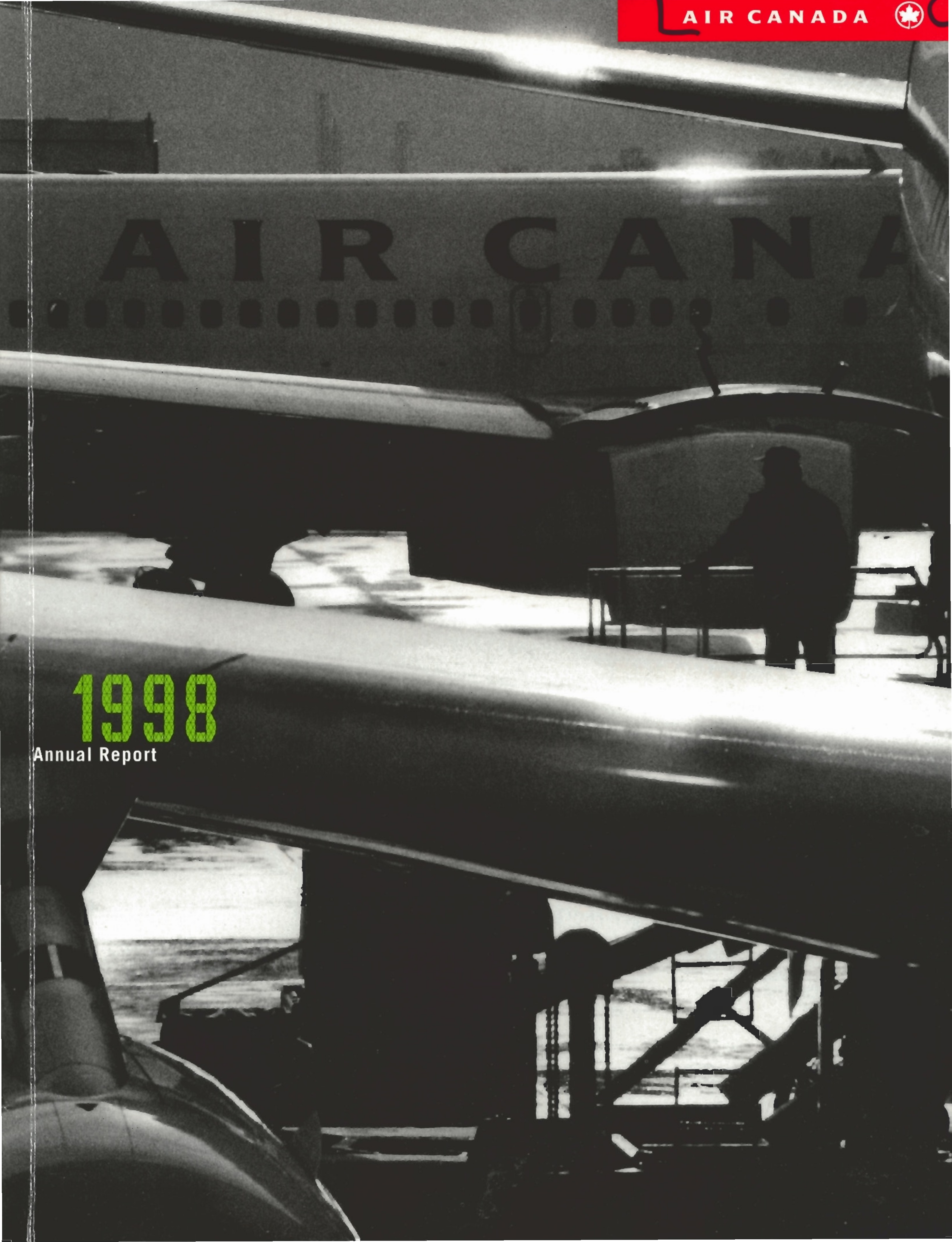
AIR CANADA
AIR CANA
1998
Annual Report

Toronto at dawn:
Sending an A340 on its way

At Air Canada, we are in the business of removing obstacles for our customers – like distance and time zones and gaps that divide families, cultures and ideas. It's our mission 24 hours a day, every day. Who should know better than we that time stands still for no one? Yesterday's good ideas can become tomorrow's obstacles if one doesn't recognize the need for change. Last year's disappointing financial results demonstrated that Air Canada's business plan must be reengineered to accommodate a global economy that has changed dramatically in a very short period. We are reassessing our strategy and reviewing every aspect of our operations with the goal of achieving future operating margins on par with the best in our industry. We will make whatever changes are necessary to ensure that Air Canada achieves the kind of profitability shareholders have a right to expect.

R. Lamar Durrett
President and Chief Executive Officer

Year at a Glance

Financial (Millions except per share figures)		1998		1997	Change
Operating revenues	$	5,932	$	5,572	6%
Operating expenses	$	5,788	$	5,204	11%
Operating income	$	144	$	368	
Income (loss) for the year	$	(16)	$	427	
Operating margin		2%		7%	
Cash flow from operations	$	296	$	366	
Cash and short-term investments	$	366	$	650	
Average common shares outstanding (fully diluted)*		190.3		189.1	
Income (loss) for the year per common share (fully diluted)*	$	(0.10)	$	2.37	
Cash flow from operations per common share (fully diluted)*	$	1.59	$	2.04	
Return on equity		(1)%		36%	
Common share, closing price (Toronto Stock Exchange)	$	6.15	$	14.75	

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

Operating Statistics (Scheduled and Charter – not consolidated)	1998	1997	Change
Revenue passenger miles (millions)*	23,211	22,788	2%
Available seat miles (millions)	32,719	32,061	2%
Passenger load factor*	70.9%	71.1%	(0.2) pts.
Yield per revenue passenger mile (cents)*	18.8	17.5	7%
Average number of employees	22,837	21,215	8%

*Includes frequent flyer redemptions.

Shareholder Base

Air Canada's shareholder base is comprised of the following: approximately, 80 percent, Institutional; 16 percent, Retail; and four percent, Employees. Eighty eight percent of the voting shares are held by Canadian residents and 12 percent by non-residents (as defined in the Air Canada Public Participation Act and Air Canada's Articles of Continuance).

The Annual General Meeting of Shareholders of Air Canada will be held at 9:30 a.m. on Wednesday, May 5, 1999 at The Palliser (Crystal Ballroom), 133-9th Avenue SW., Calgary, Alberta.

A Year of Honors

Round the clock, around the world, the Air Canada product and the commitment of our employees to delivering excellent customer service are winning the esteem of more and more discerning travellers wherever we fly. It's those customers, in surveys rating the best airlines of 1998, who helped Air Canada win this unprecedented list of honors.

- World's Best Passenger Service Airline – Air Transport World
- Bronze Medal – Airline of the Year – OAG Worldwide
- Gold Medal – Best Domestic Long Haul Airline, North America, OAG Worldwide
- Gold Medal – Best Domestic Short Haul Airline, North America, OAG Worldwide
- Best Airline for Travel to Canada – Business Traveler International

Corporate Profile

Air Canada is a Canadian-based international air carrier providing scheduled and charter air transportation for passengers and for cargo. The Corporation is Canada's largest air carrier and serves, together with its Regional Airlines, 116 destinations directly with a combined fleet of over 230 aircraft. The Corporation operates its own scheduled service to 50 cities in Canada and serves an additional 29 Canadian communities through commercial arrangements with other affiliated regional carriers. Internationally, Air Canada operates its own scheduled service to 41 cities in the United States and 22 cities in Europe, Asia, the Middle East and the Caribbean. Charter passenger services are also provided to three 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 operates an extensive global network in conjunction with its international airline partners. Its major strategic alliance partners under Star Alliance are United Airlines, Lufthansa, Scandinavian Airlines System (SAS), Thai Airways, Brazil's airline VARIG and, effective later in 1999, Air New Zealand, Ansett Australia and All Nippon Airways. Joint marketing, codeshare or commercial agreements are also in place with four other international airlines. With its strategic alliance and commercial partnerships currently in effect, the Corporation offers scheduled and charter air transportation to over 640 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 and other services are also offered. The Corporation holds 100 percent interests, directly or indirectly, in four Canadian regional airlines, AirBC Limited, Air Ontario Inc., Air Alliance Inc. and Air Nova Inc. (collectively, the "Regional Airlines"); and in *Air Canada Vacations* (Touram Inc.), a major Canadian tour operator.

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Round the clock, around the world

At every public company, the board of directors represents the shareholders. But not all shareholders have the same goals. Mutual funds and pension funds with half a million shares of a particular company may expect a faster return than an individual holding a few hundred shares in a self-directed retirement account. Unlike the individual, the institutional investor is ranked quarterly for the performance of its portfolio, and will trade a portion of it quarterly or annually according to the fund manager's strategy. Even so, it's a good rule of thumb that if Air Canada consistently rewards the individual shareholder in for the long haul, we are probably doing well by all shareholders. If not, it's time to adjust the strategy.

Last year, we didn't reward that individual investor, so a course change is indicated. Your board of directors is strongly supportive of the program formulated by president Lamar Durrett and his team to bring about balanced change to lift the airline to a higher level of profitability.

I say balanced change because in a service industry, change always will be a balancing of short- and long-term goals.

Chairman's report to shareholders

Too much focus on boosting the next few quarters' earnings might lessen an award-winning product. Frequent travellers voted Air Canada the bronze medal in the prestigious 1999 world airline of the year competition conducted by travel information publisher OAG Worldwide. OAG readers also awarded us gold medals for best domestic long-haul and short-haul North American airline, and silver for best North American business class. And *Air Transport World* named Air Canada the world's best passenger service airline. That's quite a testament to our product and people.

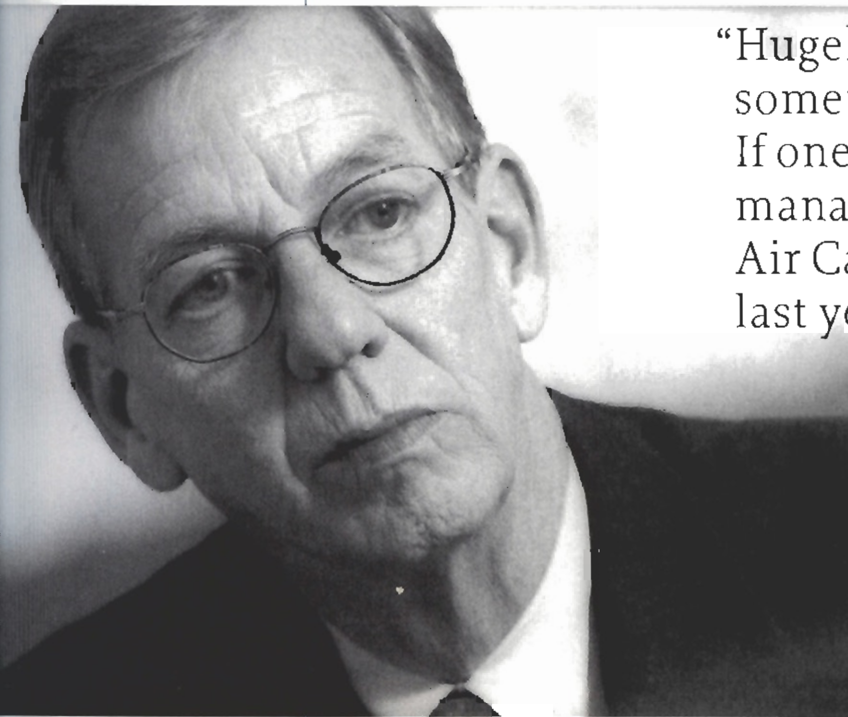
On the other hand, too much focus on the long term to the exclusion of generating respectable earnings today can make one too accepting of fiscal mediocrity.

That's why management's current drive to achieve a higher level of sustained profitability will focus on both short- and long-term improvement, restoring profitability in 1999 and introducing major cost-saving and revenue-generating initiatives to improve the airline's underlying earnings generation capability. It's the board's view that this approach, which builds on the airline's domestic leadership and enormous brand strength, will make Air Canada a better, stronger, and more profitable franchise to own.

As we pursue this goal, I would like to thank two retiring directors, David E. Mitchell and Louise Brais Vaillancourt, C.M., for their dedication and support over the past 10 years to the cause of building a great airline for the 21st century.

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

Report from the President and Chief Executive Officer



"Hugely disappointing – not something we plan to repeat." If one statement could summarize management's reaction to Air Canada's $16 million loss last year, that would be it.

The loss ended a four year string of net profits. From a high of $14.95 in January, our share price plummeted to $6.15 at year-end. That's obviously unacceptable. So a great deal of energy is being invested in reengineering Air Canada to produce the kind of higher operating profit margins which the major US carriers are known for – about 10 percent in 1998. Twelve initiatives have been identified to help us generate the incremental profit needed to accomplish that.

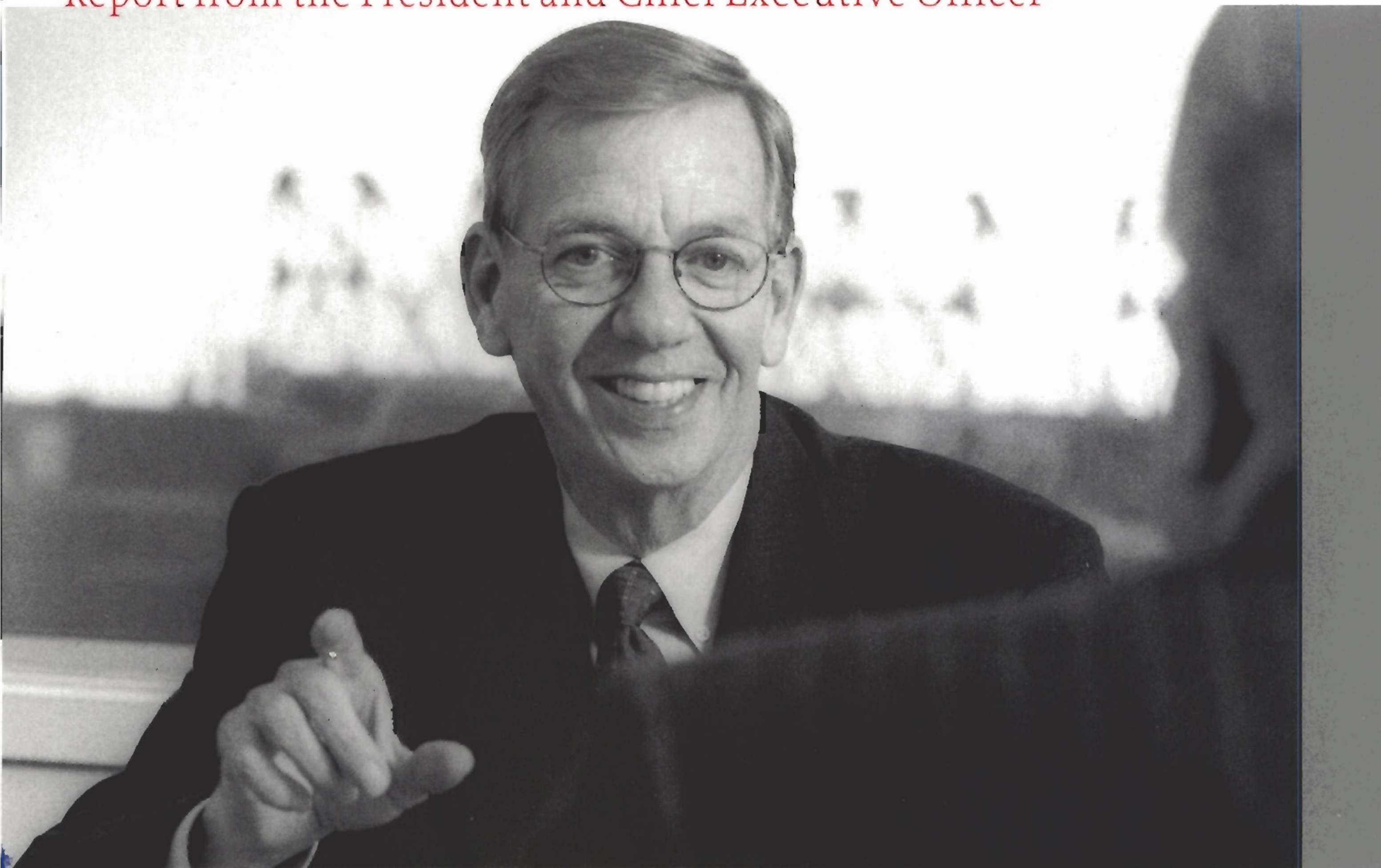
In today's uncertain global economy, spending our way to prosperity is not an option. Last year, our costs rose faster than our revenues, a function of the North American economy slowing at a time Air Canada was still in growth mode. That trend will be reversed in 1999, and decisively, by taking a hard line on controlling costs and by enhancing the revenue generating capability of current operations.

The pilots' strike, which grounded Air Canada for 13 days in September, was the year's most obvious setback, but not the cause of this reengineering. The strike had a $250 million negative impact on operating earnings. However, given the way 1998 unfolded, with travel demand leveling off, it's fair to say that even without a strike the Corporation would have made a smaller profit than planned.

The strike did mark the end of Air Canada's five year expansion. This unprecedented growth strategy increased the size of the airline by half and improved our profit generating capability. But persisting with it amid signs of a global economic slowdown would have made things worse in 1999.

At the best of times, the Canadian air travel market is a challenging place to make money, as demonstrated by the number of failed airline ventures in this decade. And these are not the best of times. The Asian recession and worldwide commodity slump have depressed the Canadian dollar and caused an economic slowdown on Canada's West Coast.

Report from the President and Chief Executive Officer



Over the first four years of expansion, 1994-97, revenues grew faster than costs. At the start of 1998, we added aircraft and staff for yet more expansion. In hindsight, that was overly optimistic. As the year progressed, the market softened. Revenue growth began to level off, but the acceleration of costs did not, partly because of this last capacity increase, but also because of a weakening Canadian dollar and domestic infrastructure costs. Soaring Canadian airport and air navigation fees are a problem all carriers are struggling with. While we endeavored to compensate by taking out some capacity and cost, earnings still suffered. Excluding the impact of the strike and other significant, non-recurring items, operating revenues rose 9.7 percent to $6.2 billion and expenses 11.1 percent to $5.8 billion.

The next section of this report outlines some of the strategies planned or already in place to improve profitability. Some are on-going programs about to produce greater returns. Others represent significant departures from how we have been doing business.

Amid the current global economic uncertainty, grounding some of our older aircraft is the fastest way to pull out cost. It's also the prudent and responsible course. Since the pilots' strike, all six Boeing 747 Classics have been retired. By June, nine of our 25 DC-9s will be out of the fleet. That will be partly offset by adding five new Airbus A340/330s in 1999. Through the course of this year, that will result in a 1.4 percent reduction in capacity, and a 2.2 percent reduction in staff to just over 22,800. The Western Canada regional network, which has sustained significant losses since being expanded in 1995, will surrender some capacity to stronger markets.

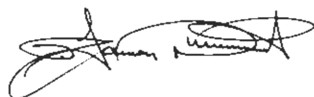
Adding to the sense of urgency about costs is the runaway growth of airport and air navigation fees. That has become an enormous burden on airlines with serious national policy implications. Since 1997, the fees levied by Canada's newly privatized airports and air navigation system have more than doubled without a commensurate improvement in services. In 1999, this airline faces over $120 million in additional fees, representing over 40 percent of the 1999 budgeted increase in Air Canada's total operating expenses. That's on top of $132 million in new fees levied on us in 1998. In some cases, Canadian airport fees already exceed those of major US airports. The ability of airports like Toronto to compete for North American gateway status with nearby US airports depends on having competitive charges. We also urge NAV CANADA to seize the opportunity to create the world leading air traffic control system Canada deserves.

Even with all the uncertainty surrounding the economy, I'm quite optimistic about 1999. Fuel prices and interest rates remain low. Proposed United States in transit status to be conferred upon major airports like Toronto and Montreal will give Air Canada added leverage to attract business from the massive US intercontinental market.

Our franchise is strong. Air Canada represents about 60 percent of the scheduled domestic travel market, and has by far the largest presence of any airline in the transborder market. In the aftermath of the pilots' strike, our market share surpassed pre-strike levels, a testament to our post-strike strategy. In December, the domestic load factor was 71.2 percent, up 5.9 points from December 1997. Our share of premium business travel has never been higher.

Compared with many of our domestic competitors, Air Canada came out of 1998 ready for almost any economic scenario. With capacity now aligned to demand, and almost $1 billion in cash and credit available, we have the wherewithal to withstand a recession. Our fleet renewal is nearly complete; the bulk of that capital outlay is behind us.

