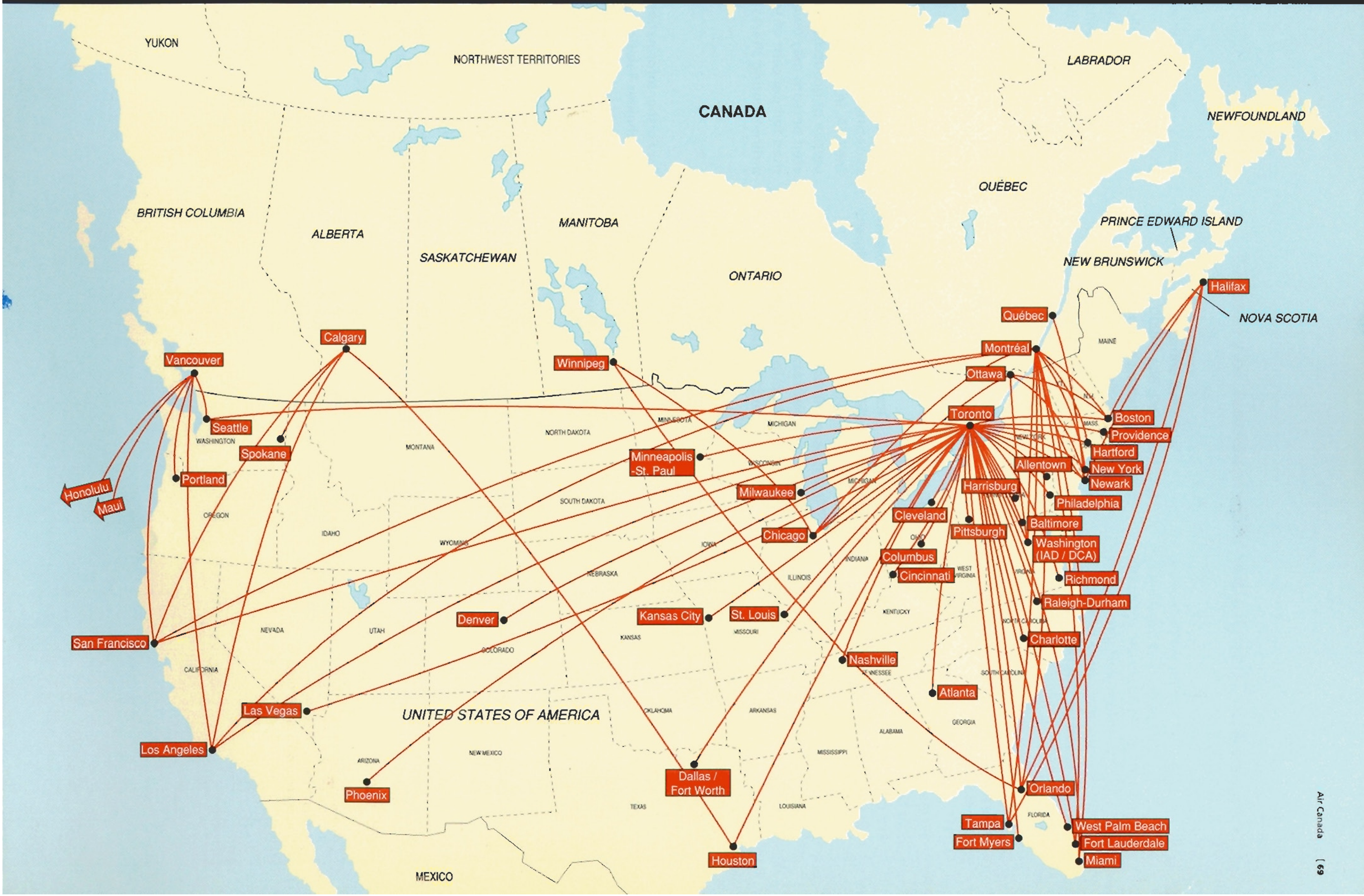
(3) Represents the net cost of the passenger transportation business, after deducting the revenue impact of non-ASM producing businesses (cargo and other revenues).

