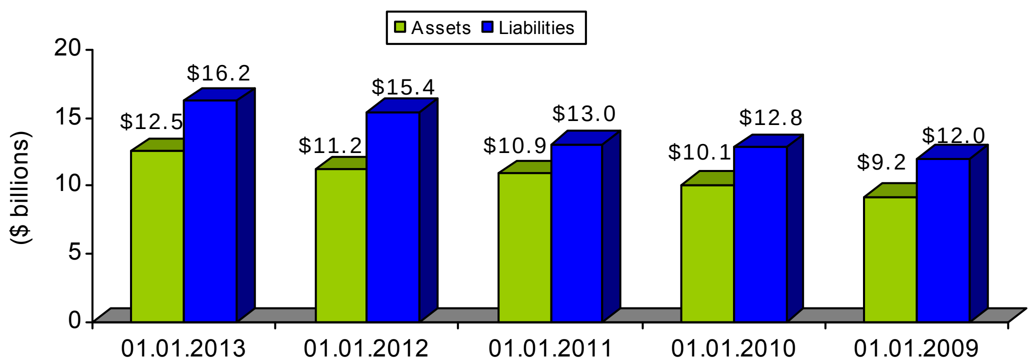
# Air Canada Pension Update
# August 2013

In June 2013, the company filed the actuarial valuation reports of the defined benefit pension plans as at January 1, 2013. The solvency positions of the defined benefit pension plans have slightly improved during 2012. However, there still is a large solvency deficit of $3.7 billion. This is consistent with many other plans in Canada and is the result of sustained low interest rates environment.

Air Canada sponsors several[1] defined benefit pension plans for its Canadian-based unionized, management, administrative and technical support and executive employees. This Pension Update shows the financial position of the pension plans and the company required contributions for 2013 as well as information regarding the funding relief agreement with the Government of Canada that will take effect in 2014.

## Financial Positions of the Plans

### At a Glance




- The combined solvency deficit decreased from $4.2 billion on January 1, 2012 to $3.7 billion on January 1, 2013. However, at such level, it is still significantly higher than in previous years.
- The solvency ratio increased from 73% to 77% in 2012.
- For **2012**, the company contributed $345 million to all plans combined ($170 million towards 2012 current service costs and $175 million towards eliminating the deficits) compared to $320 million for 2011.
- For **2013**, the company will be required to contribute an estimated $395 million:
  - Current service cost of $170 million
  - Special contributions of $225 million.
- The 2012 rate of return on plan assets was 13.5%, net of expenses, being the main contributing factor for the decrease in the solvency deficit.
- The interest rate used for solvency valuations decreased slightly from 3.3% to 3.0%.

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[1] Air Canada sponsored 10 defined benefit plans in 2012; however, effective October 1, 2012, the Pension Plan for Air Canada Executives Employees Formerly Employed by Canadian Airlines was converted to a defined contribution pension plan for new hired executives (subject to the approval of the Superintendent of Financial Institutions). As a result, no actuarial valuation was required for this plan as of January 1, 2013.

## What Contributed to the Improvement in Solvency Position in 2012?

The main factors contributing to the improvement in 2012 were the asset performance, with a net rate of return of 13.5%, and the company's special contributions of $175 million. However, these factors were offset by a further decrease in interest rates. The interest rate used to determine the liabilities went down from 3.3% to 3%. A lower interest rate means higher solvency liabilities because more money needs to be set aside to provide the same level of benefits. Solvency liabilities increased from $15.4 billion to $16.2 billion in 2012 representing an increase of some $800 million. In comparison, the assets increased from $11.2 billion to $12.5 billion representing an increase of $1.3 billion.

The net result, combined with other miscellaneous factors, is a slight improvement with a combined solvency deficit decreasing from $4.2 billion as of January 1, 2012 to $3.7 billion one year later.

In light of the results above, one can see that pension plans are affected not only by investment return on assets but also by long-term interest rates. Negative stock market returns decrease pension plan assets while lower interest rates contribute to higher plan solvency liabilities. The reverse is also true, that is, an increase in plan assets or increases in long-term interest rates help reduce solvency deficits. However, the impact of the latter is much bigger. For example:

| Factor | Increase (▲)/Decrease (▼) | Impact on Solvency Deficit |
|---|---|---|
| Plan asset | ▲ of 1% | ▼ of $0.1 billion |
| Long-term interest rate | ▲ of 1% | ▼ of $2.0 billion |
| Plan asset | ▼ of 1% | ▲ of $0.1 billion |
| Long-term interest rate | ▼ of 1% | ▲ of $2.3 billion |

## Highlights of the January 1, 2013 Valuations

In June 2013, Air Canada filed its actuarial valuation reports as at January 1, 2013 with the Office of the Superintendent of Financial Institutions (OSFI) and the Canada Revenue Agency (CRA) for all its Canadian defined benefit registered pension plans. These reports show the financial positions of the plans at January 1, 2013 and the company's 2013 required contributions. The final results of the valuations summarized below are in line with previous estimates disclosed in the company's financial reports and other various company communications.