Air Canada belongs to the world's strongest airline alliance. Our Star Alliance revenues almost doubled last year to over $250 million, and should exceed $500 million by 2001. Our relationship with Star partner United Airlines has evolved into one of the most extensive in the industry. Above all, the appeal of the Air Canada brand has never been greater. That strength, along with the can-do spirit of our employees and the award-winning product they deliver, will help ensure this airline is not only a market leader, but also a solid investment for your portfolio.



R. Lamar Durrett
President and Chief Executive Officer

At Air Canada, the job of serving our customers continues round the clock, around the world. Change also is a constant in our world.

After five years of sustained growth, 1998 felt like a cold shower. Investors lost faith in us. Regaining that faith is the bottom line. This is about taking a Step Up! to the next level in our evolution as a publicly traded company.

In 1994, Air Canada was one of the first to recognize the onset of a new growth cycle in air travel. Our good timing was our good fortune. The rewards of the airline's subsequent expansion included four profitable years and invaluable diversification – our first Pacific and Middle East destinations, 44 more transborder routes. No airline took greater advantage of Canada-US Open Skies. However, last year's net loss was a harsh reminder that growth cycles wane and expansion alone won't drive earnings forever. The pilots' strike in September was the final straw.

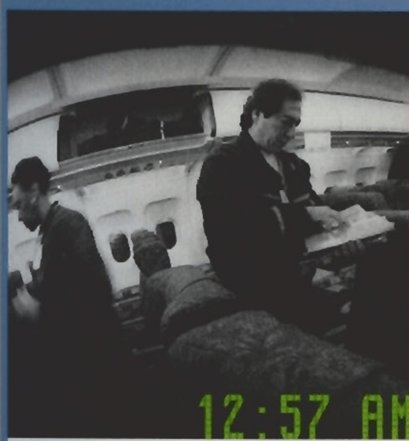
We are adjusting the strategy to make the delivery of our product more cost-effective, generating higher sustainable earnings. The 1999 plan calls for a 1.4 percent capacity reduction and a 2.2 percent reduction in staff to realign capacity to demand. An intensive review has identified operational cost efficiencies that will help generate significant incremental profit.

To use sports terminology, this is our transition game – being first to adjust to slowing market demand. Again, our good timing will be our good fortune. While the North American economy is buoyant, elsewhere the story is no growth or slowing growth. Even in North America, there are storm clouds. Many major US carriers ordered large numbers of aircraft late in the growth cycle, and now face having to add capacity faster than their customer base may be able to absorb it.

However, this drive to make Air Canada more profitable is not just about right-sizing or reengineering. It's about working more productively, about leveraging alliances, partnerships, new technology and a powerful brand.

Inflight checks over the North Atlantic

2:03 AM



Making the cabin shipshape for another day

Checking in for another day's flying

4:45 AM

Monitoring the overnight flights at System Operations Control, Toronto

Adjust the network by building on strengths

When Air Canada was expanding, part of our strategy focussed on fortifying areas of relative weakness. So long as overall profit was growing, we could be patient while these initiatives matured. In today's global economy, that's a luxury, so we're moving some of that capacity to where it can build on our strengths.

Three years ago, the Western regional network was expanded to make Air Canada a bigger regional player in Western Canada. With the Asian slump, the recession in resource industries, and growing discount airline competition, our progress slowed. Some intra-West capacity is being shifted to the transcontinental and transborder (Canada-US) routes systems where it will carry higher yielding traffic. There will be more Rapidair capacity in the Montreal-Ottawa-Toronto triangle, where Canada's economy is strongest. Shrinking intra-West capacity by 13 percent will generate a $16 million annual improvement in operating income. AirBC and partner Central Mountain Air are picking up part of the flying with smaller aircraft.

Again this year, growth of Canada-US travel is going to outstrip growth in our other major market sectors. Air Canada's transborder flying will increase by 1.4 percent, with additional routes, a full year of flying to New Orleans and San Jose and more capacity to Chicago, Washington and Denver, strongholds of Star Alliance partner United Airlines. Average revenue per passenger seat mile on transborder routes rose 10 percent to 28.7 cents last year, while domestic yields rose 4.5 percent to 24.4 cents. Most of Air Canada's newer US destinations have thriving high-tech and biotechnology sectors – pillars of the New Economy of the 21st century. Many of our newer transborder routes are profitable with below average load factors, and can handle substantial growth at hardly any additional cost. And internationally, building on strength means adding capacity to Frankfurt where the growth of our codesharing traffic over Lufthansa's European network has exceeded expectations.

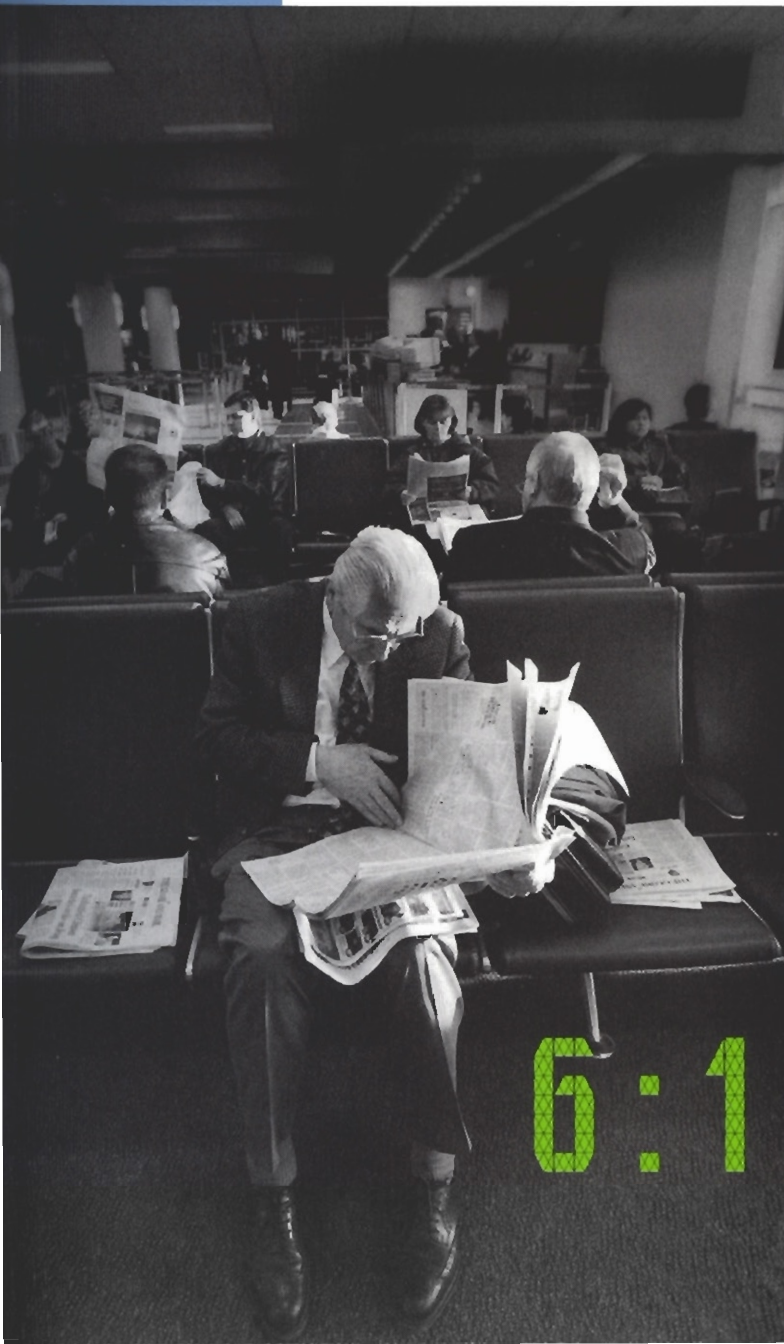
Lower fleet costs by retiring our older aircraft

During the airline's big buildup, the plan always was to use our oldest aircraft as a hedge. Parking them would be a quick and relatively painless way to adjust to a slowing economy. Since September, all six Boeing 747 Classics have been retired and nine more DC-9s are being parked, leaving 15 in service plus a spare. With this rationalization, load factors and operating margins will rise. Not refurbishing all the DC-9s as originally planned will save over $26 million in capital expenditures.

The three 747-100s and three 747-200s were like nothing else in the fleet, with their own pilot groups and spare parts inventories. They were the last aircraft requiring three pilots, rather than two. The 1970s-vintage planes were largely or fully depreciated, and will be missed for what they did best – earn big money in the summer peak. Not missed will be their enormous fuel and maintenance bills, and all the time they spent in the shop. The Classics are being replaced over the next five quarters by a combination of more A340-300s and the airline's first A330-300s. The extended range A330-300 is an ultra-efficient twinjet, virtually identical to the four engine A340s except for the number of engines. Replacing the Classics with A330/340s will produce a $30 million net annual improvement over and above the ownership cost of the new planes. This will come from lower fuel, maintenance, crew and training costs.

The 401-seat 747 Classics were a struggle to fill during the winter. With today's cutthroat price competition to most sun destinations, there aren't many winter routes where the Classics could cover their costs. The 264-seat A340-300s and A330-300s burn 40 percent less fuel and will be much easier to fill on a full-year basis.

The fleet plan for the next two years is deliberately conservative. It calls for operating 15 large widebodies this summer, and no more than 17 through 2001. That's down from 18 last summer. If market conditions warrant, more DC-9s can be parked. The remaining 16 are going to be replaced by 2002, though not necessarily on a one for one basis.



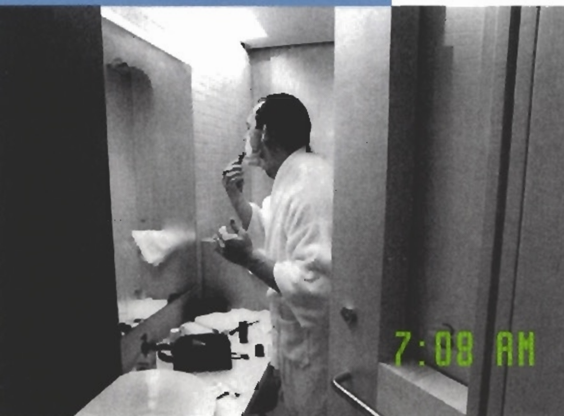
The morning read and rush. Toronto Rapidair Lounge and standby desk

By June, the average age of the fleet will be 8.3 years – young by industry standards. A young fleet can be worked harder. Part of this year's profit enhancement program includes increased fleet utilization. A young fleet also has great appeal to customers, and makes a positive statement to the community. Today's fleet is over 20 percent more fuel efficient on a unit basis than at the start of the decade. By retiring the Classics and DC-9s, aggregate carbon dioxide emissions will fall through 2000, helping Canada meet its global climate change commitments.

Make Air Canada a four-quarter profit-maker

For much of its history, Air Canada had the reputation for making money in the summer months and spending the rest of the year trying not to lose too much. All we could do is shrug: "That's Canada for you. Harsh winters, etc. etc." That's changing. The airline is being slowly "de-peaked", becoming less dependent on a big third quarter (while still having one!). As we de-peak, it can mean less seasonal hiring and a reduction in the infrastructure bulge needed to push through as much summer business as possible.

Freshening up in the Vancouver arrivals lounge



The early shift at the Saint John, NB, call centre

Besides retiring the Classics, further transborder expansion and adding more premium capacity internationally will help move us closer to a goal of being able to earn a net profit in all four quarters. Comparing 1994 (the year before Canada US Open Skies began) with 1998, the first, second and fourth quarter have shown improvement, mainly due to the success of our Open Skies expansion. All things being equal in the North American economy, further improvement will occur as more US flying is added. The new US routes attract business travel 12 months a year. Holiday traffic for US Thanksgiving and Presidents Day help spice up traditionally slow months like November and February, just as serving Hong Kong (and soon Taipei) earns a share of Chinese New Year traffic.

Demand for international Executive First continues to grow, so premium seating on the larger widebodies has been increased – to 63 seats on the 747-400s and 44 on the A340s. Since the premium demand is strongest in quarters one, two and four, while economy demand peaks in the third, some domestic Executive Class seating also will be replaced with additional economy seating from June to September to capture more vacation traffic.

Leveraging alliances to build network appeal

In one week last October, Air Canada added over 600 US flights – not one on an Air Canada aircraft. We already blanket Scandinavia, but won't even start flying there ourselves until May. Mexico City and Auckland are new Air Canada destinations. Bangkok, Singapore and Sao Paulo will follow, without one of our planes touching down there. It's all through codesharing – marketing seats on a partner's flights.

Air Canada's codeshare with partner United Airlines covers 1,050 flights daily on 172 North American routes. Hub to hub routes with United, like Montreal-Chicago or Toronto-Denver, are among our most profitable. A straight line drawn on a map from Montreal or Toronto to Los Angeles passes right over Denver, showing why it's an ideal transit point for diagonal travel across the continent.

Codesharing works both ways. By February 1998, United had its code on virtually every Air Canada transborder flight. Lufthansa and SAS are using our transborder routes to develop more US-Europe connecting services over Toronto.

As Star Alliance grows, codesharing will proliferate. Three new members – All Nippon Airways, Air New Zealand and Ansett Australia – will join us in the world's foremost global alliance this year. Leveraging Star Alliance and bilateral relationships with Korean Air, British Midland, Royal Jordanian, Singapore Airlines and Mexicana is creating a truly global Air Canada, diluting the advantage the major European and Asian carriers once enjoyed in Canada with their large networks. Some customers only flew with us 50 percent of the time because we flew to only half the places they go. Now, we offer much, much more, plus award-winning service.

Going places; transborder check-in Toronto (above); checking in the family, Vancouver

Tagged, traced and returned: central lost and found, Montreal

Seek the economies of scale of a much larger airline

For that globetrotting customer, the appeal of Star Alliance is the worldwide frequent flyer privileges, worldwide lounge access, coordinated schedules, through check in and baggage transfers and other aspects of an increasingly seamless product. Star also has another, lesser-known side: It's becoming a dynamic vehicle for lowering costs and risk. The risk management side is reflected in the hugely successful Montreal-Frankfurt joint service with Lufthansa, a formula being applied this year to the new Toronto-Copenhagen service with SAS.

Joint purchasing activities should save the group as a whole over US$100 million annually by 2001. For every blanket or headset Air Canada requires, the group needs several. When Star members jointly call for tenders for blankets and headsets or anything else for that matter, either the price falls or we get a better blanket or headset. (In a related move, a redesign of how Air Canada purchases all in-flight supplies will streamline costs and improve product consistency.)

The savings through Star are coming from consolidating activities, sharing ticket offices, terminal space and cargo terminals, providing reciprocal handling services, and by joint contracting for cargo trucking and soon, even fuel. A venture launched by Air Canada, Lufthansa and United for buying and selling aircraft parts is already saving money.

Just park it here: Loading a luxury car in Fra[illegible]

10:18 AM

Strengthening the Toronto hub

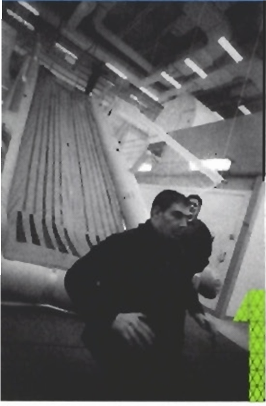
As Toronto goes, so goes Air Canada and that's no hype. When Toronto was hit by air traffic control slowdowns last summer and heavy snowfalls this past winter, it hurt the airline's bottom line. A third of all Air Canada passengers depart, arrive, or connect at Terminal 2. With 225 daily departures there, delays have a cascading effect on the whole system. So a major drive is going into enhancing the performance of the hub – to accelerate the movement of passengers and planes through the facility. That will improve product delivery, shorten aircraft turnaround times so we can schedule more flying, and reduce expenses from delays and missed connections.

Last year, strengthening Toronto meant building up the infrastructure. The transborder and international lounges were doubled in size. More transborder and international gate capacity was added, along with covered domestic gates for CL 65 regional jets. Now the emphasis is on technology. A new gate planning and deployment system will minimize delays for arriving and departing flights. Phasing in a manpower deployment system later this year and into next will improve staff productivity by five percent. And Toronto will follow Ottawa in introducing automated kiosks that dispense boarding passes in as little as ten seconds. From there, it's skip the queue, go straight to boarding. That's what most frequent travellers want – a fast lane to the plane. Almost as soon as the kiosk went into Ottawa this winter, 10 percent of passengers were using them.

Fresh and fresher still: Making today's meals; loading live lobst[illegible]

Updated mandates for the Air Canada Connectors

As part of the cost-reduction initiatives under way, new structures are being adopted for the Connector carriers. There are markets ripe for being served by smaller aircraft like the 18 seat Beech 1900D. That includes new transborder routes with no air service now, but which could provide both local traffic and network feed to a hub like Toronto. To develop this market segment known as Tier 3 flying and slash overhead costs, the eastern regionals - Air Alliance and Air Nova -- are being given new mandates according to the aircraft they fly. Air Alliance will do Tier 3 flying throughout the East. Air Nova will continue to fly larger aircraft like the Dash 8, and provide joint administration for both. The consolidation is expected to save over $5 million a year, and develop a prototype profit centre -- a Tier 3 carrier within a carrier – that could be applied throughout the Connector network.



1:20 PM

Getting it down pat: flight attendant safety training

Baggage on the move: the world under Vancouver Airport

Use foreign sales as a currency hedge (do like cargo)

Whenever the Canadian dollar slides to new lows like it did last year, the impact on Air Canada is mainly negative. The airline's foreign costs increase. Fewer Canadians travel abroad. Selling more seats in francs and marks and euros helps offset that. For 1999, the allocation of passenger seats for sale in foreign markets is being raised to anticipate Canada's strong appeal as an affordable world class holiday destination and take advantage of Air Canada's expanded codesharing.

However, the passenger side isn't likely to match Cargo for out of-country sales. Air Canada has been a global cargo player for many years, but never more so than today. Cargo's key account strategy catering to its largest customers – domestic and foreign – is helping foster a steady growth in US exports moving via our gateways to Europe and Asia. So does a lower C$. Getting more US export freight to Europe and Asia improved cargo yields last year. In 1997, US exports accounted for 17 percent of Cargo's revenues. Last year, it was 22 percent.

Key account customers get space allocations and preferential treatment. When the pilots' struck, Cargo worked hard to protect those big customers, even chartering freighters. As soon as we were flying again, they responded by sending us so much US export traffic that on some flights to Europe in late September there was room for little else.

With the retirement of the 747-200s, Cargo lost valuable upper deck freight space. But the revised fleet plan provides a couple of new selling points. Throughout the year, Cargo will be able to offer the newer 747 400 combis and their upper deck space on two crucial routes - Toronto London and Toronto-Frankfurt. That's a first. And the A330/340s can carry substantially more freight below deck than any jet we have ever flown, like the 32 tonnes of chocolate one A340 flew from Zurich last fall.

Special Services, Toronto:
Every passenger's best friend

Make technology work harder and smarter

Each dollar Air Canada spends on new technology should produce several dollars in cost savings or new revenue. That's true of the network profitability modeling system being introduced to help analyze the financial performance of different net work configurations. In 1999, that should produce a gain in excess of $15 million. A new passenger origin/destination flow model will improve our seat inventory management, boosting revenues by a factor of 0.75 to 1.5 percent, or over $25 million in 1999 and more in future years. Implementing procedural and technological enhancements in the call centres will improve productivity there.

The technology investment being made by Star Alliance partners will support further customer service enhancements like the extension of through check-in that ultimately translate into revenue gains. Spending on computer network and informational technology services is an enormous budget item and one where creative solutions – like developing IT solutions within Star – could save tens of millions more.

So will the progressive elimination of all paper ticketing. We love paper – it's a great Canadian industry – but not paper tickets or paper cargo waybills. Both create paperwork. With electronic ticketing, there is no need to distribute and account for unused ticket stock. Finance doesn't have to audit and reconcile used flight coupons. With electronic airwaybills, shipping information doesn't have to be manually entered into the airline's computer. Air Canada has been phasing in electronic ticketing, or ET, since 1996. It's available on virtually all North American routes and to London and Bermuda, with a goal of 35 percent ET usage by year-end on routes where it is offered. And the new automated boarding pass dispensers coming to airports across Canada will complement e-ticketing and help popularize the concept of automated ticketing and check-in technology.

The technology will liberate staff from mundane and repetitive tasks. Our customer service vision views staff and technology as complementary, empowering employees to provide a more personal and proactive service. And we're encouraging cargo customers down the electronic path by implementing advanced bar-code labeling and the latest in EDI – electronic data interchange.

Boarding for the East

Let your fingers do the walking – on the web

With high-speed residential Internet access and growing acceptance of online shopping, the net is emerging as the most dynamic use of automation at Air Canada since Reservec, our first reservations computer. Already www.aircanada.ca receives over seven million hits a week. People are using it for up-to-the-minute flight status updates, which they can get with fewer than a dozen keystrokes, to track lost baggage claims online, or check their Aeroplan account balance. Cargo's customers can track shipments on-line.

