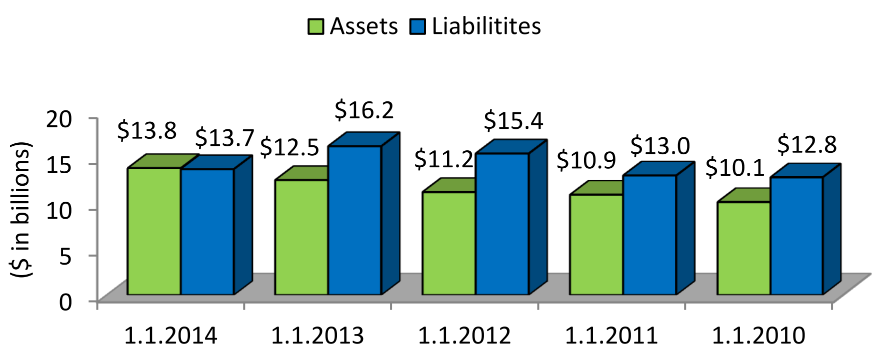
# Air Canada Pension Update
# July 2014

## Update on Air Canada's Defined Benefit Pension Plans as of January 1, 2014

Air Canada sponsors several defined benefit pension plans for its Canadian-based unionized, management, administrative and technical support and executive employees. This Pension Update communicates the financial positions of the pension plans and the company required contributions for 2014 as well as information regarding the funding relief regulations passed by the Federal Government.

**What Happened in 2013?**

As already publicly announced, the consolidated financial position of Air Canada's defined benefit pension plans has significantly improved in 2013 from a solvency deficit of $3.7 billion as of January 1, 2013 to a small surplus of $89 million as of January 1, 2014 based on actuarial valuations as at that date. This is indeed a significant improvement and good news for the Company and all plan members and retirees. The graph below shows the evolution of plan assets and liabilities since January 1, 2010.




In summary:

- The combined solvency deficit was eliminated in 2013. The consolidated financial position went from a deficit of $3.7 billion on January 1, 2013 to a small surplus of $89 million on January 1, 2014.
- The solvency ratio increased in 2013 from 77% to 101%.
- For **2013**, the company contributed $392 million to all plans combined ($167 million towards 2013 current service costs and $225 million towards eliminating the deficits) compared to $345 million for 2012.
- For **2014**, the company is required to contribute an estimated minimum of $295 million:
  - Current service costs of $145 million
  - Special contributions of $150 million based on the recently passed funding regulations

**What Helped Improve the Solvency Position in 2013?**

The elimination of the $3.7 billion deficit is principally the result of the following factors:

- An increase in long-term interest rates, which are required to be used by actuaries in calculating pension liabilities, from 3% as of January 1, 2013 to 3.9% as of January 1, 2014 (when interest rates go up, the value of pension liabilities goes down), which contributed to a reduction in the solvency deficit of $1.7 billion;
- A 13.8% return on investments in pension assets (before fees), which contributed to a reduction in the solvency deficit of $1.3 billion. For the four-year period ending December 31, 2013, return on assets have been among the top 10% Canadian pension funds of more than $1 billion.

- The implementation of changes to pension benefits for active members effective January 1, 2014, which contributed to a reduction in the solvency deficit of $940 million; and,
- A $225-million contribution in respect of the solvency deficit made by Air Canada in 2013.

**What May Cause the Plans' Financial Positions to Vary So Much?**

Seeing the above results, one can see that pension plans are affected not only by investment returns but also by long-term interest rates. A decrease in plan assets or a decrease in long-term interest rates increases solvency deficit. The table below illustrates the sensitivity of solvency deficits to returns on plan assets and decreases in long-term interest rates:

| Factor | Scenario | Impact on Solvency Deficit |
|---|---|---|
| Return on equities and alternative investments | ▼ of 10% (versus expected returns) | ▲ of $740 million |
| Long-term interest rates | ▼ of 1% | ▲ of $620 million |

For example, if long-term interest rates were to drop by 1% and return on equities and alternative investments were 10% lower than expected, the deficit would increase by approximately $1.4 billion (= $740 million + $620 million). It should be noted that the opposite scenario also holds true, that is, a 1% increase in long-term interest rates and a return on equities and alternative investments 10% higher than expected, would reduce the solvency deficit or increase solvency surplus by a similar amount.

Since 2009, Air Canada has been implementing a new investment strategy in an effort to reduce the financial risks associated with its defined benefit pension plans. At a high level, this strategy consists of managing closely the "funded status" risk (the difference between pension assets and pension liabilities). In other words, Air Canada is seeking to implement investment strategies that aim to mitigate the risks that assets of the plans will deviate from the value of pension liabilities. The pension plan assets are currently invested to protect the plans against 70% of changes in long-term interest rates (in financial terms, 70% of the interest rate risk is currently hedged). As a comparison, with a more traditional asset portfolio similar to the one in place prior to 2009 (60% equities and 40% bonds), the same unfavorable scenario mentioned above would have resulted in a $2.1 billion increase in solvency deficit (as opposed to the increase of $1.4 billion reported above).

