



**MANAGEMENT'S DISCUSSION AND
ANALYSIS**

ON FORM 51-102F1

**THREE MONTHS ENDED
NOVEMBER 30, 2009**

January 12, 2010



MANAGEMENT'S DISCUSSION AND ANALYSIS
Q1 FISCAL 2010

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CAUTION CONCERNING FORWARD-LOOKING INFORMATION

This interim management discussion and analysis (MD&A) contains certain statements about our future expectations. These statements are generally identified by words like “anticipate”, “plan”, “believe”, “expect”, “estimate”, “approximate” and the like. Because forward-looking statements involve future risks and uncertainties, actual results may be quite different from those expressed or implied in these statements. Examples include terrorist attacks, war, epidemics or pandemics, natural disasters, weather patterns, environmental concerns, labour negotiations, arbitrations, workforce recruitment, training and retention, general industry conditions, capital market and economic conditions, the ability to collect customer service charges and reduce operating costs, future credit losses on investments, changes in interest rates, changes in laws, tax changes, adverse regulatory developments or proceedings and lawsuits. Some of these risks and uncertainties are explained under “Risk Factors” in our 2009 Annual Information Form (AIF). The forward-looking statements contained in this MD&A represent our expectations as of January 12, 2010 and are subject to change after this date. We disclaim any intention or obligation to update or revise any forward-looking statements included in this document whether as a result of new information, future events or for any other reason, except as required by applicable securities legislation.

INTRODUCTION

This interim MD&A relates to our unaudited consolidated financial condition, results of operations and cash flows for the three months ended November 30, 2009 (Q1 fiscal 2010). It should be read in conjunction with our audited consolidated financial statements and the accompanying notes for fiscal 2009 (year ended August 31, 2009) as well as our fiscal 2009 AIF dated October 22, 2009. Additional information about NAV CANADA, including our financial statements for Q1 fiscal 2010 and fiscal 2009 and our fiscal 2009 AIF are filed on the System for Electronic Document Analysis and Retrieval (SEDAR) at www.sedar.com

Our financial statements are prepared in Canadian dollars and in accordance with Canadian generally accepted accounting principles. Our Audit Committee reviewed this MD&A and our Board of Directors approved it before it was filed.

Our Business

NAV CANADA is the private sector, non-share capital company that operates Canada’s civil air navigation system (ANS). With operations across Canada, we provide air navigation services to aircraft owners and operators within Canadian-controlled airspace. These services include air traffic control, flight information, weather briefings, airport advisories, aeronautical information and electronic navigation aids.

Our core business is to manage and operate the Canadian air navigation system and services in a safe, efficient and cost effective manner. Our mandate covers both Canadian airspace and airspace delegated to Canada under international agreements.

Financial Strategy and Rate Stabilization Mechanism

In establishing new charges or revising existing charges, we must follow the charging principles set out in our governing statute – the *Civil Air Navigation Services Commercialization Act* (ANS Act) – which



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prevents us from setting customer service charges higher than what is needed to meet our financial requirements for the provision of air navigation services. As a result, our aim is to essentially achieve breakeven financial results on an annual basis.

Customer service charges are set based on estimated air traffic volumes and planned expenses. Since actual revenues and expenses will differ from these estimates, a method to accumulate the variances is required so that they may be taken into account when setting future customer service charges. There is also a need to absorb the immediate effect of unpredictable factors – mainly fluctuations in air traffic volumes resulting from unforeseen events. We meet these objectives through a “rate stabilization” mechanism.

If our actual revenues exceed actual expenses, the excess is reflected as a liability in the rate stabilization account and is returnable to customers through future customer service charges. Similarly, if actual revenues turn out to be less than actual expenses, the revenue shortfall is reflected as an asset in the rate stabilization account and is recoverable from customers through future customer service charges. In the process of determining future customer service charges, we take into account the “notional” balance in the rate stabilization account, being the balance in the rate stabilization account adjusted for the non-credit related portion of the fair value adjustments on investments.

In preparing our financial statements, we adjust our actual revenues and expenses through transfers to or from the rate stabilization account, based on variations from the amounts that were used when establishing customer service charges. If the Board of Directors approves amounts to be returned in future customer service charges, these are transferred from the rate stabilization account to a rate reduction obligation.

Our financial strategy is to fulfil our essential services mandate based on a sound financial foundation, reflected in part through high credit ratings in the financial markets. Maintaining this strong foundation requires a fiscally prudent approach that balances the interests of our key stakeholders while complying with our statutory and contractual obligations.

Financial Highlights for the three months ended November 30, 2009

Our revenues for the first quarter of fiscal 2010 were \$ 301 million. Total operating expenses for the three month period were \$ 246 million, and other expenses, comprised of interest expense, depreciation and amortization were \$ 61 million. The rate stabilization account increased by \$ 1 million during the quarter from a liability balance of \$ 1 million to a liability balance of \$ 2 million. Without these rate stabilization adjustments, expenses would have exceeded revenues and other income by \$ 5 million, primarily due to lower air traffic levels than anticipated partially offset by expenses that were \$ 19 million lower than originally anticipated. This is discussed under “Operating Expenses” and “Other Income (Loss)”. The excess of expenses over revenues and other income (before rate stabilization) for Q1 fiscal 2009 was \$ 41 million, primarily due to a \$ 42 million reduction in the fair value of ABCP investments.

The following items have significant on-going financial importance to the Company:



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1. Rate Stabilization Account

The restructuring of third party sponsored asset backed commercial paper (ABCP) that was subject to the Montreal Accord was completed in January 2009. The Company expects that the majority of the fair value adjustments that it has recorded on its ABCP and restructured notes since August 2007 will be recovered over the terms of the related investments. Our determination of credit losses included in the fair value adjustments is influenced by the state of the economy and financial markets; accordingly, our estimate of such losses could change in the future. For rate setting purposes at this time, the Company has not taken into consideration the non-credit portion of the fair value adjustments. This non-credit portion has been added notionally to the balance in the rate stabilization account, to arrive at a "notional" rate stabilization account balance. This is discussed in more detail under the heading "RESULTS OF OPERATIONS - Changes in Rate Stabilization Account". The rate stabilization account had a liability balance of \$ 2 million at November 30, 2009. The "notional" balance in the rate stabilization account at November 30, 2009 had a liability balance of \$ 119 million, which is the same balance as at the end of the Company's fiscal 2009 year end and is above the target balance of \$ 93 million.

2. Air Traffic and Customer Service Charges

During the first quarter, air traffic volumes declined by 5.7 per cent year-over-year resulting in lower revenues.

In light of the notional balance in the rate stabilization account, described above, the Company does not intend to increase customer service charges at this time. We will continue to carefully monitor air traffic and revenue, and in April 2010 we will reconsider the need for a change in rates for effect thereafter, in accordance with the *ANS Act*.

3. Pension Plan

The Company is making contributions to its defined benefit pension plan in accordance with the most recently filed actuarial valuation that was performed as at January 1, 2009. Market conditions during 2008 and 2009 have been volatile, with significant negative investment returns on plan assets in calendar year 2008 and positive returns in calendar 2009. During 2009, the investment strategy for plan assets was modified to reduce risk relative to the liabilities. This resulted in a reduction in equities and an increase in Canadian fixed income securities, including real return bonds.

In October 2009, the federal government announced proposals regarding federally regulated pension plans. We understand that the Department of Finance and the Office of the Superintendent of Financial Institutions are currently developing draft regulations and legislation regarding changes to the existing funding rules. While we have no knowledge of the status of any such draft regulations or legislation, it is possible that such regulations and legislation may be made effective for actuarial valuations performed as at January 1, 2010.

Further information on the Company's pension plan is discussed under the heading "LIQUIDITY AND CAPITAL RESOURCES - Treasury Management and Financial Risk Mitigation - Pension Plan".



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4. Restructuring of Investments in Asset-Backed Commercial Paper (ABCP)

(See also "LIQUIDITY AND CAPITAL RESOURCES" and "CRITICAL ACCOUNTING ESTIMATES")

In January 2009, third party sponsored ABCP in Canada was restructured under the Montreal Accord. Pursuant to the terms of the restructuring plan, holders of third party sponsored ABCP exchanged their short-term notes for longer-term notes. The restructuring plan: (i) extended the maturity of the third party sponsored ABCP to provide for a maturity similar to that of the underlying assets; (ii) pooled certain series of the third party sponsored ABCP that are supported in whole or in part by underlying synthetic assets; and (iii) mitigated the margin call obligations of the existing conduits that have margin call risk and created a structure to address margin calls should they occur.