Cyber Ticket Office at www.aircanada.ca lets customers review or cancel bookings in addition to making new ones. CTO's Price Shopper allows them to find the best fare from up to 16 flight choices on the same route. They can even make hotel and car rentals with Aeroplan partners. CTO coupled with electronic ticketing is Air Canada's lowest cost distribution channel, saving on labor and telephone expenses as well as booking fees for third party reservations systems. And CTO is open 24 hours. At 2 a.m., there may be no room service at your hotel, but Cyber Ticket Office is open.

CTO is about giving passengers the widest choice in booking options. While CTO is bound to get its share of bookings, most customers will continue using traditional booking channels, and check in the old-fashioned way. Recognizing that, CTO, electronic ticketing and new Personal Ticket Office dial-in software for Aeroplan Elite and Super Elite members allow travel agents to do the actual ticketing.

Surfing the Internet at the Maple Leaf Lounge

Air Canada gate at Chicago O'Hare

One touch service: self-service kiosk in Ottawa

Take Aeroplan to a higher level

There's great cachet in the Air Canada product, and that's not corporate bravura. Winning the OAG Worldwide's North American airline of the year award for both domestic long haul and shorthaul service, and being voted the Air Transport World's Passenger Service Award for 1998 says it better than we ever could. And we're not resting on our laurels. Last year, Air Canada was first to introduce an arrivals lounge in Canada for premium customers, and the first Canadian carrier to open one abroad, in London. This year, the delivery of the newest Airbus widebodies will introduce a new state-of-the-art sleeper seat for Executive First, equipped with the Sony on-demand video entertainment system and power ports to plug in a laptop.

However, even infrequent fliers know about Aeroplan. Canadians may be the most avid points collectors on earth, and Aeroplan points are one of Canada's favorite collectibles. Often overlooked when pundits try to assess the financial impact of frequent flyer plans are the huge revenues earned by Aeroplan from selling the billions of points given out each year by the program's hotel, car rental, credit card and other partners. Aeroplan now has over four million members, and is adding 40,000 a month. The goal is to boost revenues by a further 20 percent this year and do a major relaunch – with additional products and partners and a new orientation that weights rewards towards the value of a customer's patronage, not just miles flown.

Riding high: engine maintenance on an A340

Keeping a watchful eye on the weather, System Operations Control

Making sure every seat is a good one

Leverage the Air Canada brand like never before

Even before the first puck was dropped at a Leafs game, before the first Raptors tip-off, the Air Canada Centre had become one of Air Canada's most potent marketing vehicles ever. Putting our name on Toronto's new sports and entertainment complex enhances our visibility in a crucial market. It is slipping the Air Canada name into local sports pages and sportscasts, network hockey and basketball telecasts, specialty cable TV and Internet sites. It will help raise the airline's profile in the US.

Acquiring naming rights for the Air Canada Centre reflects our strategy to devote a larger share of the airline's marketing and advertising budget to event-based marketing. Starting this year, that includes sponsoring the Air Canada Grand Prix Formula 1 event in Montreal and the Air Canada Championship PGA Tour event in Vancouver. This augments an already formidable lineup of Air Canada sponsorships featuring summer jazz and film festivals, the World Junior Hockey championships, five Canadian NHL teams and Canada's two NBA teams. Event-based marketing reaches key demographic groups – like upwardly mobile young professionals, urban baby boomers – who support today's sports entertainment culture. The Grand Prix and the Air Canada Championship, like the summer festivals, attract thousands of out-of-province and out-of-country visitors, many of whom will travel on Air Canada travel packages, giving the airline an immediate payback.

There is one other partnership of which we're particularly proud. It's Dreams Take Flight, which our employees, through their grit and sense of self-sacrifice and community, have developed into a nationally registered charity to fly disadvantaged, ill and physically challenged children for outings to Disneyland in Anaheim and Orlando's Disney World. With characteristic energy and enthusiasm, the volunteer teams are getting ready for another year of putting smiles on the faces of hundreds of special customers, and the whole Air Canada family salutes them.

00:00 January 1, 2000

Air Canada will be Y2K ready

For those planning to ring in 2000 somewhere special like Times Square or the Champs-Élysées, January 1 promises to be an occasion to remember. For Air Canada, it will be a workday like any other, only more so. Will the millennium bug – also called the Year 2000 or Y2K glitch – mar the celebration? We can't vouch for all the world's computers, but for almost three years now, the Corporation has undertaken an extensive program to get our systems Y2K ready.

The Year 2000 glitch has spawned sweeping, offhand remarks in the media about how flying next January 1 might not be safe. In our view that's just plain wrong. Air Canada will fly on New Year's Eve, New Year's Day, and the other 365 days of 2000 (it's a leap year). Safety will not be compromised. We will fly only where we have a very high degree of comfort that the destination or routing is safe.

Aircraft manufacturers like Airbus, Boeing and Bombardier have audited their aircraft and found no Y2K problems compromising safety. As for Y2K issues with other on-board systems with no direct safety link, very few have been found, and they will be remediated by the first quarter of this year if they haven't been already.

The airline industry, through the International Air Transport Association (IATA), is conducting an intensive worldwide campaign to incite Y2K readiness among 2,300 airports, 185 air traffic control systems and 5,500 common suppliers. That includes audits and on site verification of Y2K preparedness by airline trade groups like the Air Transport Association of Canada, and the Air Transport Association in the US. Major North American air navigation systems are already Y2K ready or soon will be and authorities overseas are working towards the same goal. IATA is maintaining a global readiness database, so Air Canada will have up-to-date information about the state of preparations at airports and air navigation providers. If we have reason to believe that there is a safety risk at an airport, we will not fly there. If any air corridors or any country's airspace is seen presenting a risk, we will use alternate routings which are safe.

Air Canada's Y2K program has been under way since 1996. Getting Y2K ready has meant updating millions of lines of software code. In a few cases, it has also involved replacing systems as part of normal course business upgrades. The objective is to ensure systems don't seize or malfunction because their software doesn't recognize "00" as the year following "99" in their two digit date code. Internally, 315 systems and over 7,000 telecommunications components are being verified.

Mission critical systems – those essential to keeping the airline running safely and smoothly – were completed in 1998. (Ninety four percent of the total remedial work was completed as of last December.) Testing is under way to ensure the fixes work. Integrated simulations of 28 crucial systems are replicating all kinds of day-to-day situations. The clock will be set at December 31, 1999, then January 1, 2000 to see that all goes smoothly. Other key dates (like February 29, 2000) will be tested.

12:01 AM

Turning in for the ni
in Executive First

Will it be red or white? Serving Executive First Passengers on the North Atlantic

Checking in for the red eye

Air Canada's Y2K program is on time and on budget. But neither the $41 million nor the 50,000 person-days invested will mean much if key suppliers and partners aren't ready. Air Canada is coordinating efforts with the Star Alliance partners. A team in our Y2K task force is working on business continuance – developing backup procedures for unexpected systems failure or loss of essential services like phones or electricity. Even if we don't expect the worst, we must try to be ready for it.

Other task force members are focusing on business compliance, verifying the readiness of our suppliers and service providers, like airports, caterers and fuel companies, even doing on-site audits and reviewing Y2K test results. If a supplier appears to present a risk to Air Canada, alternatives or contingency plans will be put in place.

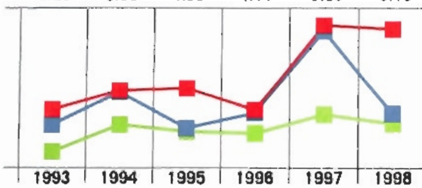
Right now, what may be lacking most in the Y2K debate is context for the public to evaluate the possible effects. There is no precedent, and there could be surprises, some of which might inconvenience customers until adjustments are made.

Insurance underwriters have the legal right to cancel insurance for any airline not going to be Y2K ready. Last year, Air Canada's insurers audited our Y2K program and reconfirmed our coverage for 2000. Another indicator of how our program is rated: It won a 1998 Canadian Information Productivity Award for crisis readiness.

Air Canada Performance at a Glance

Share price ($) – December 31

1993	1994	1995	1996	1997	1998
6.63	8.63	6.88	6.60	15.40	15.00
5.00	8.38	4.65	6.20	14.75	6.15
2.20	5.00	4.30	4.11	6.05	5.10



Common share price on the Toronto Stock Exchange

High
Close
Low

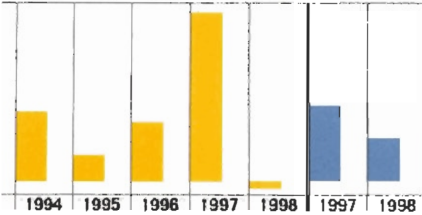
More information on page 26.

Shareholder Value

- Common share price declined in 1998 to close at $6.15 from $14.75 in 1997.
- Class A non-voting shares closed at $5.10 from $13.65 in 1997.
- In April 1998, convertible debentures were converted into 31.2 million Class A non-voting shares.

EPS ($)

1994	1995	1996	1997	1998	1997	1998
0.97	0.36	0.82	2.37	(0.10)	1.05*	0.59*



Earnings per share (EPS), fully diluted

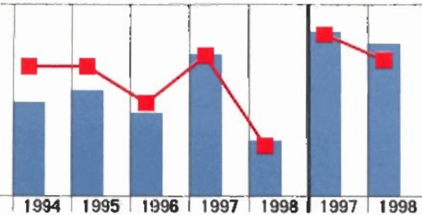
*Adjusted for pilot strikes, gains on sale and other non-recurring and significant items – See page 27.

More information on page 26.

Earnings

- Loss per share of $0.10 in 1998, fully diluted.
- 1998 pilot strike adversely affected income by an estimated $155 million (after-tax) or $0.81 per share, fully diluted.
- Excluding estimated pilot strike impact and other non-recurring and significant items, adjusted 1998 earnings per share of $0.59, fully diluted.
- 1997 earnings removing similar one-time events, were $1.05 per share, fully diluted.

1994	1995	1996	1997	1998	1997	1998
6.1	6.1	4.4	6.6	2.4	7.6*	6.4*
244	275	215	368	144	427*	396*



Operating income
Operating margin, % of operating revenue

Operating Margin (%)
Operating Income ($M)

*Adjusted for pilot strikes, gains on sale and other non recurring and significant items – See page 27.

More information on page 28.

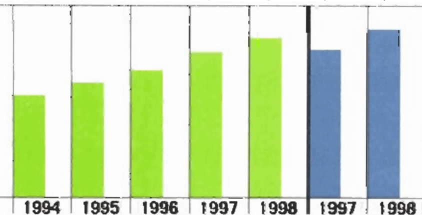
Operating Income ($) and Margin (%)

- Operating income of $144 million.
- Excluding estimated pilot strike impact and other non-recurring and significant items, operating income of $396 million, down from adjusted 1997 of $427 million.
- EBITDAR of $910 million, $1,154 million adjusted.

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

$M

1994	1995	1996	1997	1998	1997	1998
3,172	3,581	3,980	4,533	4,977	4,603*	5,226*



Passenger revenues

*Revenues adjusted for estimated labour disruption impacts in 1997 and 1998 – See page 26.

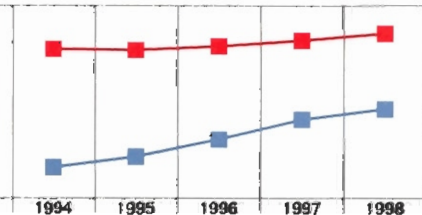
More information on page 29.

Operating Revenue Growth

- Total passenger revenues grew 10 per cent or $444 million in 1998.
- Estimated $249 million or 5 per cent passenger revenue loss due to strike. (Total revenue loss due to strike $263 million.)

% Market share

1994	1995	1996	1997	1998
56.1	55.9	56.7	57.9	59.4
31.2	33.4	37.0	41.2	43.4



Air Canada % of Canadian travel agency sales

Canada
US

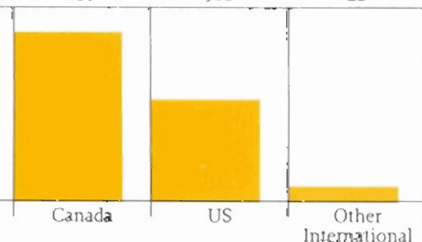
More information on page 30.

Market Share

- Canada market share was 59 per cent, up 1.5 percentage points from 1997, without adjustment for the pilot strike impact.
- US transborder market share, measured by Canadian travel agency sales, up 2 percentage points in 1998 to 43 per cent. (Majority of transborder travellers originate from Canada.)
- Fourth quarter (post strike) market share for Canada unchanged from 1997 and up 1 share point for Canada-US transborder.

$M Growth 1998 vs 1997

Canada	US	Other International
263	158	23



Passenger revenue growth by service

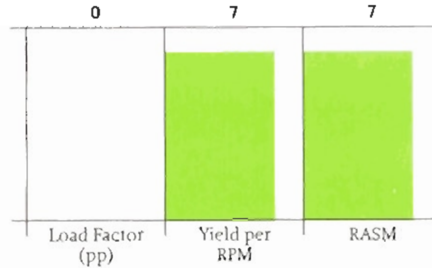
More information on page 31.

Passenger Revenue Performance

- Strong performance of Canada routes with passenger revenue up $263 million or 13 per cent.
- Canada-US transborder passenger revenue up $158 million or 12 per cent.
- Other international revenue up $23 million or 2 per cent with increased Atlantic and Caribbean revenues largely offset by reduced Pacific operations and revenues.

Passenger Revenue Performance (cont'd)

- Passenger yield per revenue passenger mile rose 7 per cent.
- System passenger load factor unchanged.
- Revenue passenger miles (RPMs) up 2.4 per cent and available seat mile (ASM) capacity up 2.7 per cent, without adjustment for pilot strike.
- RASM up 7 per cent due to strong yield.

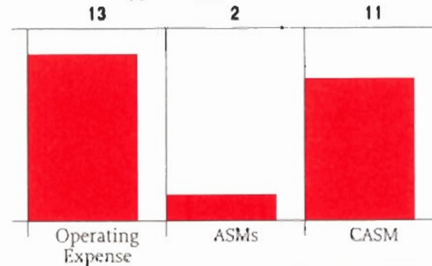


Passenger revenue per available seat mile (RASM)

More information on page 32.

Operating Cost Performance

- CASM or operating expense per ASM, rose 11 per cent over 1997 (6 per cent excluding pilot strikes and other non recurring and significant items).
- Higher unit costs for salaries, wages and benefits accounted for 28 per cent of the unit cost increase.
- Airport and navigation fee increases made up 21 per cent while aircraft rent and depreciation were 23 per cent of the increase.
- Adverse currency movements on US dollar denominated expenses were also a factor.

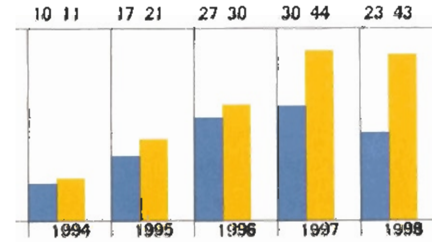


Operating expense per available seat mile (CASM) (excluding subsidiaries)

More information on page 34.

Productivity

- Significant productivity improvements since 1993.
- Operating revenue per employee down 1 per cent in 1998 from 1997, due to pilot strike but 43 per cent above 1993 level.
- Available seat miles per employee down 5 per cent in 1998 but 23 per cent above 1993 level.
- Excluding the labour disruptions in 1997 and 1998, operating revenue per employee would have improved by 3 per cent in 1998, while available seat miles per employee would have been 2 per cent below 1997 level.



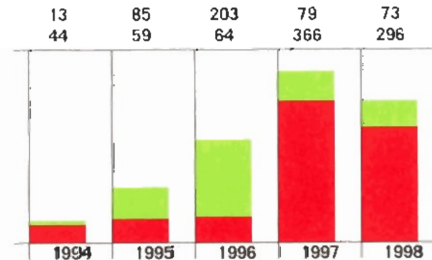
ASMs and operating revenue per employee (excluding subsidiaries)

ASMs/employee
Operating revenue/employee

More information on page 36.

Financial Management

- Cash provided by operations was $296 million, down $70 million from 1997.
- Most of estimated $250 million strike impact was cash related.
- Excluding scheduled lease payments in excess of aircraft rent, cash from operations was $369 million in 1998, $76 million less than 1997.



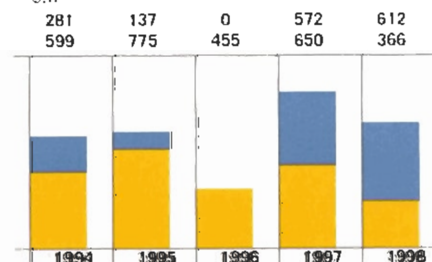
Cash generation

Scheduled lease payments in excess of aircraft rent expense
Cash provided by operations (including scheduled lease payments in excess of aircraft rent expense)

More information on page 37.

Liquidity

- Cash and available credit lines amounted to $978 million at December 31, 1998.
- Cash position of $366 million.
- Long-term strategy is to maintain cash and available credit of over $1 billion.



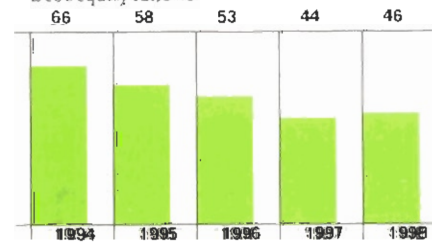
Cash & unused lines of credit

Unused lines of credit
Cash and short-term investments

More information on page 38.

Debt (excluding perpetual debt) : Debt plus Equity

- Debt/equity ratio increased to 46 per cent at year-end 1998 compared to 44 per cent at the end of 1997.
- Shareholders' equity up marginally.
- Additional debt was incurred in 1998 to partially fund purchases of eight new Airbus A319 aircraft.
- In February 1999, Air Canada issued $175 million of senior unsecured debentures to fund aircraft acquisitions and for general corporate purposes.
- Perpetual debt viewed as permanent capital.



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

*Includes current portion.

More information on page 41.

Overview of 1998

Air Canada recorded operating income of $144 million for the year ended December 31, 1998 and a net loss of $16 million or $0.10 per share, fully diluted. This was particularly disappointing given that the first six months of the year showed operating income at the highest level in the Corporation's 61 year history.

Several factors came into play:

The 13 day pilot strike in September 1998 adversely affected operating income by approximately $250 million and net income by $155 million or $0.81 per share, fully diluted, based on management's estimates.

The Corporation was initially in a growth mode for 1998, planning to increase its available seat mile (ASM) capacity by over 10 per cent compared to 1997. By mid-1998 however, the airline experienced softening in a number of key travel markets and, in response, pulled back on capacity. For the year, including the strike, ASM capacity rose by only 3 per cent (with the strike reducing capacity by an estimated 5 per cent). But because the aircraft fleet, staffing levels and related infrastructure had been put in place in contemplation of higher growth, it was not possible to adjust cost levels quickly, resulting in an 11 per cent increase to unit costs in the year, excluding subsidiaries.

External events such as adverse currency movements also affected expense levels. The decline in the Canadian dollar against the US dollar, added an estimated $70 million or more to fuel expense, aircraft rent and material costs. While many airlines were benefitting from significantly lower fuel expenses, Air Canada did not benefit to the same extent as fuel hedging expenses rose $89 million, due to hedge decisions taken mainly in 1997.

Despite the pilot disruption, passenger revenues for the year rose $444 million or 10 per cent over 1997. Domestic passenger revenues recorded 13 per cent growth and US transborder revenues grew by 12 per cent. Other international revenues increased by only 2 per cent, reflecting a 17 per cent decline in Pacific revenues as a result of weaker travel demand and capacity reductions. System yield per revenue passenger mile (RPM) rose 7 per cent due to fare increases (including increases for new Nav Canada charges) and a greater use by business travellers of higher fare products. Cargo revenues declined 5 per cent, in part due to the strike. Other revenues declined 10 per cent mainly as a result of the sale of Galileo Canada in June 1998 as well as lower third party maintenance revenues. Operating expenses during the same period rose $584 million or 11 per cent. Key elements in this expense growth were salary, wage and benefit expenses, higher airport and navigation charges including Nav Canada fees, aircraft rent and depreciation charges as well as increased maintenance and material expense. Unit costs, as measured by operating expense per ASM rose 11 per cent, excluding subsidiaries. Non-operating expense, after removing non-recurring gains on sale of investments and other assets increased $65 million due largely to currency fluctuations, lower capitalized interest amounts and higher debt levels.

For the year, operating income declined $224 million from 1997 and net income was lower by $443 million or $2.47 per share, fully diluted. Due to a number of non-recurring and significant events in both 1998 and 1997, management believes that this year-over year comparison is not meaningful. Accordingly, in order to provide a more informative comparison of the two years, the impact of such items has been removed, based on management's estimates.