**Highlights of the January 1, 2014 Actuarial Valuations**

By June 30th of each year, Air Canada must file actuarial valuation reports as at the beginning of that year 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 latest reports which were filed in June 2014 show the financial positions of the plans at January 1, 2014 and the company's 2014 required contributions. The results of these valuations, summarized below, are in line with preliminary estimates previously disclosed in the company's financial reports and other company communications.

**1) Solvency Basis**

The solvency ratio was determined for each plan. The following table compares this year's financial position with the prior year's deficits. In addition, the table shows the portion of the 2014 past service contribution of $150 million allocated to each plan in accordance with the 2014 Regulations.

(in $ millions)

| Plan | 2014 Past Service Contribution | At January 1, 2014 Solvency Ratio | At January 1, 2014 Solvency Surplus/(Deficit) | At January 1, 2013 Solvency Ratio | At January 1, 2013 Solvency Surplus/(Deficit) |
|---|---|---|---|---|---|
| Main | 35.5 | 100% | 11 | 76% | (1,989) |
| Pilots | 12.3 | 103% | 78 | 78% | (638) |
| Executives | 7.3 | 86% | (7) | 72% | (16) |
| CAIL IAMAW | 18.8 | 101% | 6 | 77% | (290) |
| CAIL CUPE | 3.8 | 105% | 40 | 77% | (208) |
| CAIL CAW | 3.2 | 99% | (3) | 75% | (190) |
| CAIL CALDA | 1.5 | 88% | (3) | 72% | (7) |
| CAIL Pilots | 46.2 | 97% | (39) | 77% | (366) |
| CAIL Management | 21.4 | 102% | 6 | 89% | (40) |
| **Total** | **150** | **101%** | **89** | **77%** | **(3,744)** |

A solvency ratio less than 100% means that if a plan were terminated on that date, the assets would not be sufficient to cover the full value of the benefits promised to plan members and a ratio above 100% means the assets would be sufficient to cover the full value of the benefits promised to plan members.

**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 consolidated financial position of the plans on a going-concern basis has evolved from a deficit of $245 million as of January 1, 2013 to a surplus of $197 million one year later. This is mainly due to Air Canada special contributions of $225 million and favorable pension asset investment returns in 2013.

In addition, the actuaries have determined that the overall employer current service costs for 2014 will decrease from 11.2% to 9.5% of pensionable earnings largely due to benefit reductions and increase in certain employee groups' contributions effective January 1, 2014.

## 2014 Required Contributions

**2014 Funding Regulations**

The *Air Canada Pension Plan Funding Regulations, 2014* enacted by the Federal Government in December 2013 sets out terms and conditions applicable to the special payments to Air Canada's defined benefit pension plans for the seven-year period from 2014 to 2020. In accordance with the 2014 Regulations, Air Canada will be required to make contributions of at least $150 million annually with an average of $200 million per year that the plans are subject to the 2014 Regulations, in addition to its current service contributions.

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 its Canadian-based unions, to seek to include in those collective agreements provisions which would have employees contribute 50% of their pension plan normal costs.

Air Canada may elect to opt out of the 2014 Regulations and have special payments in respect of all Air Canada pension plans determined in accordance with the normal funding rules. Under normal funding rules, and in addition to required annual current service contributions, Air Canada would be required to make annual past service contributions equal to one fifth of any solvency deficit (established by averaging the deficit over the previous three years).

**Contributions for 2014 and Prior Years**

For 2014, in accordance with the 2014 Regulations and based on the results of the January 1, 2014 actuarial valuations, Air Canada must contribute approximately $295 million to all plans combined compared to $74 million contributed by employees. The estimated 2014 contributions on a combined basis compared to the actual contributions for years from 2010 to 2013 are as follows:

| (in $ millions) | **Estimated 2014** | **Actual 2013** | **Actual 2012** | **Actual 2011** | **Actual 2010** |
|---|---|---|---|---|---|
| **Current service** | 145 | 167 | 170 | 170 | 171 |
| **Past service** | 150 | 225 | 175 | 150 | 9[1] |
| **Total** | 295 | 392 | 345 | 320 | 180 |
| **Employees Contributions** | 74 | 63 | 64 | 69 | 73 |

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

# Conclusion

The consolidated financial position of Air Canada's defined benefit pension plans has significantly improved in 2013 and this is indeed good news for the Company and all its employees and retirees.

The elimination of the consolidated $3.7 billion deficit was in part due to external factors but in major part due to the positive results of the new investment strategy that seeks to reduce the financial risks associated with defined benefit pension plans and also important contributions made by employees through the changes to the early retirement provisions.

The implementation of the new investment strategy seeks to maintain the variation in the financial positions of the pension plans within a range that Air Canada can sustain in the future. New plans implemented for recent hires further reduce the risks for the Company, allowing Air Canada to continue to transform and realize its full potential, all of which bodes well for the sustainability of the pension plans.