Immediately prior to the restructuring of ABCP, the Company held a portfolio of ABCP investments issued by several trusts with an overall face value of \$ 373 million. Of this amount, investments with a face value of \$ 353 million were subject to the restructuring.

On January 21, 2009, in exchange for its third party sponsored ABCP, the Company received Master Asset Vehicle II (MAV II) and Ineligible Asset Tracking notes with a face value of \$ 353 million and a fair value of \$ 183 million.

The Company holds the following investments in MAV II, Ineligible Asset Tracking notes, ABCP investments (that were not subject to the Montreal Accord) and derivative asset as at November 30, 2009:

	(millions)					
	Face Value as at August 31 2009	Principal Repayment	Write Off	Face Value as at November 30 2009	Fair Value Adjustment as at November 30 2009	Fair Value as at November 30 2009
MAV II notes						
Class A-1	\$ 191	\$ -	\$ -	\$ 191	\$ (64)	\$ 127
Class A-2	81	-	-	81	(37)	44
Class B	15	-	-	15	(10)	5
Class C	9	-	-	9	(9)	-
	296	-	-	296	(120)	176
						-
Ineligible Asset Tracking notes	46	-	-	46	(41)	5
ABCP investments	20	-	-	20	(9)	11
	362	-	-	362	(170)	192
Derivative asset	-	-	-	-	12	12
	\$ 362	\$ -	\$ -	\$ 362	\$ (158)	\$ 204



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The MAV II notes were issued by a trust referred to as the "Master Asset Vehicle II", which includes a pooling of leveraged investments as well as traditional assets and cash. The leveraged investments are subject to a potential requirement to post additional collateral based on certain triggers being met (a margin call). Traditional assets are un-levered investments and include credit card receivables, residential and commercial mortgage backed securities and cash equivalents. The pooling of the leveraged investments, the traditional assets and cash is expected to increase the stability of the notes that were received at the time of the restructuring, by using the traditional assets and available cash to meet any potential margin calls. The Class A-1 and A-2 notes provide for the payment of interest on a quarterly basis. The Class B and C notes will accrue interest with payments to be made only after the principal and interest on Class A-1 and A-2 notes have been fully paid.

The Company elected to receive notes issued by MAV II in which investors are not required to advance funds to meet future margin calls, should they occur. A margin funding facility has been arranged for MAV II to meet potential margin calls. This margin funding facility is being provided by certain international and Canadian banks. In addition, a senior margin funding facility has been arranged with the governments of Canada and the provinces of Ontario, Québec and Alberta.

The Ineligible Asset Tracking notes will track the performance and repayment of the related underlying assets in certain conduits that have significant exposure to the U.S. residential mortgage market. In fiscal 2009, subsequent to the restructuring, the Company received \$ 4 million in principal repayments against these notes. In addition, the trustee had issued a notice with respect to \$ 6 million of the Company's holdings indicating that the principal of the notes has been fully eroded and will result in a redemption value of \$ nil. These notes were written off by the Company in the prior year.

The replacement notes are classified as held for trading financial assets and are carried at fair value. Changes in fair value are recorded in income as they arise. As shown in the table above, the fair value of these notes and derivative asset is \$ 204 million as at November 30, 2009, which is \$ 158 million below the face value of the notes. The Company is aware of a limited number of trades in the replacement notes that occurred prior to November 30, 2009, but does not consider them to be of sufficient volume or value to constitute an active market. Accordingly, the Company has not used these trades to determine the fair value of its notes. The Company has used a discounted cash flow approach to determine the fair value of these investments incorporating available information regarding market conditions as at the measurement date, November 30, 2009. The estimates arrived at by the Company are subject to measurement uncertainty and are dependent on market conditions as at the measurement date. Subsequent to the measurement date, a number of investment dealers have continued efforts to establish a market for the restructured notes and a small number of transactions have been publicly announced. If an active market for the restructured notes were to develop in the future, the Company will change its valuation technique to determine the fair value of its notes using quoted market prices.

The Company's estimate of expected credit losses on its investments is \$ 41 million, which is net of the derivative asset benefit. The Company did not change its assessment of credit losses from the prior quarter. The estimate of expected credit losses with respect to Ineligible Asset Tracking notes was arrived at by estimating the expected realization of the underlying assets; in most cases this resulted in an estimated expected credit loss of 100%. The Class A-1 and A-2 notes were initially assigned a rating of A by DBRS. On August 11, 2009, DBRS downgraded the A-2 notes from A to BBB (low) and maintained the rating under review with negative implications, citing negative rating migration in the



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collateralized debt obligation (CDO) reference pools and exposure to CDOs with relatively low levels of credit enhancement. The subordinated Class B and C notes have not been rated. As a result of the concerns cited by DBRS, the Company has estimated credit losses of 38% of the face value of the Class B notes. The Company has also included in its estimate of credit losses 100% of the value of Class C notes. Our estimate of credit losses may increase in future periods should the state of the economy and financial markets cause further deterioration in the assets underlying the notes.

The future value of our investments in MAV II, Ineligible Asset Tracking notes and other ABCP cannot be predicted with any degree of certainty. The asset provider counterparties to these transactions have the right to require that additional collateral be posted under these transactions if certain triggers are breached. If the collateral requirements are not met, the asset providers may unwind the trades and liquidate collateral to cover their losses. This would likely lead to the loss of a significant portion or all of our MAV II notes with a face value as at November 30, 2009 of \$ 296 million. The likelihood of this occurring has been made more remote by certain features of the restructuring, including an 18 month moratorium on margin calls expiring in July 2010, the adoption of more remote spread/loss triggers, the pooling of trades, the retention of cash and traditional assets as collateral, the provision of a margin funding facility and a senior margin funding facility.

There is no assurance that the fair value of the Company's investments in MAV II and Ineligible Asset Tracking notes, other ABCP and derivative asset will not decline further, or that significant further deterioration in financial markets will not cause losses on the individual CDO transactions or margin calls in excess of MAV II's ability to meet them, resulting in significant credit losses. The estimated fair value of the Company's investments, including the estimate of expected credit losses, may change in subsequent periods. Any such changes could be material and would be reflected in the statement of operations as they occur.



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RESULTS OF OPERATIONS

	(millions)			
	Three months ended November 30			
	2009	2008	Change	%
Revenue	\$ 281	\$ 296	\$ (15)	(5%)
Approved rate stabilization drawdown (1)	14	-	14	
Rate stabilization	6	13	(7)	
	<u>301</u>	<u>309</u>	<u>(8)</u>	<u>(3%)</u>
Expenses before rate stabilization	288	296	(8)	(3%)
Rate stabilization	19	16	3	
	<u>307</u>	<u>312</u>	<u>(5)</u>	<u>(2%)</u>
Other income (loss) before rate stabilization	2	(41)	43	
Rate stabilization	(2)	44	(46)	
	<u>-</u>	<u>3</u>	<u>(3)</u>	<u>(100%)</u>
Excess of expenses over revenue	<u>\$ (6)</u>	<u>\$ -</u>	<u>\$ (6)</u>	

(1) In June 2009, the Board of Directors approved a \$ 57 million drawdown of the rate stabilization account to be recorded during the 2010 fiscal year in order to achieve planned breakeven results of operations in fiscal 2010. The approved drawdown is to be applied in equal instalments throughout fiscal 2010.

Revenues

The following table provides a breakdown of our revenues by category. Our fiscal 2009 AIF and the notes to our unaudited consolidated financial statements for Q1 fiscal 2010 provide more information about the different categories of our customer service charges.

	(millions)			
	Three months ended November 30			
	2009	2008	Change	%
Revenues				
En route	\$ 143	\$ 154	\$ (11)	(7%)
Terminal	105	108	(3)	(3%)
Daily / annual / quarterly	12	12	-	0%
North Atlantic & international communication	11	13	(2)	(15%)
Other	10	9	1	11%
	<u>\$ 281</u>	<u>\$ 296</u>	<u>\$ (15)</u>	<u>(5%)</u>

Other revenues consist primarily of conference and accommodation rentals at our training facility in Cornwall (Ontario), sales or licensing of technology, provision of equipment maintenance services, the sale of civil aeronautical information products and other miscellaneous revenue.