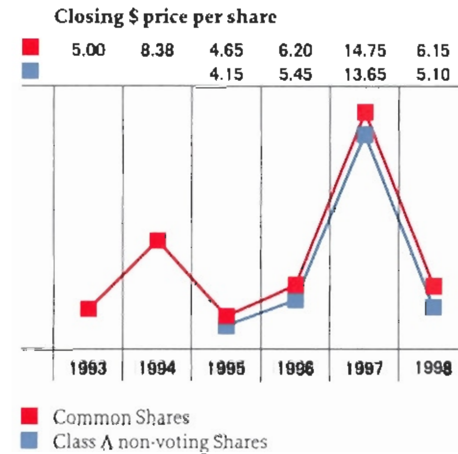
The following summarizes these non-recurring and significant items. The 1998 financial results were affected by the September pilot strike, $30 million of gains on sale of investments and other assets and by a fuel excise tax rebate repayment by a subsidiary. In 1997, non-recurring and other significant items included a Regional Airlines pilot strike which adversely affected operating income by an estimated $57 million in early 1997, $236 million of gains on sale of major investments and other assets and a significant fuel excise tax rebate repayment by Air Canada which reduced operating income by $43 million but had a $141 million favourable impact on the net accounting tax provision. Other items in 1997 included an abnormal $39 million reduction to pension expense, due to favourable pension fund performance and revised pension assumptions, as well as a fuel tax rebate to a subsidiary.

Removing the effect of these non recurring and significant items, operating income for 1998 would have been $396 million with an adjusted net income of $107 million or $0.59 per share, fully diluted. On this basis, operating income for 1998 would have been $31 million below the similarly adjusted 1997 estimate and net income lower by $70 million or $0.46 per share, fully diluted.

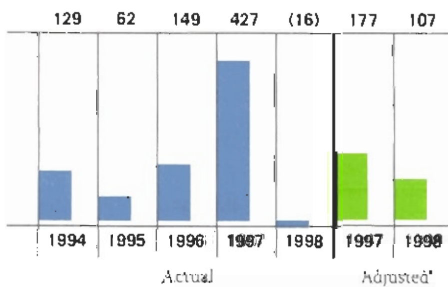
Pages 26 and 27 provide a more comprehensive presentation of the estimated impact of the pilot strike and quantification of non-recurring and significant items in both years. In the pages that follow, "Adjusted" results refers to the 1997 or 1998 actual results removing the estimated impact of these events and items. This information is provided so that the reader may have the benefit of comparing the two years without the impact of these non-recurring and significant items. Management has used its best estimates based on internal tracking of revenues and costs during the relevant periods. The reader is cautioned that these are estimates and subject to variations which the Corporation does not believe to be material.

Shareholder Value

The price of Air Canada's common shares closed on the Toronto Stock Exchange (TSE) at the end of 1998 at $6.15 per share, down from the $14.75 1997 close. Over the past several years, the common share price has experienced considerable volatility. The annualized return on Air Canada common shares from December 1993 to December 1998 was 4.2 per cent as compared to the TSE 300 index return of 10.7 per cent, measured on an annual compounded basis. The closing price of Class A non-voting shares, traded on Canadian exchanges (and the NASDAQ exchange in US dollars) declined to $5.10 per share from $13.65 at the end of 1997.



Earnings



*Adjusted for pilot strikes, gains on sale and other non-recurring and significant items – See page 27.

The pilot disruption adversely affected 1998 earnings by an estimated $155 million. Removing the estimated pilot strike impact and other non-recurring and significant items in both 1998 and 1997, adjusted earnings declined $70 million. Due to changing economic conditions and modest market growth projections for 1999, Air Canada will moderate flying capacity with a focus on improving returns in key markets. Air Canada's goal is to generate improved earnings from airline operations on a long-term basis.

1998 Estimated Strike Impact

The following table adjusts 1998 results to remove the estimated impact of the September 1998 pilot strike, based on Air Canada internal estimates. Adjusted operating income without the strike is estimated at $394 million and net income at $139 million.

($ millions)	1998 Results	Add Back: 1998 Estimated Strike Impact	1998 Adjusted Results
Passenger revenue	4,977	249	5,226
Cargo revenue	369	17	386
Other revenue	586	(3)	583
Operating revenues	5,932	263	6,195
Salaries, wages & benefits	1,573	23	1,596
Aircraft fuel	657	28	685
Commissions	464	11	475
Food, beverages & supplies	252	8	260
Airport & navigation fees	375	17	392
Aircraft rent	474	(8)	466
Other	1,993	(66)	1,927
Operating expenses	5,788	13	5,801
Operating income	144	250	394
Non-operating income (expense)	(173)	–	(173)
Income (loss) before income taxes	(29)	250	221
Income (loss) for the year	(16)	155	139
EPS – Basic	$(0.10)	$0.87	$0.76
– Fully diluted	$(0.10)	$0.81	$0.76
ASMs (billions)	35,037	1,782	36,819
RPMs (billions)	24,479	953	25,432
Load Factor	69.9	(0.8)	69.1
Yield per RMP (cents)	20.29	0.22	20.51
RASM (cents)	14.18	(0.01)	14.17

Adjusting 1998 and 1997 for Major Items

Both 1998 and 1997 results were influenced by a number of significant items, including the estimated impact of labour disruptions, large gains on sale of investments and other assets in 1997, a major transaction in 1997 to re-instate tax losses, lower than normal pension expense in 1997 and transactions relating to fuel excise tax rebates to and repayments by a subsidiary.

The tables below adjust 1998 and 1997 results for these items. On an adjusted basis, estimated operating income for 1998 would have been $396 million, compared to the adjusted 1997 amount of $427 million. Estimated net income at $107 million would also have declined from adjusted 1997 income of $177 million.

1998

($ millions)	Actual 1998 Results	Estimated Pilot Strike Impact	Gains on Sale of Investments and Other Assets (Net of Provisions)	Fuel Excise Tax Repayment	Adjusted 1998 Results
Operating revenues	5,932	263	–	–	6,195
Operating expenses	5,788	13	–	(2)	5,799
Operating income (loss)	144	250	–	2	396
Non-operating income (expense)	(173)	–	(30)	–	(203)
Income (loss) before income taxes	(29)	250	(30)	2	193
Recovery of (provision for) inc. tax	13	(95)	6	(10)	(86)
Income (loss) for the year	(16)	155	(24)	(8)	107
EPS – Basic	$(0.10)	$0.87	$(0.13)	$(0.05)	$0.59
– Fully diluted	$(0.10)	$0.81	$(0.12)	$(0.04)	$0.59

1997

($ millions)	Actual 1997 Results	Estimated Regional Strike Impact	Gains on Sale of Investments and Other Assets (Net of Provisions)	Fuel Excise Tax Repayment & Significant Items	Adjusted 1997 Results
Operating revenues	5,572	74	–	–	5,646
Operating expenses	5,204	17	–	(2)	5,219
Operating income (loss)	368	57	–	2	427
Non-operating income (expense)	98	–	(236)	–	(138)
Income (loss) before income taxes	466	57	(236)	2	289
Recovery of (provision for) inc. tax	(39)	(25)	67	(115)	(112)
Income (loss) for the year	427	32	(169)	(113)	177
EPS – Basic	$2.74	$0.21	$(1.08)	$(0.73)	$1.14
– Fully diluted	$2.37	$0.17	$(0.89)	$(0.60)	$1.05

Comparison of Adjusted 1998 versus Adjusted 1997

($ millions)	Adjusted 1998 Results	Adjusted 1997 Results	Variance
Operating revenues	6,195	5,646	549
Operating expenses	5,799	5,219	580
Operating income (loss)	396	427	(31)
Non-operating income (expense)	(203)	(138)	(65)
Income (loss) before income taxes	193	289	(96)
Recovery of (provision for) inc. tax	(86)	(112)	26
Income (loss) for the year	107	177	(70)
EPS – Basic	$0.59	$1.14	$(0.55)
– Fully diluted	$0.59	$1.05	$(0.46)

Income Taxes

In 1998, the Corporation recorded a $13 million income tax recovery related to 1998 and prior years' losses. In the prior year, the Corporation recorded a $207 million income tax provision which was reduced by $168 million by applying a portion of unrecognized income tax benefits from losses in 1992 and 1993. As at December 31, 1998, accumulated unrecognized income tax benefits amounted to $10 million.

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. The net impact of this transaction on 1997 earnings was an improvement of $98 million or $0.51 per share on a fully diluted basis.

In 1998, a subsidiary reinstated $21 million of federal income tax losses representing $10 million of income tax benefits by repaying to the Canadian government the net balance of a fuel excise tax rebate received in 1997, in the amount of $2 million.

Operating Income and EBITDAR

Operating Income

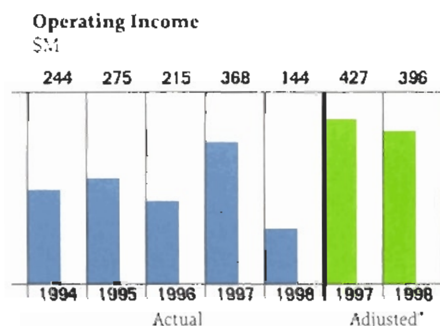
Operating revenues continued to show significant growth over 1997, however operating expenses grew at a faster pace. With the pilot strike, operating income declined $224 million in 1998, $31 million on an adjusted basis. Air Canada is working towards improving the ongoing profitability of its airline operations, with a strong focus on operating income performance.

EBITDAR

EBITDAR declined in 1998 by $99 million. The pilot strike had an estimated unfavourable impact of $242 million. On an adjusted basis, EBITDAR was above the 1997 level.

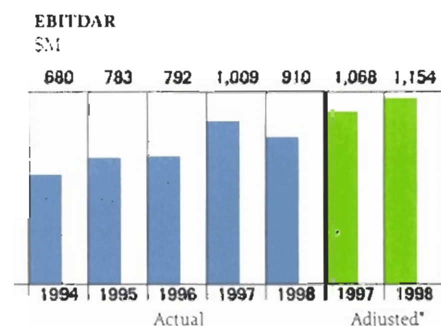
EBITDAR: Earnings (operating income) before interest, taxes, depreciation, amortization and aircraft rent.

Operating Income
$M



*Adjusted for pilot strikes, gains on sale and other non-recurring and significant items – See page 27.

EBITDAR
$M

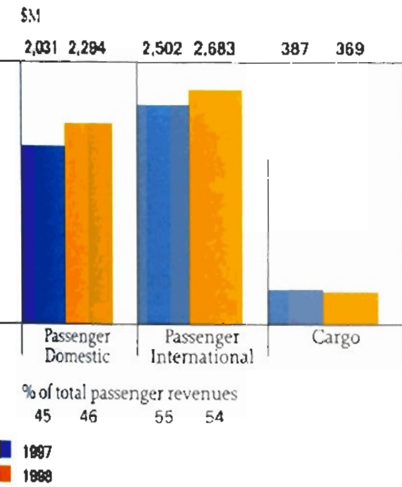


*Adjusted for pilot strikes, gains on sale and other non-recurring and significant items – See page 27.

Operating Revenue Growth

Operating revenues increased $360 million or 6 per cent in 1998, despite the strike. This continued the positive trend established over the past five years:

($ millions)	1994	1995	1996	1997	1998
Domestic Routes					
Passenger	1,814	1,898	1,923	2,031	**2,294**
Cargo	151	101	110	116	**104**
Total	1,965	1,999	2,033	2,147	**2,398**
International Routes					
Passenger	1,358	1,683	2,057	2,502	**2,683**
Cargo	183	222	237	271	**265**
Total	1,541	1,905	2,294	2,773	**2,948**
Other	518	603	553	652	**586**
Total Operating Revenues	4,024	4,507	4,880	5,572	**5,932**
% Growth	12%	12%	8%	14%	**6%**



Transportation Revenues

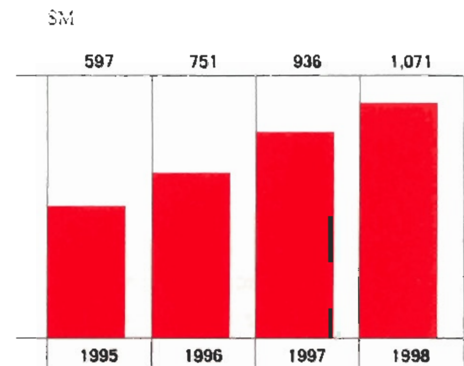
In 1998, domestic passenger revenues increased 13 per cent and accounted for 46 per cent of total passenger revenues, up 1 percentage point from 1997.

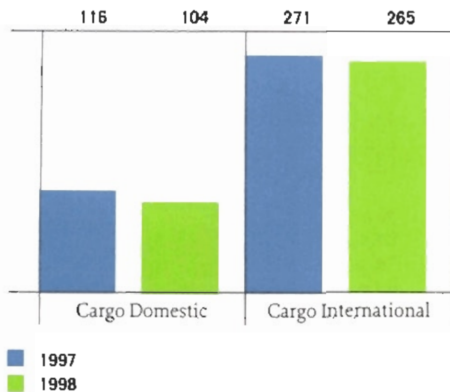
International passenger revenues grew by 7 per cent and accounted for 54 per cent of passenger revenues, significantly above the 43 per cent level recorded in 1994. Since 1994, Air Canada has pursued a strategy to diversify its revenue sources by expanding into key international markets. In 1998, domestic operations were expanded in line with greater travel demand.

Premium Class* Revenues

Premium Class revenues rose $135 million or 14 per cent in 1998 continuing the significant growth trend since 1995.

*Includes Executive Class and Executive First.





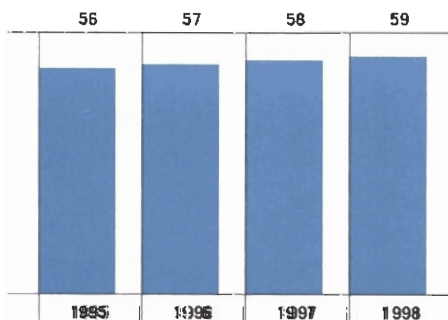
Cargo Revenues

Cargo revenues declined $18 million or 5 per cent in 1998, mainly due to the labour disruption. Cargo revenues on Atlantic routes increased 2 per cent. This was, however, offset by a 26 per cent reduction in Pacific cargo revenues due to reduced capacity, weaker economic conditions and lower demand for air cargo services on westbound flights. Domestic cargo revenues were down 10 per cent, mostly related to the labour disruption and the sale of Northwest Territorial Airways in 1997.

Other Revenues

Other non-transportation revenues declined $66 million or 10 per cent. In 1998, most of this reduction was due to the sale of Galileo Canada in mid-1998. Third party maintenance revenues declined 23 per cent due to reduced contracted maintenance services to other airlines. Revenues from Aeroplan partners rose 18 per cent.

Passenger Market Share

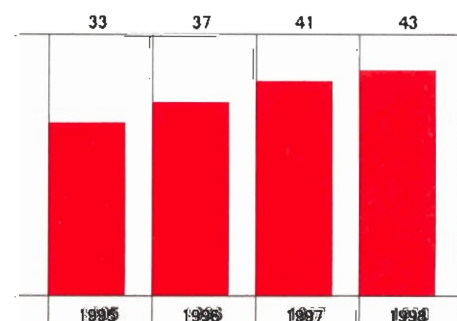


Domestic Market Share

Domestic market share rose by 1.5 percentage points for the year 1998 to 59 per cent, as measured by the dollar value of passenger sales by travel agencies in Canada. This was despite an 11 point share loss during the September strike month versus the prior year. Following the strike, the fourth quarter market share recovered to the 1997 level.

Canada-US Transborder Market Share

Air Canada's US transborder market share, measured by the dollar value of transborder passenger sales by travel agencies in Canada, rose 2 percentage points to 43 per cent. A 7 percentage point share loss in the month of September was followed by a fourth quarter gain of 1 share point versus the previous year. For the year 1998, Air Canada had an over 50 per cent market share of Canadian travel agency transborder sales at Toronto, its principal hub. Over the past several years, Air Canada has gained a considerable share of this important market.



Passenger Revenue Performance

$M	1994	1995	1996	1997	1998
	1,814	1,898	1,923	2,031	2,294
% of total passenger revenues	57	53	48	45	46

Domestic Passenger Revenues

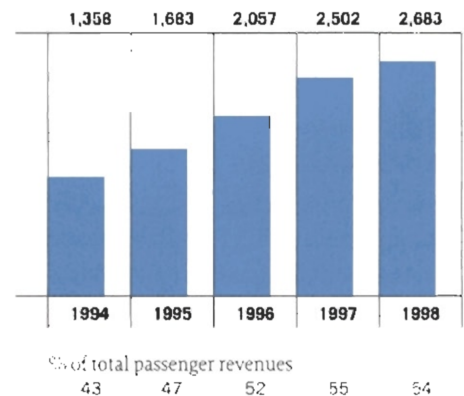
Domestic passenger revenues experienced marked growth of $263 million or 13 per cent in 1998 despite the labour disruption. This was due to stronger domestic travel demand, met by additional seat capacity.

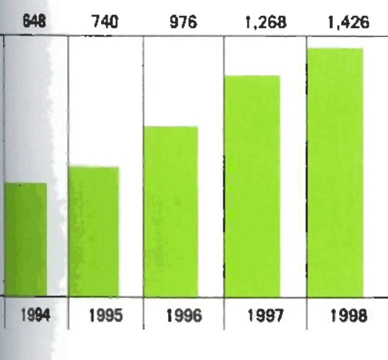
The strongest revenue growth in Canada was recorded on the short haul Commuter routes, including the main Rapidair routes linking Toronto and Montréal/Ottawa which grew 16 per cent. These Commuter routes accounted for over 25 per cent of consolidated domestic passenger revenues in 1998. The Transcontinental routes, linking Toronto, Montréal and Ottawa with major western Canada cities including Winnipeg, Calgary, Edmonton and Vancouver, recorded 14 per cent revenue growth in 1998 and represented approximately 40 per cent of domestic passenger revenues. Growth on Regional routes, which include operations within eastern and western Canada, amounted to 9 per cent. In late 1998, the Corporation reduced its flying capacity on certain western Canada routes.

The 1998 pilot strike had an estimated $106 million adverse impact on domestic passenger revenues in the year. In 1997, a Regional Airline pilot strike lowered passenger revenues by an estimated $70 million, essentially all on domestic routes.

International Passenger Revenues

Passenger revenues from international services, including US transborder services, rose $181 million or 7 per cent. Since 1994, international passenger revenues have almost doubled, reflecting Air Canada's strategy of expansion in key international markets.



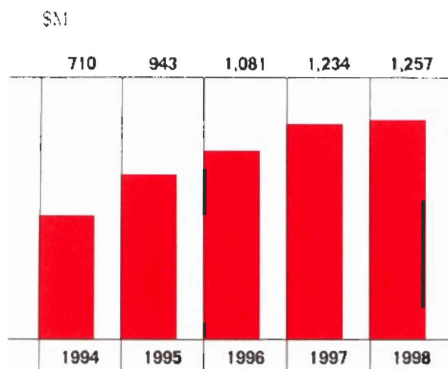


Canada-US Transborder Passenger Revenues

US transborder passenger revenues showed growth of $158 million or 12 per cent over 1997 and accounted for 29 per cent of passenger revenues. Most of the revenue growth was the result of strong performance on medium to short haul transborder routes. US revenues have more than doubled from 1994 levels, as a result of Air Canada's successful strategy to expand direct Canada-US services following the introduction of "Open Skies" in February 1995. In 1998, Air Canada inaugurated service on five new routes including the two new destinations of San Jose and New Orleans.

Executive Class premium revenues on transborder services grew by 17 per cent in 1998 reflecting strong business demand for Air Canada services.

The 1998 pilot strike adversely affected US transborder revenues by an estimated $72 million in the year.



Other International Passenger Revenues

Passenger revenues from other international routes rose $23 million or 2 per cent in 1998. Other international routes are comprised of Atlantic, Pacific and Caribbean services. These routes represented approximately 19 per cent, 3 per cent and 3 per cent of passenger revenues, respectively.

In 1998, Atlantic passenger revenues grew 5 per cent, with the greatest growth occurring on Canada-Germany routes followed by Canada-UK routes. Pacific services, including charter, recorded a 17 per cent revenue decline due, in large part, to a 50 per cent capacity reduction on South Korea services. Caribbean revenues were up 8 per cent over 1997.

Premium revenues on these international services rose 10 per cent in 1998.

The pilot labour disruption in 1998 adversely affected other international passenger revenues by an estimated $71 million.