### 1) Solvency Basis

The results on a combined solvency basis (assuming the plans are terminated) are summarized as follows:

(in $ billions)

| | Jan. 1, 2013 | Jan. 1, 2012 | Jan. 1, 2011 | Jan. 1, 2010 | Jan. 1, 2009 |
|---|---|---|---|---|---|
| **Assets** | $12.5 | $11.2 | $10.9 | $10.1 | $9.2 |
| **Liabilities** | $16.2 | $15.4 | $13.0 | $12.8 | $12.0 |
| **Surplus/(Deficit)** | ($3.7) | ($4.2) | ($2.1) | ($2.7) | ($2.8) |
| **Solvency ratio (assets/liabilities)** | 77% | 73% | 83% | 79% | 77% |
| **Valuation Interest Rate** | 3.0% | 3.3% | 4.5% | 4.5% | 4.85% |
| **Return on assets for 12-month ending** | 13.5% | 6.5% | 12.6% | 12.6% | -15.3% |

In the above table, we indicate the long-term interest rates used for each valuation and the actual rate of return on assets for the 12-month period ending on the valuation date. For the past few years, returns on assets (for example, 13.5 % for the 12 months ending January 1, 2013) have been top quartile among Canadian $1 billion + pension funds. However, in 2012, this continued top asset performance was offset by a further decrease in the valuation interest rate, which slowed down the decrease in deficits.

A solvency ratio less than 100% (i.e. 77% on a combined basis as of January 1, 2013) means that if the plans were terminated on that date, the assets would not have been sufficient to cover the full value of the benefits promised to plan members.

The solvency ratio was determined for each plan. The following table compares this year's solvency deficits with the prior year's deficits. In addition, the table shows the portion of the 2013 past service contribution of $225 million allocated to each plan in accordance with the 2009 Air Canada Regulations.

(in $ millions)

| | | At January 1, 2013 | | At January 1, 2012 | |
|---|---|---|---|---|---|
| **Plan** | **2013 Past Service Contribution** | **Solvency Ratio** | **Solvency Surplus/Deficit** | **Solvency Ratio** | **Solvency Surplus/Deficit** |
| Main | $119.5 | 76% | ($1,989) | 72% | ($2,246) |
| Pilots | $38.4 | 78% | ($638) | 74% | ($706) |
| Executives | $0.9 | 72% | ($16) | 70% | ($16) |
| CAIL IAMAW | $17.4 | 77% | ($290) | 72% | ($330) |
| CAIL CUPE | $12.5 | 77% | ($208) | 72% | ($234) |
| CAIL CAW | $11.4 | 75% | ($190) | 71% | ($208) |
| CAIL CALDA | $0.4 | 72% | ($7) | 70% | ($7) |
| CAIL Pilots | $22.0 | 77% | ($366) | 73% | ($404) |
| CAIL Management | $2.4 | 89% | ($40) | 86% | ($49) |
| **Total** | **$225** | **77%** | **($3,744)** | **73%** | **($4,200)** |

**2) Going-Concern Basis**

The plans are also valued on a going-concern basis (which assumes Air Canada will continue to operate and maintain its pension plans indefinitely). The financial positions of the plans on a going-concern basis have evolved from a deficit of $939 million as of January 1, 2012 to $245 million one year later. This is mainly due to Air Canada special contributions of $175 million and to the good performance of the assets.

In addition, the actuaries have determined that the overall employer current service costs for 2013 will slightly decrease from 11.5% to 11.2% of pensionable earnings. The aging of the population, which would typically cause the current service cost to increase, has been offset by a change in the retirement age assumption for pilots. As a matter of fact, they can now work after the age of 60 further to the elimination of mandatory retirement.

# Required Pension Plan Contributions

## Current Applicable Regulations

The pension contributions required to be made by the company are determined in accordance with the applicable regulations.

Beginning on April 1, 2009, the past service payments have been determined in accordance with the *Air Canada Pension Plan Funding Regulations, 2009* (the “2009 Air Canada Regulations”). In July 2009, following ratification of pension funding agreements by all five Canadian-based unions and the successful conclusion of a consultation process with the retirees and non-unionized employees, the Government of Canada approved the 2009 Air Canada Regulations, effective until the end of 2013, summarized as follows:

- A 21-month “moratorium” on past service contributions for the period from April 1, 2009 until December 31, 2010;
- Past service contributions are fixed to $150 million, $175 million and $225 million per year for 2011, 2012 and 2013, respectively on a combined basis, subject to the maximum past service contributions permitted under the Income Tax Act; those contributions are distributed to each plan on a pro rata to its solvency deficit as at January 1 of the plan year; and
- No plan amendments decreasing the solvency ratio of the plan are permitted unless approved by OSFI while subject to the 2009 Air Canada Regulations.