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Revenues before rate stabilization adjustments for Q1 fiscal 2010 were \$ 281 million compared to \$ 296 million for Q1 fiscal 2009. The \$ 15 million decrease is primarily due to:

- a \$ 16 million decrease in aeronautical revenues arising from a decline in air traffic as described below, partially offset by
- a \$ 1 million increase in other revenues primarily due to work associated with the 2010 Olympic project.

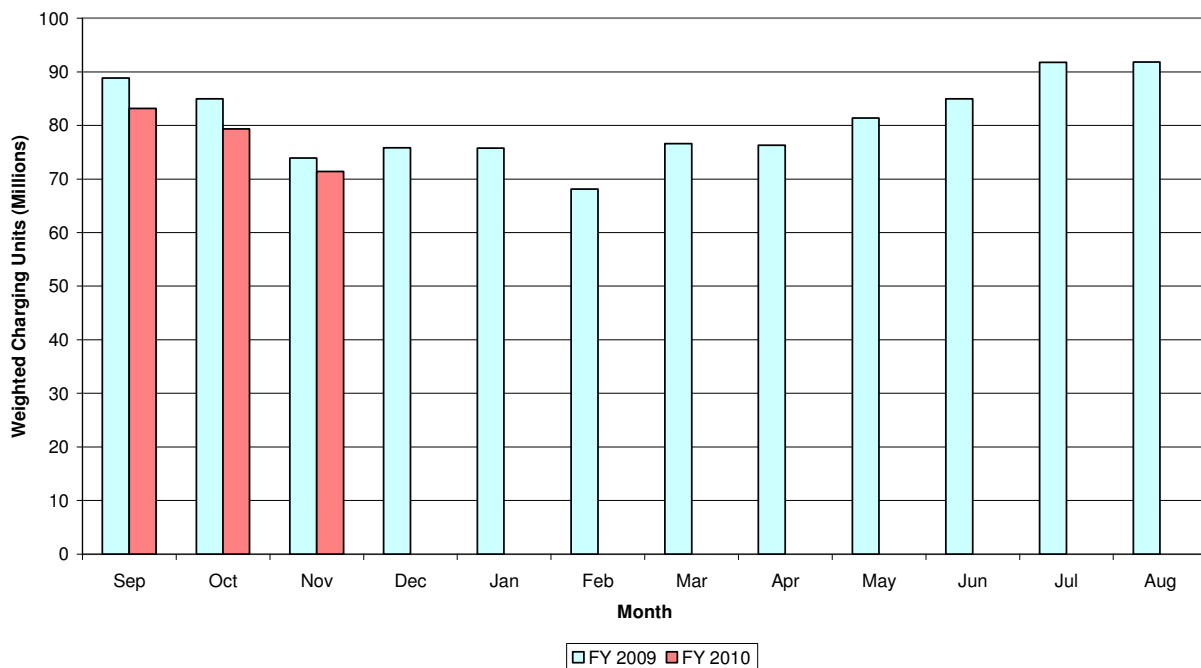
En route revenue has experienced a greater decline than other types of revenue as it includes traffic that overflies Canada, where the decline has been more significant than in domestic air traffic.

Air Traffic

The air traffic decline for Q1 fiscal 2010 was 5.7 per cent. This reduction is illustrated in the following chart showing air traffic by month since September 2008.

The chart illustrates the normal seasonal variation in traffic. The chart shows traffic in “weighted charging units”, which reflect the number of flights, aircraft size and distance flown.

**Weighted Charging Units
FY 2009 and FY 2010**





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Future air traffic volumes may be influenced by several factors, including the rate of economic growth or decline, changing air passenger demand, fuel costs, air carrier competition, airline restructurings and insolvencies, terrorist activities, epidemics or pandemics, weather patterns, natural disasters, environmental concerns and other factors.

Customer Service Charges

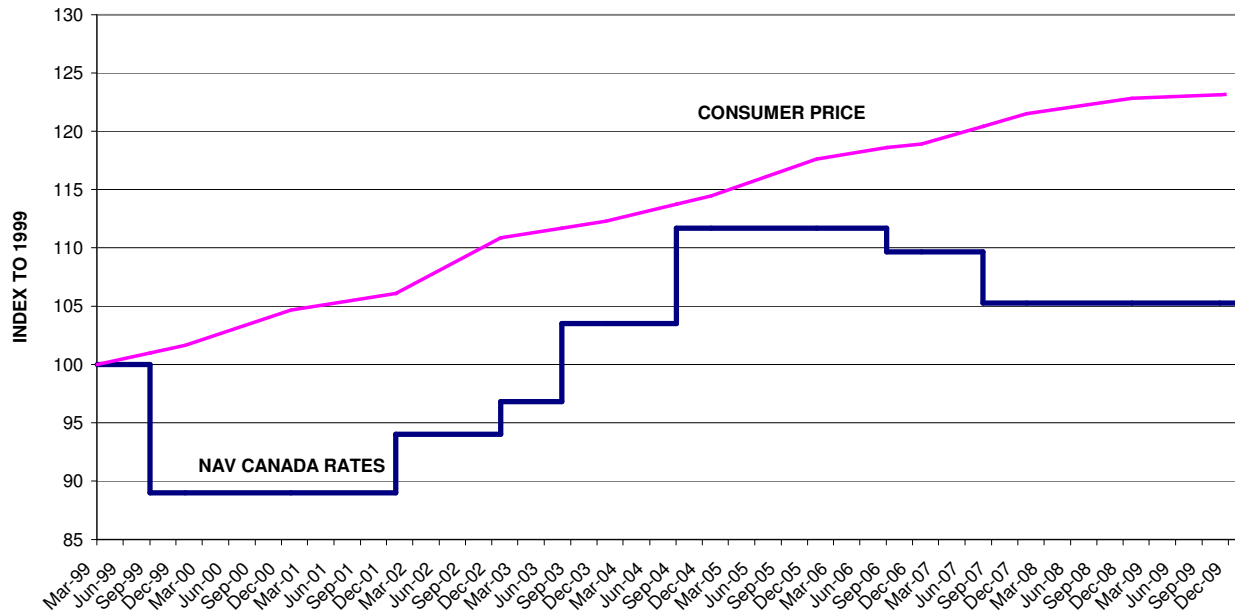
The level of our customer service charges is a function of our costs, the required level of service, air traffic volumes, revenues from non-aeronautical sources, and the “notional” balance of the rate stabilization account. Our business operates 24 hours a day, 365 days a year providing an essential, national and international safety infrastructure. Given that the majority of our costs are predominantly fixed in nature and are directly related to service delivery, we have relatively few opportunities to significantly reduce these costs further without reducing service, which is not acceptable in most cases. We continue to focus on cost management, productivity improvements and opportunities for new revenue sources from licensing or sales of technology and other non-aeronautical sources. This is assisting in keeping customer service charges as low as possible, while continuing to meet our safety and service obligations.

The following chart illustrates the evolution of our levels of customer service charges over time. On average, customer service charges are approximately five per cent higher than they were when fully implemented in March 1999, which is approximately twenty percentage points less than the compounded inflation rate. In addition, the level of our current service charges is about one third below the former Air Transportation Tax that the charges replaced.



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**HISTORY OF NAV CANADA RATE CHANGES⁽¹⁾
VERSUS CONSUMER PRICE INDEX⁽²⁾**



1. AVERAGE CHANGES SINCE CHARGES WERE FULLY IMPLEMENTED ON MARCH 1, 1999
2. CONSUMER PRICE INDEX - GROWTH ASSUMED TO BE 0.3 PER CENT FOR CALENDAR 2009

In June 2009 our Board of Directors approved the Company’s budget for fiscal 2010. The Company announced that there were no proposed changes to service charges at that time, citing an acceptable “notional” balance in the rate stabilization account (which is described under “RESULTS OF OPERATIONS – Change in Rate Stabilization Account” below).