Regional Airlines

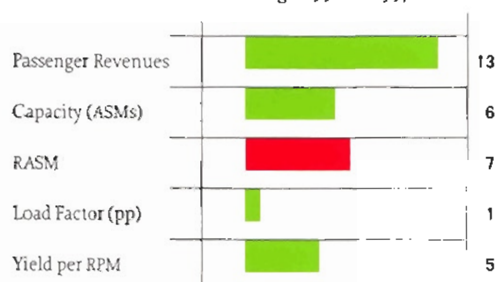
Regional Airline (Air Nova, Air Ontario, AirBC and Air Alliance) revenues are included in the above consolidated revenues as well as Northwest Territorial Airways until its sale in June 1997. Regional passenger revenues (net of consolidation adjustments) increased by 16 per cent in 1998. In early 1997, four Regional Airlines were involved in a pilot labour disruption which adversely affected their operations and revenues.

Key Components of Passenger Revenue

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. RASM is the product of two key components. The first component is load factor which represents passenger traffic expressed in relation to the capacity offered (i.e. revenue passenger miles 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 on a particular flight (i.e. the number of revenue passengers) or its yield per revenue passenger mile (i.e. the average fare per mile paid by each passenger) then the passenger revenue per available seat mile (RASM) will increase leading to greater operating profitability on that flight. Depending on market conditions, airlines may periodically have a greater focus on improving load factor or yield, however the interaction of both these factors will determine RASM. The higher the RASM, the more revenue is generated by the airline for each available seat. The following describes these components of passenger revenue in Air Canada's markets.

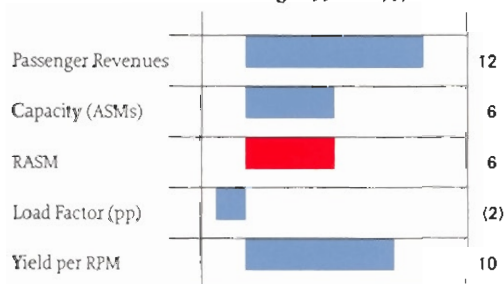
Domestic Performance

In the domestic market, passenger revenue increased 13 per cent on 6 per cent growth in ASM capacity. Domestic RASM increased 7 per cent as a result of load factor growth of 1 percentage point (pp) and a passenger yield per RPM increase of 5 per cent. The increase in passenger yield reflected fare increases introduced in 1998 and 1997, in part to recover higher Nav Canada fees, as well as greater use by business travellers of higher fare products.



Canada-US Transborder Performance

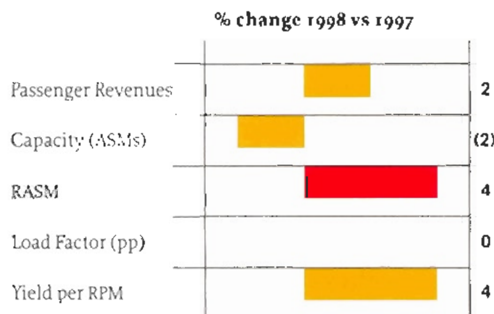
In the US transborder market, passenger revenues increased 12 per cent on ASM capacity growth of 6 per cent. Transborder RASM improved 6 per cent. Passenger yield per RPM increased 10 per cent but load factor fell 2 percentage points, as transborder traffic grew 2 per cent compared to the 6 per cent capacity increase. Passenger yield per RPM improved due to fare increases, increased traffic on shorter haul direct service routes, which cater to business travellers and have a higher yield, as well as an increase in the proportion of Executive Class and business travellers.



Other International Performance

Passenger revenues from other international services, which include Atlantic, Pacific and Caribbean markets, increased 2 per cent in 1998 on an ASM capacity reduction of 2 per cent. RASM was up 4 per cent reflecting a 4 per cent increase in yield and an unchanged load factor.

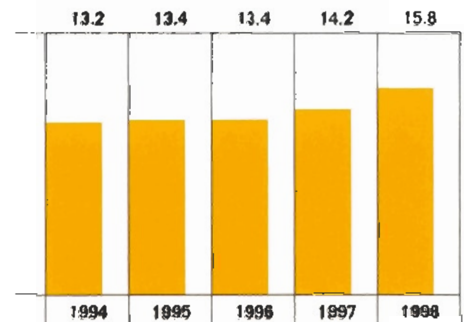
In Atlantic markets, RASM was 4 per cent higher due to a 4 per cent increase in yield reflecting, in part, stronger European currencies. In Pacific markets, which accounted for 3 per cent of total passenger revenues, RASM declined 6 per cent. While Pacific load factor improved marginally, yield per RPM declined 6 per cent due mainly to decreases on South Korea and Japan routes.



Operating Cost Performance

Operating expense rose $584 million or 11 per cent in 1998.

Unit costs, as measured by operating expense per ASM, increased 11 per cent, excluding subsidiaries. Unit costs rose mainly in relation to the higher airport and navigation fees (including Nav Canada fees), greater salary, wage and benefit expense, increased aircraft rent and depreciation expense, as well as higher aircraft material costs. These cost areas accounted for over 80 per cent of the unit cost increase. Adverse currency movements were also a component of the expense growth. Unit cost reductions occurred for fuel expense as compared to 1997, due to a fuel excise tax rebate repayment in 1997 and moderately lower prices in 1998, net of hedging and adverse currency fluctuations. Excluding pilot strikes, related capacity reductions and other non-recurring and significant items, unit cost would have been 6 per cent over 1997. Net of non-ASM producing revenues (cargo and other), operating expense per ASM increased 15 per cent to 13.0 cents per ASM, excluding subsidiaries and without adjustment for these items.



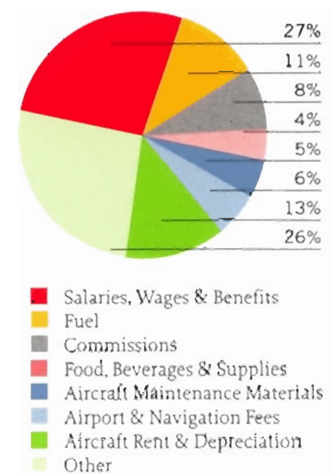
The following describes major cost changes in 1998:

Salaries and wages increased $127 million or 10 per cent due primarily to employee increases related to flight operations, maintenance, call centres, customer service and management/administrative functions. Excluding subsidiaries, average full-time employees increased 8 per cent and average salaries increased 2 per cent over 1997.

Employee benefits expense rose $57 million. This was due mainly to a $42 million increase to pension expense reflecting more normal expensing levels following the low level of pension expense incurred in 1997 due to favourable pension fund performance and revised management assumptions. Other employee benefits increased $15 million in relation to higher employee levels as well as greater benefit costs.

Aircraft fuel expense declined $55 million. Included in the prior year's fuel expense was a charge of $43 million for repayment of fuel excise tax rebates and reinstatement of tax losses. Excluding this charge, fuel expense declined $12 million. In 1997, the Corporation took a position on fuel hedging to lock in approximately one-half of its 1998 anticipated consumption at a crude oil price of approximately US$19 per barrel. As a result of major crude oil price declines in 1998, fuel hedge expense rose by $89 million offsetting a large part of the $118 million fuel expense reduction due to lower prices, net of an estimated $44 million of adverse foreign exchange. The average fuel cost per litre, excluding subsidiaries, decreased 4 per cent. Average available seat mile per litre of fuel consumed improved 1 per cent, excluding subsidiaries, reflecting greater fuel productivity mainly as a result of Air Canada's fleet modernization program.

1998
Consolidated operating expenses
% of total



Depreciation, amortization and obsolescence expense rose $34 million or 13 per cent, largely due to the ownership of additional Airbus A319 aircraft in 1998 as well as higher amortization of aircraft introductory and systems development costs.

Commission expense increased $26 million or 6 per cent on passenger and cargo revenue growth of 9 per cent. Commission expense as a proportion of revenue declined due largely to commission caps introduced in late 1997 and 1998.

Food, beverages and supplies expense was up $23 million or 10 per cent. Increased passenger volumes, higher prices for food services and product improvements, including improved video and in-cabin amenities on new aircraft, were the major factors.

Aircraft maintenance, materials and supplies expense rose $70 million or 28 per cent. Additional maintenance expenses were incurred on Airbus A320, Boeing 767 and other aircraft types. Subsidiary maintenance materials expense increased 23 per cent along with greater flying activity in 1998. Additional expense was also incurred on aircraft materials purchased in US dollars.

Airport and navigation fees recorded substantial growth of $147 million or 64 per cent. The largest factor was the introduction of Nav Canada fees which represented over $100 million of new expenses, as the Government of Canada phased out the Air Transportation Tax, previously paid by passengers. Airport fees at Toronto's Pearson International Airport rose by $40 million, while US FAA navigation fees were lower including a refund of fees previously paid.

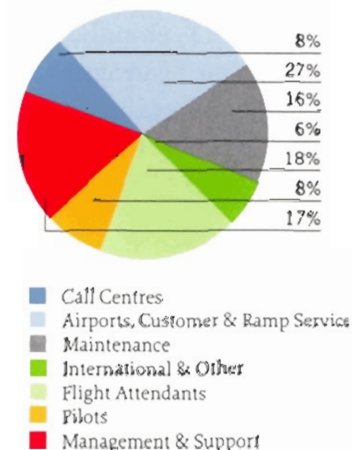
Aircraft rent increased $91 million or 24 per cent reflecting Air Canada's fleet modernization program. Higher costs were incurred as a result of the full year impact of 1997 aircraft leases of four new Airbus A340s and 17 Airbus A319s as well as leases on four Airbus A319 and one A340 aircraft received in 1998. The weaker Canadian dollar was also a factor for aircraft leases denominated in US dollars.

Customer maintenance materials expense decreased $29 million or 28 per cent and reflected reduced third party maintenance work.

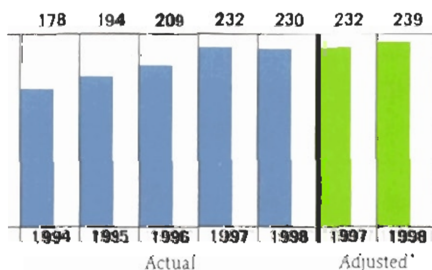
The "Other" expense category increased $93 million or 8 per cent. Air Canada expenses rose $159 million while subsidiary expenses declined $66 million due mainly to the sale of Galileo Canada in mid-1998 and declines for Regional Airlines, whose 1997 expenses had included costs of their first quarter pilot strike. Approximately $50 million of Air Canada's increased costs were for customer inconvenience charges related to the September pilot labour disruption and protection of passengers on other airlines. The remainder of the cost increases were due to higher expenses for information technology projects and services, including the Year 2000 project, as well as for higher advertising, communications, reservations, terminal handling services, facilities rent and other flying or revenue related expenses.

Productivity

In 1998, Air Canada had an average of 22,837 employees, measured on a full-time equivalent basis, excluding subsidiaries. This represented an increase of 8 per cent over 1997. Air Canada increased employees in 1998 mainly to improve the delivery of important customer service functions. Customer service personnel, including call centre and customer handling staff, flight attendants and pilots were added, together with maintenance and management/administrative employees. Focus on improved customer service, particularly for high value customers, is a continuing 1999 objective.



Employee productivity, as measured by operating revenue per employee declined 1 per cent from 1997 essentially due to the pilot strike. ASMs per employee declined 5 per cent. Excluding estimated labour disruption impacts, revenue per employee would have improved 3 per cent with ASMs per employee declining 2 per cent. Since 1993, operating revenue per employee has improved 43 per cent, on a cumulative basis, and ASMs per employee has improved 23 per cent.

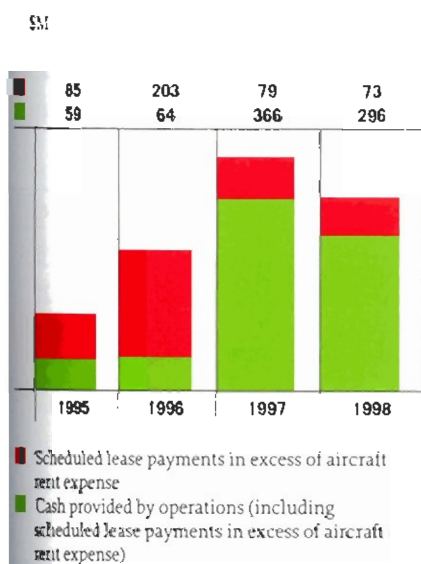


*Revenues and employee counts adjusted for estimated labour disruption impacts in 1997 and 1998.

Non-Operating Expense

Non-operating expense was $173 million compared to income of $98 million in 1997. The largest factor was a $206 million difference in gains on the sale of investments and other assets (1998 $30 million; 1997 $236 million). In 1998, Air Canada sold its interests in Galileo Canada and GPA Group plc for a gain of $57 million and recorded expense provisions of $34 million relating to the retirement of Boeing 747 aircraft. Net interest expense and foreign exchange amortization rose $57 million in 1998 due to currency fluctuations, lower capitalized interest amounts and higher debt levels.

Financial Management



Cash Generation

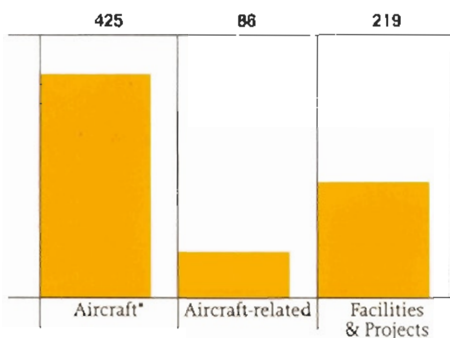
1998 cash provided by operations amounted to $296 million, a $70 million decline from 1997. Essentially all of the estimated $250 million lost operating income from the pilot strike was cash-related. Scheduled lease payments in excess of aircraft rent represent a negotiated outflow of operating cash 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 this amount, cash from operations amounted to $369 million in 1998 or $1.98 per share, fully diluted.

1998 Changes in Cash Position ($M)	Cash Outflows	Cash Inflows
Cash provided by Operations[1]		369
Scheduled Lease Payments in excess of Aircraft Rent Expense	(73)	
Reduction of Long-Term Debt	(95)	
Long-Term Borrowings		180
Proceeds from Sale of Investments and Other Assets		97
Additions to Property & Equipment[2]	(730)	
Other	(32)	
Net Decrease in Cash	(284)	

[1] Excludes scheduled lease payments in excess of aircraft rent expense.
[2] Net of progress payment refunds.

During 1998, Air Canada reduced long-term debt by $95 million and added $180 million of new debt. In early 1998, Air Canada issued Deutsche mark 200 million of seven year unsecured bonds at a coupon rate of 6 5/8 per cent. Proceeds from this transaction were used mainly to purchase Airbus A319 aircraft. In April 1998, the $250 million principal amount of the convertible unsecured subordinated debentures was converted into 31.2 million Class A non-voting shares.

1998 Capital expenditures
$M



*Net of progress payment refunds.

Sale of investments and other assets provided cash proceeds of $97 million, of which the sale of Galileo Canada represented $48 million and the sale of GPA Group plc represented $26 million. Proceeds from the sale of three Boeing 747-100 aircraft and four DC-9 aircraft were $17 million.

Additions to property and equipment of $730 million included $425 million for final payments to acquire eight Airbus A319 aircraft and two Canadair Regional Jets as well as progress payments on future Airbus A340/A330 deliveries. Refunds of progress payments on aircraft amounting to $74 million were netted against aircraft expenditures. This represented the return of progress payments made in prior years, upon completion of the lease financing of new aircraft.

Aircraft-related expenditures for inventory, spare engines, betterments and capitalized interest were $86 million. Facilities, ground equipment, computer systems and project development expenditures accounted for $219 million. Facilities expenditures included spending on the new Air Canada Centre in Toronto, the acquisition of an office building in Montréal and upgrades to airport facilities including Maple Leaf Lounges at key airports.

Liquidity

As at December 31, 1998, the Corporation had $366 million of cash and short-term investments. Together with available and undrawn lines of credit, this amounted to a liquidity position of $978 million. 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, 1998, Air Canada had other financing commitments amounting to over $1.7 billion related to the lease or debt financing of committed aircraft deliveries in the 1999 to 2002 period.

Operating Fleet

Air Canada's operating fleet, excluding subsidiary aircraft, as at December 31, 1998, is described below:

	Total Number of Aircraft[1]	Average Age of Aircraft (Years)	Owned	Operating Lease[2]	On Order[3]	Options[3]
Widebody Aircraft						
Airbus A340	9	2.1	–	9	7[4]	20
Airbus A330	–	–	–	–	6	10
Boeing 747 (400 series Combi)	3	7.5	–	3	–	–
Boeing 747 (200 series Combi)	3	21.7	3	–	–	–
Boeing 767 (300 series)	6	3.4	–	6	–	–
Boeing 767 (200 series)	23	13.7	13	10	–	–
Narrowbody Aircraft						
Airbus A320	34	7.2	21	13	–	–
Airbus A319	35	1.2	13	22	–	–
Douglas DC-9	19	29.0	19	–	–	–
Canadair Regional Jet	25	3.2	2	23	–	–
Total Aircraft	157	8.7	71	86	13	30

(1) Excludes five DC-9 aircraft which were retired from service and were available for sale as at December 31, 1998. Three Boeing 747-200s were retired from service in January 1999 and are available for sale.
(2) With the exception of three Airbus A340 aircraft, Air Canada retains a residual value interest in leased aircraft through purchase options.
(3) Does not include eight Airbus A330/A340 aircraft to which Air Canada is not committed under the third and final phase of its Airbus widebody fleet program.
(4) Does not include one Airbus A340 aircraft which will be delivered in February 1999 under a short term operating lease until 2001.

During 1998, Air Canada took delivery of 12 Airbus A319 aircraft, one Airbus A340 aircraft and one Canadair Regional Jet. As at December 31, 1998, the average age of Air Canada's operating fleet was 8.7 years (5.9 years excluding DC-9 aircraft).

As at December 31, 1998, Air Canada had 19 DC-9 aircraft in operation. Air Canada sold four DC-9 aircraft during 1998 and is planning to sell, subject to market conditions, up to eight additional DC-9 aircraft in 1999, of which five aircraft are out of service. Current plans call for the DC-9 operating fleet to be phased down to 16 aircraft by mid-1999. Air Canada also sold three Boeing 747-100 aircraft in 1998 and retired three Boeing 747-200 aircraft in January 1999 which are available for sale. Subject to market conditions, potential proceeds from the future sale of three Boeing 747-200 and eight DC-9 aircraft are estimated to be in the range of US$50 million.

Air Canada's entire operating fleet, except for the DC-9 aircraft, currently meets the Stage 3 noise regulations being implemented progressively in the United States and Canada. The final dates requiring all aircraft to be Stage 3 compliant are December 31, 1999 in the United States and April 1, 2002 in Canada. Should Air Canada decide to operate its remaining DC-9 aircraft beyond early 2002, the aircraft would require hushkitting.

As at December 31, 1998, the combined operating fleet of the Regional Airlines was comprised of 79 aircraft, of which approximately 72 per cent were owned. The de Havilland DHC-8 aircraft is the single largest fleet type by number, with 64 aircraft operated by the Regional Airlines. The next largest fleet type is the British Aerospace BAe146 jet aircraft with 10 operated.

Planned Capital Expenditures and Financing

The table below outlines Air Canada's committed purchases of new aircraft in the 1999 to 2002 period:

Aircraft Type	1999	2000	2001	2002
Airbus A340-300	2[1]	–	–	–
Airbus A340-500	–	–	–	2
Airbus A340-600	–	–	–	3
Airbus A330-300	2	2	2	–
Total	4	2	2	5

[1] Does not include one Airbus A340 aircraft which will be delivered in February 1999 under a short term operating lease until 2001

Air Canada has a purchase agreement with Airbus 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. The first phase of the program calls for the delivery of six twin-engine Airbus A330-300 aircraft and two four engine Airbus A340-300 aircraft in 1999 to 2001. The Corporation will use these aircraft and one short-term leased Airbus A340 as replacement capacity for six Boeing 747-100 and 200 aircraft which have been retired from service. These deliveries will also replace three Airbus A340 aircraft currently on short-term operating lease until 2000/2001. During 1998, Air Canada delayed the delivery of two Airbus A330 aircraft, originally scheduled to be delivered in 2000, to 2001.

In April 1998, Air Canada committed to the second phase of the program for the acquisition of two new generation Airbus A340-500 and three Airbus A340-600 aircraft in 2002. Air Canada will be the launch customer for the A340-500 and -600 series aircraft. The A340-500 aircraft, seating 308 passengers, will be the longest range airliner in the world capable of providing non-stop service on routes such as Toronto-Hong Kong on a year-round basis. The A340-600 version, seating 360 passengers, is designed for high density routes such as Toronto-London and Toronto-Frankfurt.

The widebody Airbus aircraft Air Canada is acquiring are expected to bring operational and maintenance cost savings, compared to other fleet types, through commonality with other Airbus aircraft already operated by the airline.