## Estimated Contributions for 2013 and Prior Years

For 2013, in accordance with the 2009 Air Canada Regulations and based on the results of the January 1, 2013 actuarial valuations, Air Canada must contribute approximately $395 million to all plans combined. The estimated 2013 contributions on a combined basis compared to the actual contributions for years from 2009 to 2012 are as follows:

(in $ millions)

| | Estimated 2013 | Actual 2012 | Actual 2011 | Actual 2010 | Actual 2009 |
|---|---|---|---|---|---|
| **Current service** | $170 | $170 | $170 | $171 | $155 |
| **Past service** | $225 | $175 | $150 | $ 9[1] | $ 85 |
| **Total** | $395 | $345 | $320 | $180 | $240 |
| **Employee contributions** | $63 | $64 | $69 | $73 | $74 |

[1] In respect of amendments so to not decrease the solvency ratio.

**Required Contributions in 2014 and Beyond**

As of 2014, the 2009 Air Canada Regulations will expire. However, as announced on March 12, 2013, Air Canada and the Government of Canada have agreed to new pension funding arrangements until the end of 2020.

According to the agreement reached with the Government of Canada, the Minister of Finance will propose new regulations under the *Pension Benefits Standards Act* in respect of special payments under Air Canada's defined benefit pension plans applicable to the period between 2014 to 2020 inclusive. The main terms of the agreement can be summarized as follows:

- Subject to the maximum past service contribution permitted under the *Income Tax Act*, Air Canada will be required to make payments of at least $150 million annually with an average of $200 million per year over seven years, to contribute an aggregate minimum of $1.4 billion in solvency deficit payments, in addition to its current service payments.

- During the time the regulations are in force, Air Canada will be subject to a series of covenants and undertakings, including a prohibition on dividends and share repurchases, as well as certain limitations on executive compensation arrangements.

- As requested by the Government of Canada, Air Canada has also agreed to use reasonable efforts, during the negotiations of the next collective agreements with Air Canada's Canadian-based unions, to seek to include in those collective agreements provisions which would have employees contribute 50% of their pension plan normal costs, and has agreed not to implement pension plan benefit improvements without regulatory approval.

- Air Canada can elect to opt out of the regulations and have special payments in respect of all Air Canada pension plans, collectively, determined in accordance with the normal funding rules.

The new funding arrangements will become effective upon the execution of formal documentation and the subsequent adoption of new regulations under the *Pension Benefits Standards Act*, subject to Governor in Council approval.

Absent the adoption and implementation of the agreement upon expiry of the 2009 Air Canada Regulations, under generally applicable regulations, Air Canada's pension funding obligations would be determined by the application of normal past service contribution rules which would generally require one fifth of any solvency deficit, determined on the basis of an average over the previous three years, to be funded each year in addition to required current service contributions.

**Long-Term Sustainability and Recent Pension Changes**

Air Canada addressed the long-term sustainability issue as part of the bargaining process with all unions in 2011 and 2012. Collective agreements were finalized with all unions and included changes to the pension plans, both for current employees and new hires. Similar changes have been made for Management and ATS employees as well as for Executives.

The defined benefit pension plans were maintained for current employees, with main changes related to early retirement rules. The changes resulted in a combined reduction in the solvency deficit of approximately $1.1 billion assuming the changes were to become effective on January 1, 2013. The changes are still subject to the approval by the Superintendent of Financial Institutions.

Also, new pension arrangements have been established for new hires. For employees represented by CAW and CUPE, new hires will participate in a hybrid pension plan made up of defined benefit and defined contribution components. CALDA-represented employees, ACPA-represented pilots and Management and ATS employees as well as Executives will participate in defined contribution plans. IAMAW-represented employees will participate in a multi-employer pension plan.

These changes help address both the short-term and long-term sustainability of the plans.

## Conclusion

Two important decisions are awaited, as mentioned above:

1) Air Canada and the Government of Canada agreed on new pension funding relief measures for the period from 2014 to 2020. However, formal regulations still need to be approved by the Governor in Council.

2) The Superintendent of the Financial Institutions (OSFI) still needs to approve the benefit reductions (mainly the changes to the early retirement provisions) that will take effect on January 1, 2014.

These two important decisions are key in Air Canada's strategy to make the pension plans sustainable in the future.