As shown below under “Changes in Rate Stabilization Account”, in spite of continuing monthly year-over-year traffic declines since June 2009, the “notional” balance of the rate stabilization account has in fact grown, from \$ 93 million at May 31, 2009 to \$ 119 million at November 30, 2009. This has been accomplished through strong expenditure management. As a result, the Company does not intend to increase customer service charge levels at this time. We will continue to carefully monitor air traffic levels and, in April 2010 will evaluate the need for a change in rates for effect thereafter in accordance with the ANS Act.



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Outlook: Revenues

Note: See "CAUTION CONCERNING FORWARD LOOKING INFORMATION", page 1.

In light of the prevalent economic uncertainty, airlines around the world have implemented both cost and capacity reductions; most are facing lower demand for air travel.

Total revenues before rate stabilization for fiscal year 2010 are expected to be lower by approximately \$ 20 million from \$ 1,163 million in fiscal 2009. In light of the decline in air traffic as well as current industry outlook information and recent economic forecasts, management continues to monitor air traffic developments closely. See also "LIQUIDITY AND CAPITAL RESOURCES - Treasury Management and Financial Risk Mitigation" and "RESULTS OF OPERATIONS – Customer Service Charges".

Operating Expenses

Operating expenses consist of salaries and benefits, technical services, facilities and maintenance, and other. A breakdown is provided in the following table.

	(millions)			
	Three months ended November 30			
	2009	2008	Change	%
Operating Expenses				
Salaries and benefits excluding pensions	\$ 143	\$ 151	\$ (8)	(5%)
Pensions	33	29	4	14%
Technical services	25	25	-	0%
Facilities and maintenance	12	12	-	0%
Other	15	18	(3)	(17%)
	<u>\$ 228</u>	<u>\$ 235</u>	<u>\$ (7)</u>	<u>(3%)</u>

The net decrease in salaries and benefits expense (excluding pension expense) in Q1 fiscal 2010 is a result of higher compensation levels and long-term disability costs that are more than offset by savings from active management of headcount, overtime and benefit costs, and increased capitalization of salary costs. Staffing levels were approximately 3.2 per cent lower on average compared to Q1 fiscal 2009.

The \$ 4 million increase in pension expense in Q1 fiscal 2010 compared to Q1 fiscal 2009 is primarily due to planned recoveries through customer service charges of special pension contributions. This is discussed further under the heading "LIQUIDITY AND CAPITAL RESOURCES - Treasury Management and Financial Risk Mitigation - Pension Plan".

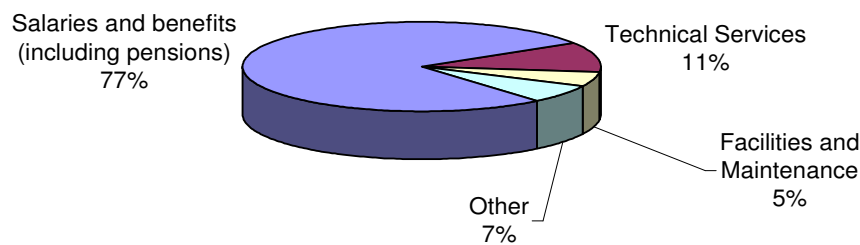
Technical services and facilities and maintenance expenses were comparable to Q1 fiscal 2009.

The decrease in other operating expenses of \$ 3 million relates mainly to decreased spending on discretionary expenses such as travel.



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**Q1 Fiscal 2010 Operating Expenses
before Rate Stabilization Adjustments**



Other Expenses

Other expenses consist of interest, depreciation and amortization expense. A breakdown is provided in the following table.

	(millions)			%
	Three months ended November 30			
	2009	2008	Change	
Other Expenses				
Interest	\$ 29	\$ 29	\$ -	0%
Depreciation and amortization	31	32	(1)	(3%)
	<u>\$ 60</u>	<u>\$ 61</u>	<u>\$ (1)</u>	<u>(2%)</u>

Interest expense for Q1 fiscal 2010 was consistent with Q1 fiscal 2009.

Depreciation and amortization expense decreased by \$ 4 million due to an increase in the useful life of the air navigation right offset by increases of \$ 3 million as a result of ongoing capital programs.

Outlook: Operating and Other Expenses

Note: See “CAUTION CONCERNING FORWARD LOOKING INFORMATION”, page 1.

Total operating and other expenses before rate stabilization for fiscal 2010 are expected to increase by approximately \$ 70 million, from \$ 1,157 million in fiscal 2009. The anticipated increase is primarily due to increased compensation levels and pension expense, increased costs related to insurance and inflation and the recognition of a one-time gain on the curtailment and settlement of certain post-employment benefits in fiscal 2009, partially offset by an increase in capitalized internal labour costs as a result of the Company’s change in approach to capitalizing these costs, effective September 1, 2009 and reduced amortization on the air navigation right.



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Across the Company, there is an ongoing focus on cost management. Over the past several years the Company has been able to achieve cost decreases per flight hour while continuing to deliver safe and efficient service. As the current economic downturn continues to impact our customers, we will remain focused on cost saving measures that are consistent with safety, which is our top priority. Our efforts are aimed at reducing headcount and discretionary expenses, as well as continuing to implement process improvement initiatives and efficiencies.

Other Income (Loss)

Other income (loss) is comprised primarily of fair value adjustments on investments. Interest received on investments is incorporated in fair value adjustments since the related investments are designated as held-for-trading.

	(millions)		
	Three months ended November 30		
	2009	2008	Change
Other Income (Loss)			
Fair value adjustments	\$ 2	\$ (41)	\$ 43

The fair value adjustments for Q1 fiscal 2010 consist mainly of interest income on investments.

The fair value adjustments for Q1 fiscal 2009 consisted of a \$ 42 million reduction in the fair value of ABCP investments, partially offset by income on other investments.

Due to the volatility of fair values, there is no outlook for other income (loss). As the ABCP restructuring plan has now been implemented, and with the exchange of ABCP investments for longer-term notes, the Company expects that the non-credit related fair value adjustments (amounting to \$ 117 million at November 30, 2009) will be recovered over the terms of the related investments. However, there is no assurance that the fair value of our investments will not decline further or that our estimate of expected credit losses will not increase. Accordingly, the estimated fair value of the Company's investments may change in subsequent periods.

Retained Earnings

The balance in retained earnings as at November 30, 2009 reflects the earnings up to that date. We plan our operations to essentially result in an annual financial breakeven position after expenditures are met through customer service charges and other revenue sources, and after adjustments are made to the rate stabilization account. As a result, the balance in the retained earnings account at the end of each fiscal year has remained stable at \$ 28 million. Any variation from this amount at the end of any interim period reflects planned seasonal or other fluctuations in revenues and expenses.



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Changes in Rate Stabilization Account

Our rate stabilization mechanism and accounting are also discussed at the beginning of this MD&A and in notes 1, 2 (b) and 10 to our consolidated financial statements. The table below shows the changes in the rate stabilization account for the three months ended November 30, 2009.

		(millions)
Rate stabilization liability, beginning of period		\$ 1
Change in rate stabilization amounts during the period:		
Approved drawdown	\$ (14)	
Revenue lower than planned	(6)	
Operating expenses lower than planned	18	
Other expenses lower than planned	1	
Other income (loss) higher than planned	2	1
Rate stabilization liability, end of period		<u>\$ 2</u>

The \$ 1 million increase in the rate stabilization account during Q1 fiscal 2010 is primarily due to the following:

- (i) The approved drawdown of \$ 14 million being one quarter of the annual amount of \$ 57 million, representing the anticipated excess of expenses over revenues at the time the fiscal 2010 budget was approved.
- (ii) Revenues were \$ 6 million lower than had been anticipated, primarily due to lower air traffic levels.

Partially offset by:

- (iii) Operating expenses were \$ 18 million lower than planned, mainly in salary and benefits expense as a result of staffing levels lower than anticipated due to active management of headcount, lower than planned non-salary operating expenses and higher than planned capitalization of labour costs.

The Company has recorded cumulative fair value adjustments on its investments of \$ 158 million which has reduced the rate stabilization account. Of this total, the Company currently estimates that \$ 117 million will be recovered over time, as the fair value of these investments should ultimately reflect the face value of the notes less credit losses, which are currently estimated at \$ 41 million.

