

October 31, 2003

Mr. Calin Rovinescu
Chief Restructuring Officer
Air Canada
Centre Air Canada 1272
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Dorval, Québec
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Dear Mr. Rovinescu:

This letter is in response to the October 27th Air Canada presentation of its funding proposal for its pension plans.

While we appreciate that Air Canada has made some movement in addressing certain of the principles as outlined in OSFI's October 23, 2003 Principles for a Proposal Providing for Funding Relief, there are a number of areas that either continue to fall short of the expectations as outlined in that document or that require further clarification. OSFI is continuing its review of the Presentation but is of the view that it is in everyone's best interest to address some fundamental points at this time. Although there has been some movement, there are some other elements and details surrounding the various elements that we believe could be worked out through further discussions with Air Canada. As a result, pending these discussions, this letter should not be taken as acceptance by OSFI of the other elements of Air Canada's Proposal.

1. Payment Schedule as provided in the October 27th AC proposal

We would like Air Canada's assurance on a plan by plan basis that the amounts payable in the first five years of the 10 year funding schedule based on a calculation of the solvency deficiency (that is consistent with the method employed in preparing the plans' previous valuations i.e., non-smoothing of assets), in respect of the solvency deficiency, do represent a significant portion of the amounts (e.g., 40%) that would be payable on the solvency deficit over 10 years on a straight line basis.

We have asked Mercer, your actuarial advisor, to provide a more detailed breakdown of the numbers presented in your revised funding proposal. More specifically, we would like to see the numbers broken down by plan for 2003 into the following components:

- Amounts attributable to current service costs
- Amounts in that year pertaining to the payment of the deficits
 - Going concern deficit
 - Solvency deficit

As you know, the legislation requires that funding and the regulations concerning funding be on a plan by plan basis. To this end, we have also asked Mercer to provide the schedule of special payments applicable to each plan for each year and the estimated solvency deficiency of each plan at January 1, 2004 on which the schedule is based.

2. Buy in Process

We wish to reaffirm that it is expected that there be an approval process by plan beneficiaries or their respective representatives based on informed consent, and that such informed consent would be achieved by the provision of relevant information to all beneficiaries. You will appreciate that any changes to the regulations must be approved by the Governor in Council on the recommendation of the Minister of Finance. A buy-in process is regarded as an important element to the Department of Finance and by various government Ministers and by OSFI. The process must be such as to evidence that a majority of each class of beneficiaries support the proposed funding plan and election by the employer for funding relief. It is proposed that these requirements will be prescribed by regulation.

3. Downside Protection

Our October 23rd document outlined some possible options that could be included in a plan to achieve an acceptable level of downside protection. The October 27th Air Canada proposal falls short of what we would consider to be acceptable. OSFI is cognizant of Air Canada's major concern of exposure to a potentially large obligation in the event of catastrophic adverse conditions. However, OSFI must also be concerned about the retention of the protection afforded by the deemed trust application. Some form of acceptable downside protection must ultimately be included in Air Canada's funding proposal in order for OSFI to be in a position to recommend that the proposed funding relief move forward.

As OSFI has stated in the past, extending the funding of a solvency deficiency from five years to ten years increases the risk of loss to the plan beneficiaries. Such a proposal, without some downside protection, while providing Air Canada with relief from its present obligations, also would appear to unduly shift the risk in respect of the plans to its beneficiaries. It is OSFI's view that this risk should be more balanced. With this in mind, OSFI would propose that downside protection should include:

- Some provision to reinstate the solvency ratio to an “initial solvency ratio” on the termination of a plan. This obligation to reinstate up to the “initial solvency ratio” will be capped at an amount representing the amounts that have not been remitted to the pension fund under the existing Directions as at the date of the termination of a pension plan. These amounts are outlined in the second bullet;
- The “initial solvency ratio” should be determined as at December 31, 2003 for each plan assuming that the following contributions or amounts were remitted to their respective pension funds on December 31, 2003:
 - The current service contributions for 2002 and 2003 made pursuant to the directions; and
 - The amount of special payments that would be due and owing for 2003 based on the “Financial Updates” for each of the plans as provided by Air Canada on May 2nd 2003 and any valuation reports subsequently filed in 2003. As you are aware, OSFI has taken the position that reports and updates filed subsequent to its directions to file valuation reports as at January 1, 2003 in respect of the pension plans may be regarded as valuation reports giving rise to certain funding obligations.