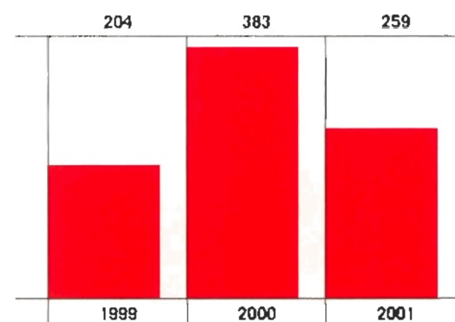
Air Canada's agreement with Airbus allows for commercial and financial flexibility for the airline. Air Canada may choose to reschedule certain deliveries or to expand further its widebody fleet in order to respond to market demand. Air Canada received a commitment for 85 per cent financing of the new Airbus A340-500/600 deliveries in 2002.

Air Canada does not currently plan, and is not committed, to proceed with the third and final phase of the program as structured, involving the acquisition of up to eight additional Airbus A340-300 and A330-300 aircraft, but will review its decision on an aircraft-by-aircraft basis prior to the required confirmation dates.

1999 to 2001 Capital Expenditures and Financing

The table below summarizes the Corporation's committed and planned capital expenditures, after committed aircraft financing for the 1999 to 2001 period.

Planned and committed capital expenditures, after committed financing
$M



($ millions)*	1999	2000	2001
Committed aircraft expenditures before committed financing	449	326	206
Committed aircraft financing	(519)	(238)	(244)
Net committed aircraft expenditures (proceeds) after financing	(70)	88	(38)
Planned expenditures for aircraft, engines, inventory, spare parts, modifications and refurbishments	116	135	135
Other planned or projected property and equipment expenditures	158	160	162
Planned and committed capital expenditures, after committed financing	204	383	259

*US dollar amounts are converted at the rate of CDN$1.53 per US dollar.

Committed aircraft expenditures before committed financing represent projected progress and final payments for committed purchases of Airbus A340-300 and A330-300 aircraft from 1999 to 2001 and progress payments for committed purchases of Airbus A340-500/600 aircraft in 2002, assuming that Air Canada purchases all aircraft prior to any lease financing arrangement.

Committed aircraft financing represents financing commitments for the same A340-300 and A330-300 aircraft deliveries in the 1999 to 2001 period. Financing commitments covering 100 per cent of the aircraft purchase price have been received covering all 1999 to 2001 Airbus aircraft deliveries. The financing amounts shown assume that the financing facilities are fully utilized under sale and leaseback arrangements. Subject to financial conditions, Air Canada may purchase rather than lease some of these aircraft.

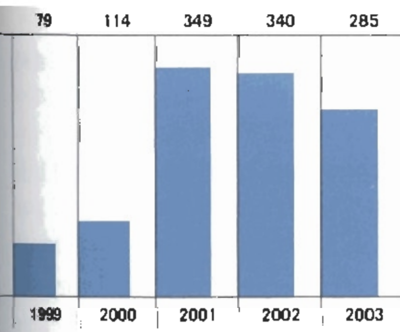
Net committed aircraft expenditures (proceeds) after financing amount to $88 million in 2000 with planned proceeds of $70 million and $38 million in 1999 and 2001 respectively. These proceeds represent, effectively, the return of a portion of aircraft progress payments made by Air Canada in prior years.

Planned expenditures for aircraft, engines, inventory and refurbishments include $44 million for the potential exercise of purchase options on two leased Boeing 767 aircraft in 2000. Subject to further review, Air Canada does not presently plan to install engine hushkits on its DC-9 fleet.

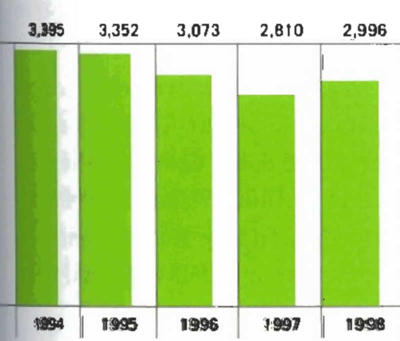
Other planned or projected property and equipment is for committed as well as planned and projected capital spending on information technology projects, airport improvements, ground equipment, facilities, buildings and expenditures by subsidiaries.

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



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



*Includes current portion of long-term debt.

The accompanying chart summarizes Air Canada's mandatory debt repayments for the years 1999 to 2003 at December 31, 1998.

At December 31, 1998, Air Canada had a US$400 million unsecured Revolving Term Credit Facility, from a group of Canadian banks, available until 2002 on a revolving basis and under which no amount had been drawn. This facility may be extended by one year on each anniversary date, subject to mutual consent of the parties. If not extended, the availability of funds under the facility declines until maturity.

In February 1999, Air Canada completed an issue in Canada of $175 million of 6.75 per cent senior unsecured debentures due 2004 for net proceeds of $171 million. Proceeds from the issue will be used to fund aircraft acquisitions and for general corporate purposes.

At year end 1998, 47 per cent of Air Canada's aircraft by number (excluding subsidiary aircraft) or 30 per cent by fair market value were owned and unencumbered. These aircraft represent a potential future source of financing through sale or sale and leaseback arrangements.

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 1998 Financial Statements, the future minimum lease payments under these operating leases amount to $3,712 million, of which $3,188 million relates to operating leases of aircraft. These contracts are 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 becomes operating expense for Air Canada. The operation of assets under operating leases is consistent with the commercial practice of airlines within the industry.

Risk Management

The Corporation periodically enters into interest rate hedging agreements to minimize the impact of changes in interest rates. Depending on market conditions and the Corporation's view of interest rate movements, part or all of the floating rate interest exposure could be fixed in the short-term or swapped to fixed rate for terms up to maturity. At December 31, 1998, US$391 million of debt was in floating rate US dollars. Approximately 44 per cent of the planned 1999 interest rate exposure on this floating rate debt was hedged with short-term interest rate contracts. A longer term interest rate agreement was also in place effectively converting the fixed interest rate exposure to floating for a small portion of the total US dollar debt. Additional floating interest rate exposure was created with the use of hedges whereby Air Canada receives a fixed interest rate in Deutsche marks in exchange for a floating interest rate in Canadian dollars, as well as Air Canada receiving a fixed interest rate in Canadian dollars in exchange for a floating interest rate in US dollars.

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, 1998, projected short-term investments and planned debt repayments, a one percentage point change in short-term interest rates would have an estimated $2.4 million impact on planned net interest expense in 1999.

Air Canada has also entered into interest rate swaps effectively fixing the next interest rate reset in late 1999 for two thirds of the principal amount of the yen perpetual debt at interest rates less than currently being paid.

Based on book value, the weighted average cost of Air Canada's long-term debt, subordinated perpetual debt and convertible debentures was 8.5 per cent in 1998, up from 7.7 per cent in 1997, including subsidiaries. The higher weighted average cost of debt reflects primarily increased interest expense caused by a weaker average Canadian dollar against US, Swiss and German currencies partially offset by a stronger average Canadian dollar against the Japanese yen during most of the year.

The Corporation also manages foreign exchange exposure through the use of options, forward contracts and cross-currency swaps. At December 31, 1998, 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 Canadian dollar debt into Japanese yen debt. At December 31, 1998, other than US dollar debt, only the principal amounts relating to 200 million of Swiss franc debt, 200 million Deutsche mark debt and 13 billion of Japanese yen notes and additional yen amounts under longer term swap arrangements were exposed to foreign exchange fluctuations. The principal amount of 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 is fully covered by surplus cash flows in European currencies, while yen denominated cash flow surpluses provide a natural hedge, to fully cover yen interest expense. Air Canada periodically sells forward surplus cash flows in foreign currencies as a means of hedging.

Air Canada has an ongoing operational requirement for US dollars to cover various expenses such as fuel, aircraft materials, interest and aircraft lease payments as well as debt repayments. 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, 1998, less than five per cent of the net projected operational requirements for US dollars in 1999 were covered by forward exchange contracts. With greater operations to the United States, Air Canada is generating increased US dollar cash flows to better cover these operational requirements.

A one cent improvement in the value of the Canadian dollar (compared to one US dollar) is estimated to increase planned operating income by approximately $2.7 million and reduce non operating expense by $2.6 million in 1999. Conversely, a one cent deterioration would generally have the opposite effect. A weakening Canadian dollar can potentially stimulate ticket sales and revenues from passengers in foreign countries, reducing this expected negative impact on operating results. A strengthening Canadian dollar can potentially stimulate ticket sales and travel from Canada.

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 well as reduce volatility in this expense category. As at December 31, 1998, the Corporation had effectively hedged 29 per cent of its anticipated 1999 equivalent fuel consumption through financial swap agreements (including range options) at an average effective fixed price of US$16.43 per barrel for West Texas Intermediate crude oil. Taking into account hedging as at December 31, 1998, a one US dollar per barrel movement in the price of crude oil could result in an approximate CDN$19 million change in annual operating expense, as compared to planned 1999 expense levels.

The Euro was launched on January 1, 1999 and became the legal currency for 11 participating countries in Europe including Germany and France. Air Canada has modified its sales, banking and accounting systems in order to handle transactions in this new currency.

Year 2000 Readiness

The Year 2000 issue refers to computerized systems not being able to use two digit year codes across the millennium change. Air Canada is an extensive user of information technology and its operations and business processes are highly dependent on these systems. As a result, Air Canada identified the critical nature of this issue and has been actively addressing it since 1996.

The Corporation is aware of the potential adverse impact that Year 2000 could have on its operations and financial performance and has a full time team of specialists dedicated to addressing the issue. The Corporation also has a senior management steering committee responsible for monitoring its Year 2000 project and reporting regularly on its progress to the Board of Directors.

Based on an applications inventory completed in 1996, approximately one quarter of Air Canada's business applications 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's business systems, were part of the Corporation's Year 2000 project with the mandate to modify these remaining systems. At the present time, this part of the project is over 95 per cent complete as the majority of computer applications have been modified and it is expected that the vast majority of computer modifications, including testing and implementation, will be concluded by the end of the first quarter of 1999. Air Canada is also proceeding, separately from the Year 2000 project, with the replacement of certain of its legacy systems (such as finance and payroll) with new Year 2000 compliant applications. Such replacement is planned for completion by the second quarter of 1999. Other areas being addressed include personal computers, properties and facilities computer systems embedded within facilities and equipment and all electronic interfaces to external businesses. These measures are also targeted to be completed, including testing and implementation, by the second 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. In that respect, upgrades to Air Canada's two data centres are over 95 per cent complete.

Air Canada is dependent on a number of business partners and suppliers in its ongoing operations. Air Canada has been actively 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 also 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, Air Canada incurred operating expenses of $5 million in 1997 for the Year 2000 project. Based on current information, additional costs charged to operating expense were $14 million in 1998 and will be an estimated $16 million in 1999. Capital expenditures for the project are currently estimated to be an additional $6 million, split equally between 1998 and 1999.

Air Canada's subsidiaries also plan to substantially complete their Year 2000 compliance activities by the second quarter of 1999. Air Canada provides its subsidiaries with a number of computer applications, covered by the Air Canada Year 2000 project. Costs for subsidiaries' Year 2000 compliance are included in the above estimates.

Air Canada is revising its business continuance plans to address internal and external issues specific to the Year 2000 problem. Such revisions are expected to be completed by June 1999. These plans are intended to enable Air Canada to continue to operate safely. They include performing certain processes manually, repairing or obtaining replacement systems, changing suppliers and adding supplementary staff in critical areas. Air Canada believes, however, that due to the widespread nature of potential Year 2000 issues, the contingency planning process is an ongoing one which will require further modifications as the Corporation obtains additional information.

Air Canada believes that, based on the current status of the project, completed and planned modifications and conversions of its internal mission critical systems and equipment will allow it to be Year 2000 compliant in a timely manner. The effects of the Year 2000 issue may be experienced before, on or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect Air Canada's ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 issue affecting Air Canada, including those related to business partners, suppliers or other third parties, will be fully resolved.

The preceding Year 2000 readiness disclosure contains forward-looking statements which represent Air Canada's beliefs or expectations regarding future events. They involve a number of risks and uncertainties that could cause the actual results to differ materially from the projected results. Factors that may cause these differences include, but are not limited to, the availability of qualified personnel and other information technology resources, the ability to identify and remediate all date sensitive lines of computer code as well as the actions of governmental agencies or other third parties with respect to Year 2000 problems.

Outlook

During the past five years, Air Canada has pursued a significant expansion strategy of its passenger operations with an average ASM capacity growth in excess of 10 per cent per year, particularly in key international markets (excluding the impact of the 1998 pilot strike). Due to slowing economic conditions and more moderate growth projections, Air Canada now plans to moderate growth in flying capacity for the coming years. This will be achieved through retiring older aircraft, by deferring the delivery of two Airbus A330 aircraft from 2000 to 2001 and by the planned return of several short-term leased Airbus A340 aircraft to the lessor upon expiry of the leases in 2000 and 2001.

In the fourth quarter of 1998, Air Canada sold three older Boeing 747-100 aircraft. In addition, three Boeing 747-200 aircraft were retired in January 1999, eliminating the Boeing 747-100/200 aircraft types from Air Canada's operating fleet. As well, during 1998, nine DC-9 aircraft were retired, of which four were sold. By the end of the second quarter of 1999, three additional DC-9 aircraft are planned to be withdrawn from operations.

These aircraft retirements are planned to reduce Air Canada's operating aircraft fleet from 166 aircraft in June 1998 down to 156 aircraft by December 1999. For 1999, the Corporation plans to reduce its total ASM capacity by approximately 1 per cent as compared to 1998, excluding the estimated pilot strike impact. Domestic ASM capacity is planned to remain at 1998 levels, excluding the estimated strike impact. International services, including US transborder routes, are expected to decline by approximately 2 per cent largely due to reduced Pacific and Atlantic ASM capacity. Expansion of US operations is expected to continue in 1999, but at a slower rate of growth than 1998. Air Canada maintains, however, the flexibility to add additional aircraft in order to respond to favourable market growth conditions in the future through aircraft purchase option agreements with Airbus Industrie ("Airbus"), short term aircraft lease arrangements and the ability to re-activate retired aircraft.

Air Canada will continue to pursue international expansion opportunities in conjunction with its Star Alliance partners through codeshare, joint venture or other commercial agreements. Air Canada's participation as a founding member of Star Alliance offers significant long-term potential to improve revenues and reduce costs. Star Alliance carriers had combined revenues of some US$46 billion in 1997 and carried over 190 million passengers. Star Alliance carriers currently serve over 630 cities across the globe in 110 countries. The alliance facilitates 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. Additionally, the carriers 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 1998, Air Canada's interline revenues from Star Alliance partners almost doubled to over $250 million and continued growth is expected in 1999.

In addition to Star Alliance, Air Canada extends its passenger network and services through joint marketing, codeshare or commercial arrangements with other airlines. Air Canada enters into discussions with other airlines, on an ongoing basis, to explore the possibility of establishing additional commercial arrangements to expand its network and improve service to its customers.

In February 1999, Air Canada confirmed that discussions were being held with WestJet Airlines, a regional airline operating in western Canada, regarding a potential limited commercial agreement between the two carriers. Should any commercial agreement be reached between the parties, details would be made available at that time.

In the latter part of 1997, a number of Asian countries experienced economic difficulties resulting in reduced economic growth and reductions in the value of their currencies. Air Canada has a limited exposure for its direct operations on the Pacific as this region represents 3 per cent of the Corporation's total passenger revenues. In 1998, Air Canada reduced capacity to South Korea by 50 per cent. Air Canada has aspirations to expand its operations in the major Pacific markets and believes that Asia has significant long-term profit potential. Subject to negotiation of final arrangements between Canada and Hong Kong and Canada and Taiwan, Air Canada plans to introduce additional service to Hong Kong and new services to Taipei later in 1999.

During the course of 1998, the Canadian dollar lost value compared to the currency of its major trading partner, the US, and traded in the range of $1.53 per US dollar at the end of December 1998. Should the Canadian dollar remain at this level throughout 1999, 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 $1.53 Canadian dollar to US exchange rate (as compared to the 1998 average of $1.48) is estimated to adversely affect planned 1999 pre tax income by approximately $26 million, excluding any change to passenger volumes and foreign sales as a result of changes in foreign exchange rates. Due to changing market conditions, it is not possible to predict currency movements and their effect on financial results.

Prices for West Texas Intermediate ("WTI") crude oil fell during 1998 to approximately US$12 a barrel in December, and averaged US$14.43 per barrel for the year, well below the US$21.21 experienced in 1997. Should the WTI price average US$13 a barrel for the year 1999, Air Canada could experience an over $80 million favourable effect on its fuel expense compared to the prior year, taking into account hedge positions as at December 31, 1998. Most of this reduction relates to lower fuel hedging expense due to a reduced volume of fuel hedged and more favourable hedge prices as compared to the prior year. Due to changing market conditions, however, there is no certainty that this level of saving will be realized.

In 1999, aircraft rent and aircraft depreciation expense is projected to increase by approximately $43 million due to new aircraft deliveries and the full year impact of aircraft purchased or leased in 1998. New generation aircraft have improved operating efficiencies in the form of better fuel consumption, lower maintenance expense and savings in other operating 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.

In 1999, Air Canada has three major Canadian labour agreements up for renewal. The agreement covering over 3,900 flight attendants (represented by the Canadian Union of Public Employees), which expired at the end of October 1998, is currently under negotiation. The current agreement covering approximately 3,800 customer sales and service employees (represented by the Canadian Auto Workers Union) is up for renewal at the end of March 1999. As well, the agreement covering approximately 7,500 maintenance, ramp, purchasing and cargo employees (represented by the International Association of Machinists and Aerospace Workers) is up for renewal in June 1999. Air Canada expects that, through the collective bargaining process, new labour agreements will be concluded with these employee groups during the course of 1999.

Labour agreements between three Regional Airlines (Air Nova, Air Alliance and AirBC) and their pilots (represented by the Air Line Pilots Association – Canada) are up for renewal having expired in the spring of 1998 and in December 1998. The parties are working on concluding mutually beneficial agreements in 1999 through the collective bargaining process.

In March 1998, Nav Canada, the corporation which operates the air navigation system in Canada, began to charge airlines fees for air navigation services covering operations to, from and within Canada. The Air Transportation Tax ("ATT"), previously paid by passengers and used by the Government of Canada to fund the air navigation system, was reduced by approximately one-half in March 1998, and subsequently eliminated in November 1998. From a reporting standpoint, Nav Canada fees became a direct operating cost for the airlines beginning in March 1998 and Air Canada's operating expenses and unit costs increased accordingly with the introduction of the new arrangements. In 1998, the Corporation's Nav Canada expenses increased over $100 million. Effective March 1, 1999, as a result of the earlier elimination of the remainder of the ATT, Nav Canada will increase charges to the airlines. For 1999, Air Canada's expenses related to Nav Canada are expected to be almost double the 1998 levels.

In 1998, Air Canada increased passenger fare levels commensurate with the reduction of the ATT, with the objective of recovering all or a substantial portion of the March 1998 Nav Canada charges. From the passenger's perspective, the ATT was reduced but fare levels increased by a similar amount. In late January 1999, Air Canada's main domestic competitor announced the introduction, beginning March 1999, of passenger surcharges to defray the cost of the new March 1, 1999 Nav Canada increase. In early February 1999, Air Canada announced that it would also introduce such a surcharge effective March 1, 1999.

In 1997, the Federal Aviation Administration of the United States ("FAA") commenced charging overflight fees for air navigation services for aircraft operating in US controlled domestic and oceanic airspace. The estimated cost to Air Canada of these overflight charges was approximately $8 million annually. A legal challenge was filed regarding the level of certain charges and, in January 1998, the United States Court of Appeal struck down these charges and all payments made for these services have since been refunded. The court ruled that while the FAA has the right to impose overflight charges on airlines for air navigation services, the FAA had used inappropriate pricing methodology. These charges could be reinstated by the FAA with revised pricing methodology in 1999.

For the past two years, Air Canada has been in active discussions with the Greater Toronto Airports Authority ("GTAA") regarding the planned expansion and development of Pearson International Airport, Air Canada's main hub airport. The GTAA is the corporation responsible for operating and developing airports in the Greater Toronto area. The GTAA has proposed a significant expansion plan to replace two of the three major terminals, including Air Canada's Terminal 2, and has introduced large increases to fees paid by Air Canada and other airlines. Air Canada agrees that redevelopment must occur but it is not in agreement with the GTAA regarding the scope of the Pearson redevelopment project, the projected on-going costs that it would be required to pay for such an expansion nor the commercial terms and conditions governing the relationship between the GTAA and Air Canada. In late January 1999, the GTAA announced that it had filed an application with the Ontario Court (General Division) requesting a declaration as to whether Air Canada is entitled to a new 40-year lease of Terminal 2 at Toronto's Pearson Airport pursuant to a 1989 document which set out "Guiding Principles" between Air Canada and Transport Canada. This application is ongoing.