When establishing customer service charges, the rate regulator, which is the Company's Board of Directors, considers the balance in the rate stabilization account, adjusted notionally for the non-credit related portion of the fair value adjustment on investments. The long-term target liability balance of the rate stabilization account is 7.5% of total planned annual expenses net of other income, excluding non-recurring items, on an ongoing basis. For fiscal 2010, the target balance is \$ 93 million.



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The table below shows the “notional” balance in the rate stabilization account liability of \$ 119 million at November 30, 2009.

		(millions)
Rate stabilization liability		\$ 2
Fair value adjustment on investments	\$ 158	
Adjusted for credit loss provisions	(41)	117
"Notional" balance in the rate stabilization liability		\$ 119

Outlook: Rate Stabilization Account

Note: See “CAUTION CONCERNING FORWARD LOOKING INFORMATION”, page 1.

Assuming no change in the fair value adjustment on investments, the Company currently anticipates that the rate stabilization account balance will decline by approximately \$ 85 million in fiscal 2010, resulting from estimated revenues of \$ 1,141 million and total expenses and other income (loss) of \$ 1,226 million. The estimated revenues for 2010 are approximately 1.9 % lower than in fiscal 2009, reflecting an anticipated decrease in air traffic levels. Total expenses and other income (loss) are estimated to increase by approximately 3.1 % or \$ 37 million. The net expected outcome is for the rate stabilization account to become an asset balance by the end of fiscal 2010, whereas it is anticipated that the “notional” balance will remain in a liability position.

Earnings Coverage

During a fiscal year, quarterly revenues will reflect seasonal or other fluctuations in the airline industry and therefore our net results vary from quarter to quarter. Our mandate to operate on essentially a financial breakeven basis results in a planned earnings coverage ratio – calculated on the basis of earnings before interest divided by interest expense – that is close to one-to-one. However, the seasonal nature of our revenue flow may result in an earnings coverage ratio of less than one-to-one for any interim period.

For the twelve months ended November 30, 2009, our interest cost was \$ 117 million. Consolidated earnings (after rate stabilization) before interest were \$ 111 million, which is 0.95 times our interest requirement for the year and less than one-to-one by \$ 6 million. Depreciation and amortization expense for this period was \$ 134 million. Our cash flow coverage – calculated on the basis of earnings (after rate stabilization) before interest, depreciation and amortization divided by interest expense – was 2.09 times our interest requirements for this period.

In addition, we maintain a debt service reserve fund and an operations and maintenance reserve fund under our Master Trust Indenture and we are subject to liquidity covenants under our General Obligation Indenture, designed to cover 12 months interest on borrowings, and 25 per cent of our annual operating and maintenance expenses. As at November 30, 2009, we were in full compliance with our debt indentures, including the Master Trust Indenture’s requirements regarding the reserve funds, the flow of funds and with the rate covenants, as well as the liquidity and other provisions of the General Obligation Indenture.



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Credit Ratings

The Company's debt obligations have been assigned the following credit ratings:

Rating Agency	Senior Debt	General Obligation Notes	Outlook
DBRS Limited (DBRS)	AA	AA (low)	Stable
Moody's Investors Service (Moody's)	Aa2	Aa3	Stable
Standard & Poor's (S&P)	AA	AA-	Stable

On February 25, 2009, Moody's issued an announcement confirming the Company's ratings and outlook. Moody's noted that "fiscal 2009 is shaping out to be materially more challenging" than fiscal 2008. They noted that the Company was estimating a traffic decline of at least 5% versus fiscal 2008 which would result in a revenue shortfall versus a traffic budget which had assumed an increase of 3%. They noted that the Company was faced with a widening pension deficit which could lead to material funding and letter of credit requirements. Moody's also noted that the third party ABCP situation had largely stabilized, the Company was taking steps to improve its liquidity position and the Company is prepared to implement any necessary rate, charge or fee increase in order to meet its obligations and meet its financial covenants.

On March 20, 2009, DBRS issued a press release and rating report confirming the Company's ratings and outlook. DBRS voiced concern over the current state of the air transportation industry citing Transport Canada's projected drop in air passenger traffic for 2009 of 5.7%, which they view as "carrying material downside risk". Nevertheless, they confirmed the Company's rating based on the expectation of a "notable" rise in service charges and plans to improve liquidity.

On March 23, 2009, S&P issued a research update confirming the Company's ratings and outlook. They stated that their ratings "rest on our assessment of the Company's strong business profile and sound, although softening, financial profile." S&P stated that the stable outlook assumes the Company will rationalize spending and potentially increase user charges to maintain debt service coverage metrics and liquidity. Furthermore, they stated that they assume that the Company will undertake measures to bolster liquidity by either issuing new subordinated General Obligation Indenture debt or expanding credit facilities.

The Company expects the annual update of credit opinions and reports by the credit rating agencies to take place in the early part of calendar 2010.

A credit rating is not a recommendation to buy, sell, or hold securities and may be subject to revision or withdrawal at any time by the rating organization. Our fiscal 2009 AIF contains more detailed information about the credit ratings, including each rating agency's rationale for assigning the given rating.



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SUMMARY OF QUARTERLY RESULTS

Quarterly Financial Information (unaudited)

	(millions)			
	Three months ended			
	Q1 November 30 2009	Q4 August 31 2009	Q3 May 31 2009	Q2 February 28 2009
Revenue before rate stabilization	\$ 281	\$ 322	\$ 284	\$ 261
Rate stabilization	20	32	25	20
	<u>301</u>	<u>354</u>	<u>309</u>	<u>281</u>
Operating expenses before rate stabilization	228	194	241	236
Rate stabilization	18	62	14	15
	<u>246</u>	<u>256</u>	<u>255</u>	<u>251</u>
Other expenses (interest, depreciation and amortization)	60	63	66	61
Rate stabilization	1	1	(1)	2
	<u>61</u>	<u>64</u>	<u>65</u>	<u>63</u>
Other income (loss)	2	1	1	6
Rate stabilization	(2)	3	2	(3)
	<u>-</u>	<u>4</u>	<u>3</u>	<u>3</u>
Excess of revenue and other income over expenses (expenses over revenue and other income)	<u>\$ (6)</u>	<u>\$ 38</u>	<u>\$ (8)</u>	<u>\$ (30)</u>
	Three months ended			
	Q1 November 30 2008	Q4 August 31 2008	Q3 May 31 2008	Q2 February 29 2008
Revenue before rate stabilization	\$ 296	342	\$ 305	\$ 281
Rate reduction	-	3	3	3
Rate stabilization	13	(2)	(9)	(10)
	<u>309</u>	<u>343</u>	<u>299</u>	<u>274</u>
Operating expenses before rate stabilization	234	239	250	238
Rate stabilization	14	6	-	8
	<u>248</u>	<u>245</u>	<u>250</u>	<u>246</u>
Other expenses (interest, depreciation and amortization)	62	65	63	63
Rate stabilization	2	-	1	-
	<u>64</u>	<u>65</u>	<u>64</u>	<u>63</u>
Other income (loss)	(40)	(16)	(48)	(20)
Rate stabilization	43	20	52	26
	<u>3</u>	<u>4</u>	<u>4</u>	<u>6</u>
Excess of revenue and other income over expenses (expenses over revenue and other income)	<u>\$ -</u>	<u>\$ 37</u>	<u>\$ (11)</u>	<u>\$ (29)</u>



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Discussion of Quarterly Results

The quarterly variations in revenues mainly reflect seasonal fluctuations. Typically, revenues are highest in our fourth quarter (June to August) as a result of increased air traffic in the summer months. The second quarter (December to February) typically has the lowest air traffic volumes. Air traffic for Q1 fiscal 2010 was 5.7 per cent lower on average than in Q1 fiscal 2009.

The majority of our operating expenses are incurred evenly throughout the year. Quarterly results are impacted by one-time events such as the settlement and curtailment of certain post-employment health care benefits that resulted in a \$ 40 million gain during the fourth quarter of fiscal 2009.

Fair value adjustments on investments and derivative instruments have fluctuated significantly from quarter to quarter based on changes in market factors and increasing expectations of credit losses.