(4) Excludes maintenance down-time.

## Air Canada Transborder Routes Prior to Open Skies February 24, 1995



## **Air Canada Transborder Routes** year end 1997



# Investor and Shareholder Information

### Price Range and Trading Volume of Air Canada Common Shares

| 1997 | High | Low | Volume |
|---|---|---|---|
| 1st Quarter | $ 8.45 | $ 6.05 | 61,260,796 |
| 2nd Quarter | $10.10 | $ 6.65 | 41,057,943 |
| 3rd Quarter | $13.65 | $ 9.25 | 69,437,754 |
| 4th Quarter | $15.40 | $11.80 | 78,822,279 |

The above table sets forth the price ranges and combined trading volumes of the common shares of Air Canada on the Montréal, Toronto, Winnipeg, Alberta, and Vancouver Stock Exchanges

### Price Range and Trading Volume of Air Canada Class "A" Shares

| 1997 | High | Low | Volume |
|---|---|---|---|
| 1st Quarter | $ 7.95 | $ 5.35 | 22,641,668 |
| 2nd Quarter | $ 9.40 | $ 6.25 | 14,109,024 |
| 3rd Quarter | $12.60 | $ 8.75 | 44,339,950 |
| 4th Quarter | $14.40 | $11.00 | 42,966,023 |

The above table sets forth the price ranges and combined trading volumes of the Class A Non-Voting shares of Air Canada on the Montréal and Toronto Stock Exchanges

### Price Range and Trading Volume of Air Canada Class "A" Shares on The Nasdaq Stock Market

| 1997 | High | Low | Volume |
|---|---|---|---|
| 1st Quarter | $ 6.00 | $3.81 | 1,193,155 |
| 2nd Quarter | $ 6.81 | $4.44 | 723,692 |
| 3rd Quarter | $ 9.19 | $6.31 | 1,045,815 |
| 4th Quarter | $10.19 | $8.13 | 1,054,132 |

The above table sets forth the price* ranges and combined trading volumes of the Class A Non-Voting shares of Air Canada on The Nasdaq Stock Market.

*Prices are quoted in U.S. Dollars.

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Station Airport
Dorval, Québec
Canada H4Y 1H4
(514) 422-5000

**Stock Exchange Listings**
Montréal, Toronto, Winnipeg, Alberta, Vancouver Stock Exchanges and The Nasdaq Stock Market.

**Transfer Agents and Registrar**
CIBC Mellon Trust Company
(514) 285-3552
1 800 387-0825
Halifax, Montréal, Toronto, Winnipeg, Regina, Calgary and Vancouver.

Chase Mellon Shareholder Services, L.L.C.
New Jersey.

**Duplicate Communication**
Some registered holders of Air Canada shares might receive more than one copy of shareholder information mailings such as this Annual Report. While every effort is made to avoid duplication, if securities are registered in different names and/or addresses, multiple copies are forwarded.

Shareholders receiving more than one copy are requested to write to the Assistant Secretary and Shareholder Relations Director.

**Restraints on Air Canada Shares**
The Air Canada Public Participation Act and Air Canada's Articles of Continuance limit ownership of the airline's voting shares by all non-residents of Canada to a maximum of 25 per cent. The Canada Transportation Act, (CTA) requires inter alia that at least 75 per cent of the voting shares of Air Canada be owned or controlled by Canadians, as defined in section 55 of the CTA. In addition, no person or group of associated persons may own more than ten per cent of the airline's voting shares.

**For Further Information**
**Shareholder Relations**
Assistant Secretary and Shareholder Relations Director
Telephone: (514) 422-5787
Canada/USA
1 800 282-SHARE
Faxcom: (514) 422-5789

**Investor Relations**
Manager,
Investor Relations
Telephone: (514) 422-5724
Faxcom: (514) 422-5739

Air Canada complies with the guidelines adopted by the Toronto Stock Exchange. A report on governance matters is included in the February 18, 1998 Management Proxy Circular.