Air Canada's passengers comprised almost one-half of all passengers at Pearson International Airport in 1997. Discussions are continuing with the GTAA with the objective of achieving an appropriate development plan and cost strategy acceptable to both parties.

Following the successful in-transit pre-clearance trial program which was implemented in 1997 at Vancouver airport, the US and Canadian governments announced their agreement in early December 1998 to expand the program to other airports in Canada. In-transit pre-clearance facilitates travel through Canada for US bound overseas travellers and will be introduced gradually at other Canadian airports equipped for customs and immigration pre-clearance to the United States in 1999 once the necessary legislation is passed in Canada. Air Canada stands to benefit from the implementation of the simplified one-stop inspection process as it removes the disincentive of having to clear Canadian customs when connecting through a Canadian gateway.

Over the past two years, Air Canada has invested in technology initiatives to improve customer service and operational/cost performance. Many of these investments have reached the implementation phase or are soon to be implemented including product distribution initiatives (such as Internet and direct access booking products), airport processing and handling systems, improved Origin and Destination yield management systems, as well as new scheduling, financial and human resources systems. Over the next three years, Air Canada plans to invest over $200 million in technology. These technology investments will contribute to improving revenue, cost and productivity performance in the coming years.

In the course of 1997 and 1998, Air Canada was faced with a rate of expense growth greater than its available seat mile ("ASM") capacity increase. In order to assist in benchmarking Air Canada's revenue, cost, productivity and operational processes against other airlines' best practices, external consultants have been engaged to review all of Air Canada's major operating areas, including technical operations, for completion in the first quarter of 1999. One of the Corporation's major priorities is to achieve and maintain a unit revenue and cost profile which is competitive with major US air carriers. With the recently announced profitability initiatives, Air Canada will increase its focus on measures to improve revenue generation, productivity and on expense reduction initiatives including fleet utilization, reductions to distribution costs through direct access products, improved airport, call centre and customer service processes and reduced costs through Star Alliance, improved purchasing, inventory and other measures. However, with reduced ASM capacity, the projected increase to airport and navigation fees, including Nav Canada charges, and mandatory growth in other expense areas, Air Canada expects a 2 per cent increase to its average unit cost per ASM for 1999, excluding subsidiaries, as compared to 1998 (7 per cent excluding the estimated 1998 pilot strike impact).

The airline industry is subject to a number of influences over which it has limited or no control including economic conditions and fuel prices, as well as regulatory and political events. Economic conditions in Canada are expected to remain reasonably favourable in 1999. 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 1999. Passenger traffic and yields have shown improvement in 1998, 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 is working towards completing structural and other changes in the next three years aimed at improving all aspects of its business including cost performance, operational processes, customer service, products, network and fleet utilization with the objective of increasing operating profitability and cash flow to enhance shareholder value in 1999 and subsequent years.

This discussion contains certain forward-looking statements, which involve a number of risks and uncertainties. As a result of many factors including fuel prices, the economic environment, interest rates, foreign exchange rates, Year 2000 compliance activities by Air Canada, governments and suppliers, the airline pricing environment, industry capacity decisions, new entrants and external events, actual results could differ from expected results and the differences could be material.

Management's Report

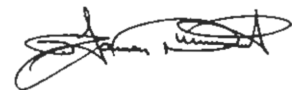
The consolidated financial statements contained in this annual report have been prepared by management in accordance with generally accepted accounting principles and the integrity and objectivity of the data in these financial statements are management's responsibility. Management is also responsible 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, PricewaterhouseCoopers, 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, 1998 and 1997 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, 1998 and 1997 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.

PricewaterhouseCoopers LLP

Chartered Accountants
Montréal, Québec
January 27, 1999

Consolidated Statement of Operations and Retained Earnings
(in millions except per share figures)

Year ended December 31	1998	1997
Operating revenues		
Passenger	$ 4,977	$ 4,533
Cargo	369	387
Other	586	652
	5,932	5,572
Operating expenses		
Salaries and wages	1,363	1,236
Benefits	210	153
Aircraft fuel	657	712
Depreciation, amortization and obsolescence	292	258
Commissions	464	438
Food, beverages and supplies	252	229
Aircraft maintenance, materials and supplies	318	248
Airport and navigation fees	375	228
Aircraft rent	474	383
Customer maintenance materials	76	105
Other (note 1j)	1,307	1,214
	5,788	5,204
Operating income	144	368
Non-operating income (expense)		
Interest income	41	26
Interest expense	(242)	(203)
Interest capitalized	22	43
Amortization of deferred foreign exchange on long-term debt	(32)	(20)
Gain on sale of investments (notes 1a & 4)	57	201
Gain (loss) on sale of other assets	(27)	35
Other	8	16
	(173)	98
Income (loss) before income taxes	(29)	466
Recovery of (provision for) income tax (note 10)	3	(207)
Recovery of prior years income tax benefits previously not recorded (note 10)	10	168
Income (loss) for the year	(16)	427
Retained earnings (deficit), beginning of year	171	(257)
Charge relating to convertible debentures (note 8)	(3)	1
Retained earnings, end of year	$ 152	$ 171
Earnings per share		
– Basic	$ (0.10)	$ 2.74
– Fully diluted	$ (0.10)	$ 2.37

See accompanying notes.

Consolidated Statement of Financial Position
(in millions)

December 31		1998		1997
Assets				
Current				
Cash and short-term investments (note 1d)	$	366	$	650
Accounts receivable		405		467
Spare parts, materials and supplies		258		225
Prepaid expenses		21		17
Deferred income taxes		42		35
		1,092		1,394
Property and equipment (note 2)		3,243		2,817
Deferred charges (note 3)		1,722		1,456
Investments and other assets (note 4)		365		324
	$	6,422	$	5,991
Liabilities				
Current				
Accounts payable and accrued liabilities	$	840	$	668
Advance ticket sales		360		400
Current portion of long-term debt		79		71
		1,279		1,139
Long-term and subordinated perpetual debt (note 5)		2,917		2,739
Other long-term liabilities		279		218
Deferred credits (note 7)		490		460
		4,965		4,556
Shareholders' Equity				
Convertible debentures (note 8)		–		201
Share capital (note 9)		1,305		1,063
Retained earnings		152		171
		1,457		1,435
	$	6,422	$	5,991

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	1998	1997
Cash provided by (used for)		
Operating		
Income (loss) for the year	$ (16)	$ 427
Adjustments to reconcile to net cash provided by operations		
Depreciation, amortization and obsolescence	292	258
Gain on sale of investments (notes 1a & 4)	(57)	(201)
(Gain) loss on sale of other assets	27	(35)
Deferred income taxes	(23)	17
Deferred pension expense	34	(38)
Amortization of deferred foreign exchange	32	20
Amortization of deferred gains	(16)	(20)
(Increase) decrease in accounts receivable	62	(80)
Increase in spare parts, materials and supplies	(46)	(38)
Increase in accounts payable and accrued liabilities	172	53
Increase (decrease) in advance ticket sales	(40)	130
Aircraft lease payments in excess of rent expense	(73)	(79)
Other	(52)	(48)
	296	366
Financing		
Issue of share capital	1	7
Reduction of long-term debt	(95)	(482)
Long-term borrowings	180	235
Other	(26)	(26)
	60	(266)
Investing		
Proceeds from sale and leaseback of assets	–	137
Proceeds from sale of investments and other assets	97	375
Additions to property and equipment (net of recovered progress payments)	(730)	(439)
Investments and advances	(7)	22
	(640)	95
Increase (decrease) in cash position	(284)	195
Cash position, beginning of year	650	455
Cash position, end of year	$ 366	$ 650
Cash flow per share from operations		
Basic	$ 1.66	$ 2.34
Fully diluted	$ 1.59	$ 2.04

See accompanying notes.

Notes to Consolidated Financial Statements
(currencies in millions)

1. Significant Accounting Policies

Nature of Operations
Air Canada is a Canadian based domestic and international air carrier providing air transportation for passengers and cargo. The Corporation's airline route network, together with those of its regional airline subsidiaries, offers air transportation services on routes authorized by the Government of Canada and the foreign governments concerned. The Corporation operates its own scheduled service to 50 cities in Canada and serves an additional 29 Canadian communities through commercial arrangements with other affiliated regional carriers. Internationally, Air Canada operates its own scheduled service to 41 cities in the United States and 22 cities in Europe, Asia, the Middle East and the Caribbean. Charter passenger services are also provided to three international destinations on a seasonal basis. With Air Canada's strategic alliance and commercial partnerships currently in effect, scheduled and charter air transportation is offered to over 640 destinations in more than 110 countries. Air transportation and related revenues represent over 95% of consolidated operating revenues.

The Corporation provides aircraft and engine maintenance, 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.) and a tour operator, Air Canada Vacations (Touram Inc.), all of which are wholly-owned operating subsidiaries. In 1998, the Corporation sold its 100% interest in the previously consolidated Galileo Canada Distribution Systems Inc. for proceeds of $48 and a gain of $31.

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 $295 (1997 $611). All short-term investments may be liquidated promptly and have maturities of less than one year.

1. Significant Accounting Policies (cont'd)

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.

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			
A319-113	15%	15%	20 years
A320-211	15%	15%	20 years
Boeing 747-233B	38%*	10%	to December, 1998
Boeing 767-233	15%	15%	20 years
Canadair Regional Jet	15%	10%	20 years
DC-9-32	33%*	10%	to March, 2002
Subsidiaries			
Various	15-20%	15-20%	12-20 years

*Expected fair market value approximates or exceeds residual value.

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.

1. Significant Accounting Policies (cont'd)

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.

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

	1998	1997
Cost:		
Flight equipment	$ 3,430	$ 3,130
Other property and equipment	1,377	1,239
	4,807	4,369
Accumulated depreciation and amortization:		
Flight equipment	1,124	1,071
Other property and equipment	801	774
	1,925	1,845
	2,882	2,524
Progress payments	361	293
Property and equipment at net book value	$ 3,243	$ 2,817

2. Property and Equipment (cont'd)

Interest capitalized during the year amounted to $22 using an average interest rate of 7.75% (1997 $43 at 8.0%).

In 1998, flight equipment included five DC-9 aircraft retired from active service with a net book value of $10. In addition, three B747-200 aircraft with a net book value of $54 were retired in January 1999.

3. Deferred Charges

		1998		1997
Employer pension plan funding in excess of pension expense	$	495	$	502
Foreign currency exchange on long-term debt		288		155
Aircraft lease payments in excess of rent expense		799		659
Financing costs		83		79
Aircraft introduction costs		29		41
Other		28		20
Deferred charges	$	1,722	$	1,456

4. Investments and Other Assets

		1998		1997
Security and other deposits	$	211	$	174
Notes receivable		97		74
Goodwill, net of amortization		39		42
Partnership interests in international computer reservation systems		3		2
Other		15		32
Investments and other assets	$	365	$	324

During the year, the Corporation sold its common shareholding of GPA Group plc, which had been carried at a nominal amount, for proceeds of $26.

Included in other assets are 1.3 million shares in Equant N.V., previously known as SITA Telecommunications Holdings N.V., which are carried at a nominal amount and have a quoted market value of $139 as at December 31, 1998. After June 2000, the Corporation has the right to sell this holding and prior to this date any sale is subject to certain constraints. A registration statement filed in January 1999 with the Securities and Exchange Commission may provide Air Canada with the opportunity to sell up to 50% of its holding in 1999.

Notes receivable bear interest at a weighted average rate of 11.8% and mature 1999 through 2010. The carrying value of notes receivable approximates fair value.

5. Long-term and Subordinated Perpetual Debt

	Final Maturity	Interest Rate (%)	1998	1997
U.S. dollar debt (a)	1999-2008	6.0 – 8.7	$ 904	$ 867
Canadian dollar debt (b)	1999-2007	7.25 – 12.1	389	422
Swiss franc debt (c)	2002	5.1	207	182
Deutsche mark debt (d)	2001-2005	6.6 – 7.1	391	207
Japanese yen notes (e)	2007	5.8	174	156
			2,065	1,834
Subordinated perpetual debt (Note 6)			931	931
Long-term debt portion of convertible debentures (Note 8)			-	45
			2,996	2,810
Current portion of long-term debt			(79)	(71)
Long-term and subordinated perpetual debt			$ 2,917	$ 2,739

All debt is unsecured by the assets of the Corporation with the exception of subsidiaries' debt totalling $159 (1997 $192) which is secured by certain of their assets.

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

1999	2000	2001	2002	2003
$ 79	$ 114	$ 349	$ 340	$ 285

As at December 31, 1998, 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 2002 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, 1998, U.S. dollar debt totalled U.S. $591, of which U.S. $391 is at floating interest rates based on U.S. dollar LIBOR. Approximately 44% of the 1999 interest rate exposure on the floating rate U.S. dollar debt is hedged by short-term interest rate contracts. Of the U.S. $591 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. $225 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. $76 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 whereby 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 whereby the Corporation owes, on a compounded basis, a floating rate of interest.

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

5. Long-term and Subordinated Perpetual Debt (cont'd)

b) Canadian dollar debt is comprised of $230 debentures maturing in 2007 and various other subsidiary debt totalling $159. The debentures are redeemable by the Corporation in whole or in part at any time, with an indemnity.

A hedge exists with a credit worthy counterparty related to the long-term debt above and is comprised of a swap whereby 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 CDN $239 with a fixed rate of interest.

In January 1999 the Corporation finalized a prospectus to issue, in February 1999, CDN $175 6.75% debentures which have a final maturity in 2004.

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 totalled DEM 450 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:
  - 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.
- 200 Deutsche mark 6.6 % fixed rate bonds maturing in 2005.

e) Japanese yen debt is comprised of 12,857 Japanese yen notes. These will be repaid in 18 equal semi-annual instalments ending October 2007. The interest rate on the notes will be reset in 2002 based on interest rate indices. Two thirds of these notes may be called by the Corporation at par on any interest payment date. If the Corporation were to default on its obligations and the debt became payable prior to maturity, one third of the debt amount outstanding would be payable in U.S. dollars at a predetermined foreign exchange rate.

6. Subordinated Perpetual Debt

	1998	1997
60,000 Japanese yen at 5.30% until 1999, callable in 1999 and every fifth year thereafter at par (a)	$ 813	$ 657
300 Swiss francs at 6.25%, callable in 2001 and every fifth year thereafter at 102% of par	334	293
200 Swiss francs at 5.75%, callable at 101.5% of par in 1999 and every fifth year thereafter at 102% of par	223	196
200 Deutsche marks at 4.625% until 2000, callable in 2000 and every third year thereafter at par (b)	184	159
Subordinated perpetual debt, at year-end foreign exchange rates	1,554	1,305
Less foreign exchange	(623)	(374)
Subordinated perpetual debt	$ 931	$ 931

6. Subordinated Perpetual Debt (cont'd)

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. 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, 1998 the foreign exchange fluctuation related to 60,000 Japanese yen is $315 (1997 $159), 500 Swiss francs is $221 (1997 $153), and 200 Deutsche marks is $87 (1997 $62).

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 two thirds 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**

		1998		1997
Gain on sale and leaseback of assets	$	140	$	156
Aircraft rent expense in excess of lease payments		272		220
Income taxes		55		71
Other		23		13
Deferred credits	$	490	$	460

8. **Convertible Debentures**

In April, 1998, the Corporation's $250 principal amount of the convertible unsecured subordinated debentures was converted through the issuance of 31.2 million Class A non-voting shares.

A portion of convertible debentures, $45 in 1997, representing the present value of interest payments on the debentures to April 2000 had been classified as long-term debt. Prior to the conversion, this amount was declining to zero over the period to April 2000, and was being offset by an increase in convertible debentures classified as Shareholders' Equity. This charge to Shareholders' Equity in 1998, prior to the conversion, was $5 less income taxes of $2 for a net debit of $3 and in 1997 was $15 less income taxes of $6 and a $10 recovery of prior years income tax benefits previously not recorded for a net credit of $1.

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 per cent and 25 per cent respectively, including associates of such shareholders.

9. Share Capital (cont'd)

The issued capital consists of common shares and Class A non-voting common shares, and the changes during 1997 and 1998 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, 1996	119,802,742	$ 816	35,778,827	$ 240
Share purchase options exercised	260,276	2	879,558	5
Share Appreciation Rights Plan	–	–	17,375	–
December 31, 1997	120,063,018	818	36,675,760	245
Share purchase options exercised	159,800	1	31,198	–
Debenture Conversions (Note 8)	–	–	31,206,770	241
December 31, 1998	120,222,818	$ 819	67,913,728	$ 486

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
1991	1,758	$9.13	–	–
1992	2,889	$5.55	–	–
1993	36,142	$2.79	7,882	$2.79
1994	82,455	$6.42-$6.56	58,541	$6.42-$6.70
1995	136,509	$5.05-$7.89	39,665	$7.88
1996	364,709	$4.73-$4.94	317,068	$4.17-$4.64
1997	369,364	$7.77	183,101	$7.32
1998	443,652	$12.78	218,660	$11.64-$12.49
	1,437,478		824,917	

All 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.

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:

	1998	1997
Provision based on combined federal and provincial tax rates	**$ (12)**	$ 189
Non-taxable portion of capital gains	**(5)**	(19)
Large corporations tax	**7**	6
Non-deductible expenses	**10**	29
Other	**(3)**	2
	$ (3)	$ 207
Current	**$ 20**	$ 205
Deferred	**(23)**	2
Income tax provision (recovery)	**$ (3)**	$ 207

10. Income Taxes (cont'd)

In 1998, a subsidiary reinstated $21 of federal income tax losses, representing $10 of income tax benefits, by repaying the Canadian government the net balance of fuel tax rebates received in 1997 in the amount of $2.

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, 1998, accumulated unrecognized income tax benefits amount to $10.

11. Commitments

The Corporation has commitments to purchase, along with spare engines, six Airbus A330 and two Airbus A340-300 in 1999 to 2001 and two Airbus A340-500 and three Airbus A340-600 in 2002. The remaining payments of U.S. $1,093 are payable as follows:

		U.S.
1999	$	309
2000	$	222
2001	$	135
2002	$	427

The Corporation has received financing commitments for 100% of the 1999 to 2001 aircraft deliveries and up to 85% of the 2002 aircraft deliveries.

Other commitments for property, ground equipment and spare parts, amount to approximately $93.

Future minimum lease payments under operating leases of aircraft and other property total $3,712 and are payable as follows:

		Operating Leases of Aircraft		Operating Leases of Other Property
1999	$	616	$	76
2000		566		65
2001		534		53
2002		488		49
2003		477		47
Remaining years		507		234
	$	3,188	$	524

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 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, 1998 of $2 in favour of Air Canada (1997 $7 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. As at December 31, 1998, the estimated present value of the accrued pension benefits totalled $4,380, based upon the latest actuarial reports prepared using management's assumptions (all reports as at December 31, 1997 except the U.K. plan which is at December 31, 1996). The net assets of these plans totalled $4,857, 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, 1998 was $59 (1997 $80) in favour of counterparties and $12 (1997 $4) in favour of the Corporation, 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, 1998 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, 1998 the aggregate face amount of such contracts was approximately $69 (1997 $161). The related realized and unrealized gains and losses for such contracts at December 31, 1998 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, 1998 was $31 (1997 $19) in favour of the Corporation and $21 (1997 $6) in favour of counterparties.

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, 1998 the Corporation had effectively hedged approximately 29% of its projected 1999 fuel requirements. As at December 31, 1998 the fair value of fuel contracts was $27 (1997 $10) in favour of the counterparties.

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 debt, including the current portion, is based on rates currently available to the Corporation for debt with similar terms and maturities. The fair value of subordinated perpetual debt is calculated assuming the debt has no maturity date and using an estimated rate based on current interest rates. Management believes at the present time there is no market for new perpetual debt issues and the fair value of the perpetual debt as calculated does not reflect any premium or discount that may be realized if the perpetual debt was traded in an open market. The fair value of long-term and subordinated perpetual debt as at December 31, 1998 was $3,526 (1997 $3,165) compared with carrying values, net of deferred foreign currency exchange, of $2,708 (1997 $2,655).