LIQUIDITY AND CAPITAL RESOURCES

Working Capital Requirements

Our non-cash current assets are less than our current liabilities. This results from accounts receivable collections that are more rapid than the settlement of accounts payable and accrued liabilities. Should this situation change, the Company has adequate credit facilities and cash to fund the shortfall, as noted below.

We set customer service charges to essentially achieve a financial breakeven position on an annual basis, after considering changes in the rate stabilization account. The inclusion of non-cash depreciation and amortization expenses in the calculation of breakeven rates leads to a positive cash flow from operations. Our strategy is to use this positive cash flow to fund working capital, capital expenditures and contributions to our pension plan. In addition, our strategy is to maintain a financial structure and credit ratings that will allow the Company to access the capital markets to meet debt maturities as they come due. Should we believe that conditions are not appropriate to undertake a refinancing at a particular time or should we experience a temporary downturn in revenues from seasonal or other factors, we have \$ 219 million of cash and cash equivalents plus an \$ 883 million credit facility at our disposal, of which \$ 481 million of the credit facility is available for unrestricted use by the Company.



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The total credit facility as at November 30, 2009 is utilized as follows:

	(millions)
Revolving credit facility expiring May 31, 2012	\$ 683
Additional tranche expiring November 2, 2010	200
Total available credit facility	883
Less: Letter of credit regarding pension solvency requirement	69
Undrawn committed borrowing capacity	814
Less: Operations and maintenance reserve fund allocation (1)	250
Less: Capital leasing transaction restriction	83
Credit facility available for unrestricted use (2)	\$ 481

- (1) The operations and maintenance reserve fund may be used to pay operating and maintenance expenses, if required.
- (2) If required, \$250 million of this amount can be used to refinance the series MTN 2007-1 medium term notes maturing May 3, 2010.

Cash flows for the three months ended November 30, 2009

During Q1 fiscal 2010 our cash balance decreased by \$ 2 million. This is the result of capital expenditures of \$ 36 million offset by cash inflows from operations of \$ 34 million.

During Q1 fiscal 2009 our cash balance decreased by \$ 9 million. This was the result of cash outflows of \$ 20 million for capital expenditures, an increase in reserve funds of \$ 1 million, and \$ 35 million relating to the extinguishment of bank borrowings, partially offset by cash inflows from operations of \$ 47 million.

Outlook: Cash Flow

Note: See "CAUTION CONCERNING FORWARD LOOKING INFORMATION", page 1.

Given that customer service charges are not being increased at this time, the Company's surplus cash position at November 30, 2009 is expected to decline during 2010. Long-term debt levels are expected to decrease by \$ 25 million, from \$ 2,250 million at November 30, 2009 to \$ 2,225 million at August 31, 2010. To mitigate the effect of traffic declines, the Company has implemented a freeze on new capital spending and hiring, except for projects and positions deemed essential, as well as a management salary freeze. As discussed below, the Company has adequate existing sources of financing to cover all known requirements, and has filed a shelf prospectus under which it can issue long-term debt, as required, subject to market conditions at the time of issue.



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Sources of Liquidity

As a corporation without share capital, NAV CANADA finances its operations with borrowed money. When the Company was created, we developed a financing plan called the Capital Markets Platform. All borrowings were incurred and secured under a Master Trust Indenture, which initially provided a total drawn and undrawn borrowing capacity of \$ 3 billion. The Master Trust Indenture provides for a gradually escalating reduction of the initial borrowing capacity over 33 years.

In February 2006, we entered into a new trust indenture (the General Obligation Indenture) that establishes a borrowing program that qualifies as subordinated debt under the Master Trust Indenture. As subordinated debt, general obligation notes are not subject to the mandatory annual debt reduction provisions of the Master Trust Indenture. Provided that we meet an additional indebtedness test, we are not limited in the amount of debt we can issue under the General Obligation Indenture. Under the terms of the General Obligation Indenture, no new indebtedness may be incurred under the Master Trust Indenture. Therefore, as bonds mature or are redeemed under the Master Trust Indenture, they will be replaced with general obligation notes or borrowings under our credit facility, as discussed above under "Working Capital Requirements".

Borrowings under the Master Trust Indenture are secured by an assignment of revenues and a security interest over the debt service reserve fund and revenue account maintained under the Master Trust Indenture. The General Obligation Indenture is unsecured but contains positive and negative covenants similar to the Master Trust Indenture.

In January 2009, the Company filed a Base Shelf Prospectus qualifying \$ 1 billion of general obligation notes to be issued pursuant to the Company's medium term notes program. A final receipt for the prospectus was issued on January 22, 2009. The Company intends to use this prospectus to issue long-term debt to replace long-term debt that is maturing within the 25 month period during which the prospectus remains valid.

We have an \$ 883 million committed bank credit facility of which \$ 683 million will expire on May 31, 2012 and \$ 200 million will expire on November 2, 2010, unless otherwise extended.



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The table below shows our debt, liquidity and investments profile as at November 30, 2009 and August 31, 2009.

	(millions)	
	As at November 30 2009	As at August 31 2009
DEBT:		
Revenue bonds and medium-term notes		
Under the Master Trust Indenture	\$ 700	\$ 700
Under the General Obligation Indenture	1,550	1,550
Total long-term debt outstanding	2,250	2,250
Less: current portion	25	25
Less: deferred financing costs	9	9
	<u>\$ 2,216</u>	<u>\$ 2,216</u>
Capital lease obligations (2)	<u>\$ 527</u>	<u>\$ 540</u>
LIQUIDITY (excludes ABCP, MAV II notes and ineligible asset tracking notes shown below):		
Cash and cash equivalents	\$ 219	\$ 221
Debt service reserve fund	107	107
Capital lease obligation reserve fund	5	5
	<u>\$ 331</u>	<u>\$ 333</u>
Undrawn committed borrowing capacity (1)	<u>\$ 814</u>	<u>\$ 814</u>
Capital lease obligations reserve fund (2)	<u>\$ 495</u>	<u>\$ 506</u>
MAV II, INELIGIBLE ASSET TRACKING AND ABCP NOTES:		
Face value *	\$ 362	\$ 362
Fair value adjustments	(158)	(159)
	<u>\$ 204</u>	<u>\$ 203</u>
* See also "Treasury Management and Financial Risk Mitigation – Liquidity Risk".		
(1) \$ 250 million of these amounts have been allocated to meet the operations and maintenance reserve fund requirement (see also "Working Capital Requirements").		
(2) These amounts are translated from U.S. into Canadian currency at the rate of exchange applicable at the end of each quarter.		

On December 1, 2009, \$ 9 million of cash was used to make a regularly scheduled interest payment.

Our Board of Directors has approved a plan whereby pension contributions in excess of annual pension expense and available cash will be borrowed and then recovered from customers in future years. The amount of the borrowing required will be dependent primarily on the investment experience of plan assets



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and the discount rates used to determine pension contributions in our actuarial valuations. The full amount of the going concern and solvency contributions will be recovered through future customer service charges.

Reserve Funds and Financial Instruments

Financial instruments are also discussed in note 4 to our financial statements. Under the Master Trust Indenture (MTI), we maintain a debt service reserve fund and an operations and maintenance reserve fund. We are also required to meet certain minimum liquidity levels under the General Obligation Indenture. In addition, we also have a capital lease obligations reserve fund that is unrelated to the Master Trust Indenture or General Obligation Indenture.

The debt service reserve fund is maintained in cash and qualified investments deposited with the Trustee. An amount equal to one year's debt service (excluding General Obligation debt) is required to be maintained. The debt service reserve fund also counts toward our minimum cash liquidity level under the General Obligation Indenture, which is one year's interest on all debt.

The operations and maintenance reserve fund requirements are met with an allocation of \$ 250 million in undrawn availability under our committed credit facility. At a fiscal year end the fund must cover at least one quarter of the annual operating and maintenance expenses. This fund also serves to meet the minimum liquidity level under the General Obligation Indenture, which consists of the minimum cash liquidity level mentioned above plus one quarter of the previous year's operating and maintenance expenses.

As at November 30, 2009, we were in full compliance with our debt indentures, including the Master Trust Indenture's requirements regarding the reserve funds, the flow of funds and with the rate covenants, as well as the liquidity and other provisions of the General Obligation Indenture.