# Glossary of Terms

**Operating Margin**
Operating income (loss) as a percentage of total operating revenues.

**Current Ratio**
Current assets divided by current liabilities.

**Return on Equity**
The rate of return on average convertible debentures and shareholders' equity.

**Revenue Passenger Miles**
Total number of revenue passengers carried multiplied by the miles they are carried.

**Available Seat Miles**
A measure of passenger capacity calculated by multiplying the total number of seats available for revenue traffic by the miles flown.

**Passenger Load Factor**
A measure of passenger capacity utilization derived by expressing revenue passenger miles as a percentage of available seat miles.

**Revenue Ton Miles**
Total number of cargo tons carried multiplied by the miles they are carried.

**Yield**
Average revenue per revenue passenger mile or revenue ton mile.

# Board of Directors

4 3

12 9 5

6 10 1 7

13 8 11 2

1 **Hon. W. David Angus, Q.C.**
Partner
Stikeman, Elliott
Montréal, Québec

2 **J.V. Raymond Cyr, O.C.**
Chairman of the Board
Telesat Canada, Vistar Telecommunications Inc. and SSIG Group Inc.
Montréal, Québec

3 **R. Lamar Durrett**
President and Chief Executive Officer
Air Canada
Montréal, Québec

4 **John F. Fraser, O.C.**
Chairman of the Board
Air Canada
Winnipeg, Manitoba

5 **David A. Ganong**
President
Ganong Bros. Limited
St. Stephen, New Brunswick

6 **William James**
President and Chief Executive Officer
Inmet Mining Corporation
Toronto, Ontario

7 **Fernand Lalonde, Q.C.**
Counsel
Leduc Leblanc
Westmount, Québec

8 **Hon. Edward C. Lumley, P.C.**
Vice Chairman
Nesbitt Burns Inc.
South Lancaster, Ontario

9 **Gordon F. MacFarlane**
Director
BC TELECOM Inc.
Surrey, British Columbia

10 **David E. Mitchell, O.C.**
Chairman of the Board
Alberta Energy Company Ltd.
Calgary, Alberta

11 **Paul D. Mitchell**
President and Chief Executive Officer
McNeil Consumer Products Company
Waterloo, Ontario

12 **Claude I. Taylor, O.C.**
Chairman Emeritus
Air Canada
Montréal, Québec

13 **Louise Brais Vaillancourt, C.M.**
Corporate Director
Outremont, Québec

# Officers of the Company

3 2 1

9 8 7 10

4 6 5

12 11 17 13

16 15 18 14

1 **R. Lamar Durrett**
President and Chief Executive Officer

2 **Jean-Jacques Bourgeault**
Senior Executive Vice President

3 **Robert A. Milton**
Executive Vice President and Chief Operating Officer

4 **Geoffrey Elliot**
Senior Vice President, Corporate Affairs and Government Relations

5 **M. Robert Peterson**
Senior Vice President, Finance and Chief Financial Officer

6 **Douglas D. Port**
Senior Vice President, Europe

7 **John M. Baker**
Vice President and General Counsel

8 **Paul E. Brotto**
Vice President, Finance and Treasurer

9 **Rupert Duchesne**
Vice President, Marketing

10 **Lise Fournel**
Vice President, Information Technology and Chief Information Officer

11 **Paul R. Garratt**
Vice President, Human Resources

12 **Paul Létourneau, Q.C.**
Secretary of the Company

13 **G. Ross MacCormack**
Vice President, Corporate Strategy

14 **B. Wayne MacLellan**
Vice President, Flight Operations

15 **Eileen McCoy**
Vice President, Customer Service

16 **Marc Rosenberg**
Vice President, Sales and Product Distribution

17 **H. Alan Thompson**
President and Chief Executive Officer – AirBC

18 **Robin Wohnsigl**
Vice President, Technical Operations

Note:
Chris W. Nassenstein, Vice President, Technical Operations, left the company to pursue other business interests.

Ce rapport annuel est publié dans les deux langues officielles du Canada. Pour en recevoir un exemplaire en français, écrire à la Secrétaire adjointe et Directrice – Relations avec les actionnaires.

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