14. Contingencies

Various lawsuits and claims are pending by and against the Corporation and provisions have been included in current liabilities where appropriate. 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, 1998 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 1989 and 1990, the Corporation concluded agreements with a substantial U.S. financial institution whereby, upon payment by the Corporation, the financial institution assumed liability for scheduled payments relating to certain long-term obligations in amounts of $107 in 1989 and $98 in 1990 and interest thereon. These obligations (which amount to $81 and $72 respectively at December 31, 1998) 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. Segment Information

The Corporation operates in one business segment, air transportation and related services. The services within that segment are as follows:

		1998	1997
Transportation Revenue:			
Domestic			
Air Canada:	Passenger	$ 1,810	$ 1,616
	Cargo	92	97
Regional Airlines:	Passenger	484	415
	Cargo	12	19
		2,398	2,147
Canada US Transborder			
Air Canada:	Passenger	1,304	1,161
	Cargo	36	35
Regional Airlines:	Passenger	122	107
	Cargo	1	1
		1,463	1,304
Other International			
Air Canada:	Passenger	1,257	1,234
	Cargo	228	235
		1,485	1,469
Total transportation revenue		5,346	4,920
Non-transportation revenue		586	652
Total revenues		$ 5,932	$ 5,572

For passenger and cargo, the allocation to service is determined based on flight destination. Other revenues are almost exclusively attributable to Canada.

Property and Equipment:
Air Canada is a Canadian based domestic and international carrier and while the Corporation's flight equipment is used on various routes internationally, for purposes of segment reporting, the Corporation attributes the location of flight equipment to Canada. As a consequence, substantially all of the Corporation's property and equipment and goodwill is related to operations in Canada.

16. Uncertainty Due to the Year 2000 Issue

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect an entity's ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 Issue affecting the entity, including those related to the efforts of customers, suppliers, or other third parties, will be fully resolved.

17. 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.

	1998	1997
Income Adjustments		
Income (loss) for the year in accordance with Canadian GAAP	$ (16)	$ 427
Convertible debentures (1)	(5)	(15)
Unrealized foreign exchange gain (loss) on translation of:		
Long-term debt with principal repayment requirements (2)	(133)	29
Subordinated perpetual debt (3)	(249)	94
Pension costs (4)	(2)	(22)
Post-retirement benefit costs other than pension (5)	(19)	(17)
Income tax recovery (provision) (6)	85	(51)
Current year income adjustments	(323)	18
Income (loss) for the year in accordance with U.S. GAAP	(339)	445
Minimum pension liability adjustment (4)	(22)	(8)
Comprehensive income (loss) for the year in accordance with U.S. GAAP (10)	$ (361)	$ 437
Financial Position Adjustments		
Cash and short-term investments:		
Balance under Canadian GAAP	$ 366	$ 650
Reclassification of short-term investments with maturities greater than three months (8)	(13)	–
Balance under U.S. GAAP	$ 353	$ 650
Short-term investments:		
Balance under Canadian GAAP	$ –	$ –
Reclassification of short-term investments with maturities greater than three months (8)	13	–
Balance under U.S. GAAP	$ 13	$ –
Investments and other assets:		
Balance under Canadian GAAP	$ 365	$ 324
Deferred income taxes (6)	360	261
Balance under U.S. GAAP	$ 725	$ 585
Deferred charges:		
Balance under Canadian GAAP	$ 1,722	$ 1,456
Adjustment for foreign currency exchange on long-term debt (2)	(288)	(155)
Adjustment for pension costs (4)	81	92
Balance under U.S. GAAP	$ 1,515	$ 1,393

17. United States Generally Accepted Accounting Principles (cont'd)

	1998	1997
Long-term and subordinated perpetual debt:		
Balance under Canadian GAAP	$ 2,917	$ 2,739
Reclassification of convertible debentures (1)	–	201
Foreign exchange on subordinated perpetual debt (3)	623	374
Balance under U.S. GAAP	$ 3,540	$ 3,314
Other long-term liabilities:		
Balance under Canadian GAAP	$ 279	$ 218
Adjustment for pension costs (4)	133	119
Adjustment for post-retirement benefit costs (5)	284	265
Balance under U.S. GAAP	$ 696	$ 602
Shareholders' equity:		
Balance under Canadian GAAP	$ 1,457	$ 1,435
Reclassification of convertible debentures	–	(201)
Charge relating to convertible debentures	5	15
Tax effect of charge relating to convertible debentures	(2)	(16)
Current year income adjustments	(323)	18
Current year adjustment for available-for-sale securities	–	(119)
Current year retained earnings adjustments for pension costs	(22)	(8)
Cumulative prior year adjustments for:		
Foreign currency exchange:		
Subordinated perpetual debt	(374)	(468)
Long-term debt	(155)	(184)
Pension costs	(12)	10
Post-retirement costs	(265)	(248)
Available-for-sale securities	–	119
Deferred income tax	261	321
Balance under U.S. GAAP	$ 570	$ 674

(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.

(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.

(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, the amortization of changes in assumptions and experience gains and losses and for U.S. GAAP reporting the recognition of a minimum pension liability adjustment. 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.

17. United States Generally Accepted Accounting Principles (cont'd)

(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 178,681,905 (1997 156,030,221) and dilutive potential common shares of 188,482,925 (1997 188,326,269).

	1998	1997
Earnings (loss) per common share	$ (1.90)	$ 2.85
Earnings (loss) per common share assuming dilution	$ (1.90)	$ 2.47

(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 used for investing activities of $13 (1997 provided by $8).

(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.

(10) Under U.S. GAAP, comprehensive income must be reported which is defined as all changes in equity other than those resulting from investments by owners and distributions to owners.

(11) Recent U.S. accounting pronouncements include Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, and 98-5, Reporting the Cost of Start-up Activities, which are both effective for the Corporation's December 31, 1999 year-end, and Financial Accounting Standard 133, Accounting for Derivative Instruments and Hedging Activities, which is effective for the Corporation's December 31, 2000 year-end. The impact of the new rules on the Corporation's net income and financial position for U.S. GAAP reporting purposes has not yet been determined.

Ten Year Comparative Review

Financial data – consolidated ($ millions)	1998	1997	1996
Operating revenues:			
Passenger	**4,977**	4,533	3,980
Cargo	**369**	387	347
Other	**586**	652	553
	5,932	5,572	4,880
Operating expenses:			
Salaries, wages and benefits	**1,573**	1,389	1,331
Aircraft fuel[1]	**657**	712	640
Depreciation, amortization and obsolescence	**292**	258	258
Aircraft rent	**474**	383	319
Other	**2,792**	2,462	2,117
	5,788	5,204	4,665
Operating income (loss) before the undernoted item	**144**	368	215
Staff reduction and retirement costs	**–**	–	–
Operating income (loss)	**144**	368	215
Non-operating income (expense):			
Net interest expense	**(179)**	(134)	(157)
Amortization of deferred foreign exchange	**(32)**	(20)	(46)
Gain on sale of investments	**57**	201	129
Provision for investments and writedown of goodwill	**–**	–	–
Gain (loss) on sale of other assets	**(27)**	35	4
Other	**8**	16	8
Total non-operating income (expense)	**(173)**	98	(62)
Income (loss) before income taxes and minority interest	**(29)**	466	153
Recovery of (provision for) income taxes	**13**	(39)	(4)
Minority interest	**–**	–	–
Income (loss) from continuing operations	**(16)**	427	149
enRoute Card discontinued operations	**–**	–	–
Income (loss) for the year	**(16)**	427	149
Cash provided by (used for):			
Operating	**296**	366	64
Financing	**60**	(266)	(218)
Investing	**(640)**	95	(166)
Increase (decrease) in cash position	**(284)**	195	(320)
Cash position, end of year	**366**	650	455
Operating margin before provision for staff reduction and retirement costs	**2.4%**	6.6%	4.4%
EBITDAR[2]	**910**	1,009	792
EBITDAR margin	**15.3%**	18.1%	16.2%
Current ratio	**0.85**	1.22	0.95
Total assets	**6,422**	5,991	5,441
Long-term debt (including current portion)	**2,065**	1,879	2,142
Subordinated perpetual debt	**931**	931	931
Shareholders' equity	**1,457**	1,435	985
Debt (excluding perpetual debt) to debt plus equity	**46%**	44%	53%
Earnings (loss) per share[3]	**$ (0.10)**	$ 2.37	$ 0.82
Cash flow from operations per share[3]	**$ 1.59**	$ 2.04	$ 0.41
Book value per share	**$ 7.75**	$ 9.15	$ 6.33
Average common shares outstanding (millions)[3]	**190.3**	189.1	189.1
Return on equity	**(1.1)%**	35.7%	16.9%

(1) Includes fuel excise tax rebates of $46 million in 1998 and $2 million in 1997, repayments of fuel excise tax rebates of $43 million in 1997 and $2 million in 1998.

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

(3) Fully diluted.

1995	1994	1993	1992	1991	1990	1989
3,581	3,172	2,849	2,813	2,815	3,103	2,884
323	334	335	342	354	413	398
603	518	414	346	316	383	336
4,507	4,024	3,598	3,501	3,485	3,899	3,618
1,252	1,167	1,122	1,188	1,199	1,230	1,131
527	474	397	472	515	637	539
216	206	219	206	190	170	150
292	230	214	164	156	136	120
1,945	1,703	1,569	1,616	1,589	1,676	1,559
4,232	3,780	3,521	3,646	3,649	3,849	3,499
275	244	77	(145)	(164)	50	119
–	–	(76)	(52)	(36)	(61)	(16)
275	244	1	(197)	(200)	(11)	103
(201)	(185)	(191)	(190)	(126)	(49)	(52)
(69)	(67)	(34)	(17)	(5)	(6)	(3)
57	66	–	–	–	7	193
–	–	(111)	(15)	(17)	(11)	(57)
17	67	33	(29)	(5)	15	27
3	32	(14)	–	(1)	12	27
(193)	(87)	(317)	(251)	(154)	(32)	135
82	157	(316)	(448)	(354)	(43)	238
(20)	(25)	(9)	(4)	142	18	(85)
–	(3)	(1)	(2)	1	(1)	–
62	129	(326)	(454)	(211)	(26)	153
–	–	–	–	(7)	(48)	(4)
62	129	(326)	(454)	(218)	(74)	149
59	44	(34)	(243)	(221)	60	149
380	(359)	335	246	742	402	427
(263)	69	126	287	(829)	(583)	(375)
176	(246)	427	290	(308)	(121)	201
775	599	845	418	128	436	557
6.1%	6.1%	2.1%	(4.1)%	(4.7)%	1.3%	3.3%
783	680	510	225	182	356	389
17.4%	16.9%	14.2%	6.4%	5.2%	9.1%	10.8%
0.91	1.34	1.36	1.09	1.15	1.47	1.79
5,397	4,997	5,039	4,810	4,921	4,579	4,121
2,421	2,464	2,640	2,492	2,183	1,384	973
931	931	931	883	834	834	834
833	365	230	316	770	988	1,062
58%	66%	69%	68%	58%	43%	34%
$ 0.36	$ 0.97	$ (4.23)	$ (6.13)	$ (2.94)	$ (1.01)	$ 1.99
$ 0.41	$ 0.37	$ (0.44)	$ (3.28)	$ (2.99)	$ 0.80	$ 1.99
$ 5.37	$ 3.08	$ 1.96	$ 4.27	$ 10.40	$ 13.35	$ 14.55
168.7	143.5	80.7	75.9	75.1	74.9	74.8
10.1%	46.7%	(237.6)%	(86.2)%	(25.0)%	(7.0)%	15.4%

Ten Year Comparative Review (cont'd)

	1998	1997	1996
Operating statistics – not consolidated			
Passenger – scheduled and charter:			
Revenue passengers carried (millions)[1]	**14.8**	14.0	13.0
Revenue passenger miles (millions)[1]	**23,211**	22,788	20,596
Available seat miles (millions)	**32,719**	32,061	29,431
Passenger load factor[1]	**70.9%**	71.1%	70.0%
Yield per revenue passenger mile (cents)[1]	**18.8**	17.5	16.4
Yield per available seat mile (cents)	**13.3**	12.5	11.5
Cargo – scheduled and charter:			
Revenue ton miles (millions)	**833**	895	783
Yield per revenue ton mile (cents)	**42.7**	41.1	41.6
All operations:			
Operating expense per available seat mile (cents)[2]	**15.8**	14.2	13.4
Operating expense (net of non-ASM producing revenue) per available seat mile (cents)[2][3]	**13.0**	11.4	10.8
Average number of employees (thousands)	**22.8**	21.2	19.9
Available seat miles per employee (thousands)	**1,433**	1,516	1,481
Revenue per employee ($ thousands)	**230**	232	209
Average aircraft utilization (hours per day)[4]	**10.3**	10.4	10.7
Average aircraft flight length (miles)	**955**	944	957
Fuel price per litre (cents)[5]	**26.3**	27.5	26.3
Fuel litres (millions)	**2,251**	2,235	2,080
Operating statistics – consolidated			
Revenue passenger miles (millions)[1]	**24,479**	23,896	21,894
Available seat miles (millions)	**35,037**	34,117	31,988
Passenger load factor[1]	**69.9%**	70.0%	68.4%
Yield per revenue passenger mile (cents)[1]	**20.3**	18.9	18.1

Quarterly Financial and Operating Data

(unaudited)

	1998				
	Year	Q4	Q3	Q2	Q1
Financial data – consolidated ($ millions)					
Operating revenues	**5,932**	1,495	1,487	1,594	1,356
Operating income (loss)	**144**	(1)	(7)	148	4
Income (loss) for the period	**(16)**	(20)	(61)	91	(26)
Cash flow from operations	**296**	(146)	155	286	1
Operating statistics – not consolidated					
Revenue passenger miles (millions)[1]	**23,211**	5,509	6,477	6,180	5,045
Domestic	**8,312**	2,058	2,253	2,215	1,786
International	**14,899**	3,451	4,224	3,965	3,259
Available seat miles (millions)	**32,719**	8,019	8,549	8,508	7,642
Domestic	**11,317**	2,815	2,896	2,938	2,668
International	**21,402**	5,204	5,653	5,570	4,975
Passenger load factor[1]	**70.9%**	68.7%	75.8%	72.6%	66.0%
Domestic	**73.4%**	73.1%	77.8%	75.4%	66.9%
International	**69.6%**	66.3%	74.7%	71.2%	65.5%
Yield per revenue passenger mile (cents)[1]	**18.8**	19.8	17.3	19.2	18.9

[1] Includes frequent flyer redemptions (1996 to 1998).
[2] Includes a fuel excise tax rebate in 1993 of $45 million and a repayment of fuel excise tax rebate in 1997 of $43 million (not consolidated).
[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.
[5] Includes fuel handling expense in 1998 and 1997 (restated).

1995	1994	1993	1992	1991	1990	1989
10.8	9.9	9.5	9.9	9.9	11.8	12.0
16,747	14,995	13,768	14,391	13,658	16,577	16,278
26,578	23,730	21,157	21,628	19,953	23,233	23,348
63.0%	63.2%	65.1%	66.5%	68.4%	71.4%	69.7%
18.0	17.7	17.1	16.3	17.3	16.7	16.3
11.4	11.2	11.1	10.8	11.9	11.9	11.4
707	633	586	532	549	645	595
43.3	43.5	47.6	53.1	53.1	53.2	53.5
13.4	13.2	13.8	14.2	15.6	14.8	13.4
10.5	10.5	11.1	11.7	12.9	12.1	10.9
19.6	18.4	18.2	19.4	20.6	23.1	23.2
1,359	1,288	1,166	1,112	969	1,005	1,005
194	178	161	148	141	148	139
10.6	10.3	9.6	9.6	9.8	9.5	9.3
958	946	907	925	898	900	850
23.5	23.8	24.4	24.6	26.6	28.9	24.3
1,910	1,707	1,529	1,609	1,627	1,965	1,991
17,905	16,143	14,820	15,519	14,642	17,271	16,868
28,968	25,991	23,341	23,886	22,031	24,630	24,562
61.8%	62.1%	63.5%	65.0%	66.5%	70.1%	68.7%
20.0	19.6	19.2	18.1	19.2	18.0	17.1

1997				
Year	Q4	Q3	Q2	Q1
5,572	1,396	1,623	1,415	1,138
368	16	284	135	(67)
427	94	181	71	81
366	(2)	318	66	(16)
22,788	5,132	7,127	5,701	4,828
7,739	1,878	2,269	1,971	1,621
15,049	3,254	4,858	3,730	3,207
32,061	7,801	9,453	7,822	6,985
10,760	2,712	2,979	2,638	2,431
21,301	5,089	6,474	5,184	4,554
71.1%	65.8%	75.4%	72.9%	69.1%
71.9%	69.3%	76.2%	74.7%	66.7%
70.6%	63.9%	75.0%	72.0%	70.4%
17.5	19.0	16.9	17.6	16.8

Board of Directors

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President and Chief
Executive Officer
Air Canada
Montréal, Québec

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

3 **J.V. Raymond Cyr, O.C.**
Chairman of the Board
GEOMAT International Inc
and Vice Chairman of
the Board ART Aerospace
Research Technologies Inc
Montréal, Québec

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

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

6 **David P. O'Brien**
Chairman, President and
Chief Executive Officer
Canadian Pacific Limited
Calgary, Alberta

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

8 **William James**
President and Chief
Executive Officer
Inmet Mining
Corporation
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9 **Hon. W. David Angus, Q.C.**
Partner
Stikeman, Elliott
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10 **Fernand Lalonde, Q.C.**
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Executive Officer
McNeil Consumer
Healthcare
Waterloo, Ontario

13 **Eva Lee Kwok**
Chair and Chief
Executive Officer
Amara International
Investment Corp.
West Vancouver,
British Columbia

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Officers of the Company

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

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

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

4 **Edouard J. D'Arcy**
Vice President, In-Flight Service

5 **William G. Bredt**
Vice President, System Operations Control

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

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

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

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

10 **Paul E. Brotto**
Senior Vice President, Business Development

11 **Rupert Duchesne**
Vice President, Marketing

12 **Eileen McCoy**
Senior Vice President, Customer Service

13 **Douglas D. Port**
Senior Vice President, Corporate Affairs and Government Relations

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

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

16 **Danielle Poudrette**
Vice President, International

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

18 **Robert G. Giguere**
Vice President, Flight Operations

19 **Elizabeth E. Graham**
Vice President, Airports

20 **Paul R. Garratt**
Vice President, Financial Planning and Controller

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

B. Wayne MacLellan
Vice President, Flight Operations, retired in 1998

Geoffrey Elliot
Senior Vice President, Corporate Affairs and Government Relations, left the Corporation to pursue other business interests

International Network

ARCTIC OCEAN
PACIFIC OCEAN
ATLANTIC OCEAN
INDIAN OCEAN
ANTARCTICA
RUSSIA
CANADA
UNITED STATES
MEXICO
BRAZIL
CHINA
INDIA
AUSTRALIA
INDONESIA
Vancouver
Calgary
Edmonton
Toronto
Montréal
Ottawa
Halifax
St. John's
San Francisco
Los Angeles
Denver
Chicago
New York
Washington, D.C.
Honolulu
Maui
Sydney
Auckland
Bangkok
Hong Kong
Osaka
Seoul
Rio de Janeiro
São Paulo
London
Frankfurt
Munich
Paris
Zürich
Copenhagen
Oslo
Stockholm
Helsinki
Tel Aviv
Delhi

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Star Alliance Hub Cities

Air Canada Routes
Code Share Routes

STAR ALLIANCE

AIR CANADA	Lufthansa	SAS	Thai	UNITED AIRLINES	VARIG	ANSETT AUSTRALIA	AIR NEW ZEALAND
Montréal Toronto Vancouver	Frankfurt Munich	Copenhagen Oslo Stockholm	Bangkok	Chicago Denver Los Angeles San Francisco Washington, D.C.	Rio de Janeiro São Paulo	Sydney	Auckland

Domestic Network

Routes shown include all Air Canada, Air Nova, Air Alliance, Air Ontario, AirBC flights and Air Canada code share flights operated by United Airlines.

Transborder Network

Routes shown include all Air Canada, Air Nova, Air Alliance, Air Ontario, AirBC flights and Air Canada code share flights operated by United Airlines.

Investor and Shareholder Information

Price Range and Trading Volume of Air Canada Common Shares

1998	High	Low	Volume
1st Quarter	$15.00	$12.05	105,689,006
2nd Quarter	$14.20	$12.25	61,085,418
3rd Quarter	$13.30	$ 5.50	99,143,611
4th Quarter	$ 7.05	$ 5.10	74,180,641

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

1998	High	Low	Volume
1st Quarter	$13.75	$11.10	37,926,560
2nd Quarter	$13.10	$11.10	30,256,939
3rd Quarter	$11.95	$ 4.90	26,854,464
4th Quarter	$ 6.00	$ 4.50	40,028,121

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

1998	High	Low	Volume
1st Quarter	$ 9.69	$7.75	827,461
2nd Quarter	$ 9.13	$7.50	778,751
3rd Quarter	$ 8.13	$3.22	1,642,787
4th Quarter	$ 3.91	$2.88	1,925,814

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.

Head Office

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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

Director,
Investor Relations
Telephone: (514) 422-5724
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Air Canada complies with the guidelines adopted by the Toronto Stock Exchange. A report on governance matters is included in the February 18, 1999 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.

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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