The capital lease obligations reserve fund relates to our leasing transactions and is comprised of three elements:

- funds placed with two financial institutions in exchange for their commitment to meet our future financial obligations under the capital leases (see Capital Lease Obligations risks below);
- the investment of the benefits that we realized through the transactions; and
- the interest earned on investments, net of payments made by the two financial institutions.

We hold and intend to continue holding the benefits in reserve until certain contingent obligations arising from the leases are extinguished. This is discussed in more detail below.



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Treasury Management and Financial Risk Mitigation

Credit Risk on Investments: In order to mitigate the risk of losses arising from investment activities, we invest only in highly-rated and short-term obligations. Excluding investments in MAV II, Ineligible Asset Tracking notes and other ABCP notes, the Company limits investments to obligations of the federal government, certain provincial governments, entities guaranteed by a federal or provincial government or other obligations of entities rated in the top two categories for long-term debt or the highest category for short-term debt by at least two rating agencies. Asset backed securities must be sponsored by a Schedule I bank and may not contain synthetic assets. Our portfolio is diversified, with dollar and percentage limits on investment counterparties.

Interest Rate Risk: We are exposed to the risk that net interest expenses will increase as a result of changes in market interest rates. First, this risk relates to the possibility that maturing bonds may need to be re-financed at higher interest rates. Second, the Company has \$ 332 million invested in floating rate instruments and an additional \$ 192 million of notes that bear interest at floating rates. Thus, if interest rates decline, earnings on these instruments would fall. Third, the Company has \$ 250 million of floating rate debt obligations, which bear interest at a rate that is adjusted every 90 days. We mitigate these sources of interest rate risk in the following ways:

- maturities of borrowings are currently spread over periods up to and including 2027 so that only a portion of outstanding debt will mature in any given fiscal year; and
- floating rate investments are made (subject to market availability) with terms that match the interest rate-setting dates on floating rate notes so that declines in interest earnings are offset to some degree by declines in interest expense on the notes.

Interest rate risk relating to our pension plans is discussed below under Pension Plan.

Liquidity Risk: We are also exposed to liquidity risks. We mitigate this risk by monitoring current and expected liquidity requirements taking into account trends in air traffic and expected payments under our pension plans, to ensure that we maintain sufficient reserves of cash, cash equivalents, investments and/or available undrawn credit facility to meet our liquidity requirements in the short and longer term.

As a result of declines in air traffic levels, we anticipate that total revenue may decrease by approximately \$ 20 million in fiscal 2010. The Company has \$ 814 million of undrawn availability under its committed credit facility and has allocated \$ 250 million of this facility to meet its Operations and Maintenance Reserve fund requirement under the MTI and \$ 83 million of the facility for the capital lease transactions described in note 11 of our financial statements. The Company has investments in highly rated short-term obligations in its Debt Service Reserve fund. The Company has sufficient available liquidity to meet its operating needs after considering the current economic environment.

Based on current information, as described in the Financial Highlights section, the Company does not expect the degree of liquidity of the notes received upon restructuring of third party ABCP to have a material adverse impact on its business or its ongoing compliance with financial covenants. The Company plans to maintain sufficient liquidity from other sources in order to maximize the value of the notes by holding them to maturity.



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Refinancing Risk: We are also exposed to re-financing risk with respect to our bond maturities. We mitigate this risk by maintaining a committed revolving credit facility in an amount sufficient to meet our refinancing needs in the event of temporary capital market disruptions or lack of access to the market for any reason. In January 2009 we filed a new shelf prospectus that qualifies up to \$ 1 billion of general obligation notes, which amount is sufficient to cover all issues maturing during the twenty-five month life of the prospectus. Any refinancing would be subject to market conditions at the time of the refinancing. In April 2009, we issued \$ 600 million of notes under the shelf prospectus.

Foreign Exchange Risk: We invoice and receive the vast majority of our revenues in Canadian dollars and also incur operating expenses and capital expenditures mostly in Canadian dollars. Accordingly, we do not have a significant exposure to losses arising from fluctuations in exchange rates. In some cases, we use forward exchange contracts to purchase or sell foreign currencies to mitigate our foreign exchange risk on contractual agreements in foreign currencies.

As a result of entering into the capital leasing transactions described in note 11 of our financial statements, the Company has capital lease obligations and payment undertaking agreements (that are part of the capital lease obligations reserve funds) denominated in U.S. dollars. The U.S. dollar cash flows from the payment undertaking agreements, comprising funding commitments from two financial institutions, have been structured to fully meet the U.S. dollar capital lease obligations.

Capital Lease Transaction Risks: Capital lease obligations and the assets related to their collateralization are reflected on our balance sheet, and the accounting is described in the notes to our financial statements. We have collateralized our obligations to pay base rent under the leasing transactions by entering into payment undertaking agreements with two financial institutions rated by Standard and Poor's as AA- negative and A+ stable, respectively. Nevertheless we would be obligated to fulfil these financial obligations ourselves if a payment undertaker were unable to do so. We can replace any payment undertaker at any time if its credit rating falls below a certain level, or for any reason at our discretion.

In February 2009, the downgrade of one of the payment undertakers triggered a clause in the capital lease transaction agreements that required the payment undertaker to collateralize its obligations with AAA rated U.S. government or U.S. government guaranteed securities. The financial institution was required to select a custodian, execute a pledge and custody agreement and transfer to the custodian collateral having an aggregate value equal to or greater than the collateral requirement. This process was completed in March 2009.

In certain circumstances we may be required to replace the collateral with similar collateral. Furthermore, we are required to provide additional collateral for our contingent obligations under the lease transactions if:

- the long term senior unsecured debt obligations of the Company are not rated at least A+ by Standard & Poor's and A1 by Moody's Investors Service, or
- the Company's rights and powers under the ANS Act are substantially reduced.

The replacement of existing collateral, or the provision of additional collateral, could result in significant costs. The posting of collateral by the payment undertaker described above resulted in only minor costs to the Company.



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Under the leasing transactions, we may be required to make early termination payments if any portion of the leased equipment is removed, retired or destroyed, and we choose not to replace it. Such termination payments could be in excess of the collateral provided for this purpose. The maximum amount by which these early termination payments could exceed the amounts payable under the payment undertaking agreements and the invested net present value benefits derived from the transactions is approximately \$ 62 million. We currently expect that if any equipment subject to the leases is removed, retired or destroyed it will be replaced.

Rating Triggers: We are also exposed to risks related to the level of our credit ratings. Specifically, under the leasing transactions, if our credit ratings were to fall below certain levels, we would be required to post a letter of credit to offset certain contingent obligations under the transactions (see Capital Lease Transaction Risks above). In addition, our credit facility agreement contains a pricing scale that is based on our credit ratings. If our senior debt ratings were to fall below AA- (or equivalent) our cost of borrowing under the facility would increase, as would the commitment fees payable under the facility. The Company's credit ratings were confirmed in February and March of 2009 (see "RESULTS OF OPERATIONS - Credit Ratings").

Collection of Accounts Receivable: We have strong credit policies. We have established a maximum credit limit of \$ 4 million for our largest customers and we have other credit control measures that have reduced our exposure in this regard. Our general payment terms provide for payment periods of 30 days, but shorter payment terms are imposed where customer circumstances warrant. Our credit policies also require payments in advance or satisfactory security to be posted under certain circumstances. The accounts of all our major customers are current at this time.

Cash Flow Variances arising from Air Travel: We are exposed to unpredictable changes in air traffic volumes that directly affect the Company's cash flows, such as happened following 9/11 in 2001 and during the SARS epidemic in 2004. Future traffic volumes could be influenced by a number of factors, including:

- Economic climate:

Air travel generally is influenced by economic growth or decline. For example, during an economic downturn, growth rates in air travel generally decline. Since a substantial portion of air travel is international, traffic volumes are influenced by both Canadian and global economic circumstances. Given the global economic slowdown, it is uncertain how deep the current downturn will be or how long it will last. On an annual basis, a 1.0 per cent change in air traffic volumes flown in Canadian airspace corresponds to a \$ 12 million change in our revenues before rate stabilization.

- Aviation fuel prices:

As fuel represents a major portion of airline operating costs, a change in the price of fuel can affect air travel demand to the extent that the change is passed on to consumers.