The obligation will only arise where a plan terminates with a ratio below the initial solvency ratio and this obligation will be capped at a predetermined set amount (i.e., the amounts required to be paid in accordance with or as result of the issuance of the Directions). According to Air Canada’s median projections, on which Air Canada’s funding model is based, the solvency ratios are expected to improve over time and as a result the impact of the above provision would be reduced as plan ratios move closer to the “initial solvency ratio” and ultimately eliminated as the solvency ratios exceed this floor. The attractiveness of such a provision is that while it provides a level of downside protection it will not leave Air Canada with an open-ended obligation in funding future deficiencies in the event of plan termination. For further clarification, the Attached Appendix provides a high level outline on how this could be workable.

It is OSFI’s view that, by not requiring ongoing top ups, the above provision addresses Air Canada’s concerns about the vulnerability of cash flows in the early years while at the same time providing a level of downside protection to pension beneficiaries. It also takes into account amounts that OSFI considers would be due and owing to the plans, and which it would pursue through the courts, should any motion be made at this time to terminate the plans.

OSFI also requires some assurance that adequate funding will be maintained in the event that a substantial number of active members cease membership in the plan.

You mentioned on Monday, October 27th that OSFI's confirmation should be submitted to Air Canada by Friday, October 31st. However, as you are aware, OSFI has repeatedly requested from Air Canada information it requires in order to propose a funding relief regulation. Earlier this week our financial advisors, Stonecrest Capital Inc. ("Stonecrest") received a Confidentiality Agreement respecting the information relating to agreements with GE Capital Aviation Services, Inc. and its affiliates ("GE Capital Agreements") and are now reviewing the same with OSFI. As a result, you will appreciate that some time will be needed to not only access the required information but also to analyze it. If access to relevant and required information concerning the GE Capital Agreements is unnecessarily restricted to the point where OSFI cannot draw a conclusion, OSFI will file a motion with Justice Farley for access and copies of the information it requires. I have been informed that Stonecrest received the collateral analysis yesterday and will require some time in order to review this information. Consequently, confirmation of OSFI's position by close of business today is not possible.

We appreciate that time is of the essence in this matter and accordingly our Superintendent, Mr. Nicholas Le Pan is available to a meet with you at your earliest convenience at our Ottawa office to further discuss this matter.

Yours truly,

John Doran
Assistant Superintendent

Encl.

APPENDIX

It is OSFI's view that Air Canada's proposal of October 27, 2003 is lacking in providing adequate downside protection for the plans' beneficiaries. The following describes elements which we would consider as moving the proposal to a more acceptable level of downside protection.

As background, we consider the current amount in the deemed trust to have priority over other creditors in the event of bankruptcy of the employer or termination of a plan and are not willing to give up this position without appropriate safeguards. We would, however, be willing to use the deemed trust as a vehicle for topping up the pension funds in the event of future failure or termination of a plan and in this way provide pension beneficiaries with some degree of downside protection. The following would also provide a "cap" on the worst case scenario for Air Canada.

The following describes the main elements:

1. The deemed trust as at the date Air Canada adopts the ten year funding proposal would remain available in the event of bankruptcy or plan termination to top up the plan to a specified initial solvency ratio;
2. The specified initial solvency ratio would be the solvency ratio as at the day before the valuation date identifying the solvency deficiency to which the ten year proposal will apply (e.g., December 31, 2003) calculated by adding the amount of the deemed trust (i.e., amounts under the various Directions) to the plan asset base;
3. The deemed trust would be used only to raise the solvency ratio up to the level of the specified initial solvency ratio. To the extent the plan solvency ratio exceeds the specified initial solvency ratio level at the termination of the plan, then the deemed trust would not apply. To the extent the plan solvency ratio is below the specified initial solvency ratio level, then the deemed trust would be used, but only to increase the assets to required level to generate the specified initial solvency ratio;
4. The potential for erosion in the value of plan assets could be minimized by either a conservative investment policy, or by obtaining insurance using the assets currently in the plans. This would provide a degree of downside protection for plan beneficiaries and protection for Air Canada against a catastrophic market downturn.

In the event that any future payments to the plan are outstanding subsequent to the date of adoption of the 10 year regulation, these amounts would continue to be payable and any shortfall in payments would be subject to the deemed trust provisions of our legislation. This would be in addition to any initial deemed trust amounts payable.