- Terrorist activities, epidemics, pandemics, natural disasters, environmental concerns or weather patterns may all affect air traffic volumes within the airspace for which NAV CANADA provides air navigation services.



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Our strategy is to mitigate the immediate impact of a sudden decline in air traffic with the least disruption possible to our customer base. We do this with our rate stabilization mechanism, which reduces short-term volatility in customer service charges. Our rate stabilization account tracks and accumulates revenue and expense variances from planned levels (whether positive or negative), so that they may be factored into the setting of future customer service charges. We also mitigate the impact of sudden declines in air traffic by maintaining substantial liquidity in the form of our reserve funds and unrestricted available credit facilities (see discussion under "Liquidity Risk").

Pension Plan:

Note: This discussion contains forward-looking information - see "CAUTION CONCERNING FORWARD LOOKING INFORMATION", page 1.

The Company has defined benefit pension plans for employees under which the majority of benefits are indexed to inflation. We use an annual measurement date of May 31 for estimating the accounting surplus or deficit and establishing pension costs for the coming fiscal year. Required pension contributions are determined by an actuarial valuation performed as at January 1 at least every three years or annually when plans are in a deficit position. Our latest actuarial valuation as of January 1, 2009 was completed and filed with the Office of the Superintendent of Financial Institutions (OSFI) in August 2009.

Pension Plan Accounting Deficit: The plans had an accounting deficit of \$ 498 million as at the annual measurement date of May 31, 2009, as disclosed in our audited financial statements for the year ended August 31, 2009. This deficit at May 31, 2009 increased from a deficit of \$ 48 million at May 31, 2008. The increase since May 31, 2008 was primarily due to unfavourable investment experience on plan assets partially offset by a 0.50 per cent decrease in the assumed rate of inflation and a 0.10 per cent increase in the market-based discount rate used to determine pension obligations. The market-based discount rate is based on the yield on long-term high quality corporate bonds, with maturities matching the estimated cash flows of the plan. A 0.25 per cent decrease in the discount rate would increase the accounting deficit by approximately \$ 125 million. Conversely, a 0.25 per cent increase in the discount rate would decrease the deficit by approximately \$ 117 million.

Pension Plan Expenses: Net pension expense (charged to the statement of operations) for Q1 fiscal 2010 was \$ 33 million (2008 - \$ 29 million), consisting of pension benefit costs of \$ 4 million (2008 - \$ 13 million) and \$ 31 million relating to the recovery of special pension contributions (2008 - \$ 16 million) less \$ 2 million (2008 - \$ nil) capitalized to capital assets under development. Our net pension expense for fiscal 2010 is estimated to be \$ 133 million, consisting of pension benefit costs of \$ 15 million and \$ 125 million relating to the recovery of special pension contributions through customer service charges, less \$ 7 million capitalized to capital assets under development.

Annual pension benefit costs can increase by approximately \$ 13 million from a 0.25 per cent decrease in the discount rate used in actuarial calculations, or decrease by approximately \$ 6 million from a 0.25 per cent increase in the discount rate. Annual pension benefit costs can change by approximately \$ 8 million for each 0.25 per cent change in the expected rate of return on plan assets.



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Pension Contributions (Going Concern): The actuarial valuation of the plans performed as of January 1, 2009 reported a going concern deficit of \$ 451 million (January 1, 2008 - \$ 82 million). This deficit increased significantly, primarily as a result of negative investment returns of approximately 21 per cent during calendar year 2008. During calendar 2009 positive investment returns in conjunction with the Company's contributions and other factors affecting the plans' funded position has resulted in a significant improvement in the plans' going concern position. Very preliminary high level estimates of the going concern funded status at January 1, 2010 indicate a going concern position of between a deficit of \$ 50 million and a surplus of \$ 50 million. The Company's contributions to the pension plans on a going concern basis (before considering solvency contributions discussed below) were \$ 103 million for the year ended August 31, 2009 and are estimated to be approximately \$ 95 million for the year ending August 31, 2010. The going concern contributions include both the funding of current service as well as the funding of going concern deficits over 15 years.

Pension Contributions (Solvency): The regulations governing federally regulated pension plans include a solvency test, which assumes the plans are terminated as of the valuation date. The actuarial valuation performed as at January 1, 2009 resulted in a solvency deficit of \$ 156 million. The Company's total contributions including both going concern and solvency contributions were \$ 109 million for the year ended August 31, 2009.

In November 2006 regulations were announced to provide temporary solvency funding relief for federally-registered defined benefit pension plans. Those regulations temporarily extended the solvency funding period from 5 to 10 years subject to certain conditions being met. For the purposes of these regulations, the initial solvency deficiency was \$ 312 million on January 1, 2007. The Company has been contributing an amount sufficient to amortize this deficiency over a period of 10 years. As required by these regulations we arranged a \$ 69 million letter of credit representing the difference between the solvency payments on the 5 and 10 year basis.

In June 2009, regulations were released providing temporary funding relief to allow plans to extend their payment schedule from five to ten years in respect of solvency deficiencies as at January 1, 2009, with the difference between the five and ten year payment schedules secured by a letter of credit unless plan members' consent is received. Since the January 1, 2009 going concern deficit was greater than the solvency deficit, contributions to the pension plan are currently based on the going concern deficit and the 2009 funding relief regulations do not apply. Accordingly, the required letter of credit amount has been reduced to \$ 27 million as of January 1, 2010.

In October 2009, the federal government released a plan for the reform of the legislative and regulatory framework governing federally regulated private pension plans. The funding period for solvency deficits will remain at 5 years but past deficits will be consolidated on a permanent basis for establishing solvency special payments resulting in a fresh start every year. Funding will be based on an average of solvency ratios over the three most recent consecutive years, based on market value of assets. Special solvency payments may be replaced by letters of credit provided the total value of the letters of credit does not exceed 15% of the pension plan assets. It is possible that the new solvency funding rules will be in place for actuarial valuations performed as of January 1, 2010, but certain details of the new funding rules, including transitional issues from the current funding rules, remain to be finalized.



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The amount of required Company contributions and additional letters of credit in future years will be dependent on the investment experience of plan assets and the discount rates that will be used in future actuarial valuations to determine plan liabilities, as well as the changes in funding rules that may be enacted by the Government and OSFI including the Company's consequent determination whether to fund solvency deficits with cash contributions or letters of credit (which will be permissible under the federal government's October 2009 pension funding proposals). The Company will decide whether to fund any future solvency deficit with cash or letters of credit at the time it files its actuarial valuations.

The Company is currently underway with its January 1, 2010 pension funding valuations which are to be filed by June 30, 2010. Based on very preliminary estimates of the funded status and economic assumptions applicable for the actuarial valuation of the pension plans as of January 1, 2010, pension contributions are expected to change from \$ 109 million in fiscal 2009 to approximately \$ 90 - 140 million in fiscal 2010. Depending on the effective date of regulations resulting from the federal government's October 2009 proposals regarding pension solvency funding, the requirement to post letters of credit during fiscal 2010 may vary between \$ nil and \$ 85 million. The letter of credit requirement for pension solvency requirements (related to temporary solvency funding relief announced by the federal government in 2006) has decreased from \$ 69 million to \$ 27 million by January 1, 2010.

The full amount of the Company's going concern and solvency contributions, including the balance of the accrued pension benefit asset account will be recovered through future customer service charges.

Insurance:

Our aviation liability insurance program was renewed for U.S. \$ 3.7 billion per occurrence, on November 15, 2009. This insurance, placed with syndicates at Lloyd's of London and other international insurers, covers all of our ANS operations for both bodily injury and property damage.



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Contractual Obligations

A breakdown of contractual obligations for the next five years and thereafter is presented in the following table.

		Remaining payments - for years ending August 31						
		(millions)						
		Total	2010	2011	2012	2013	2014	Thereafter
Accounts payable and accrued liabilities		\$ 179	\$ 179	\$ -	\$ -	\$ -	\$ -	\$ -
Long-term debt (including current portion)	(1), (2)	2,250	275	275	275	25	25	1,375
Interest payments	(2)	993	82	105	97	87	85	537
Operating leases		79	5	6	6	6	6	50
Purchase obligations		101	101	-	-	-	-	-
Other long-term obligations	(3)	199	8	5	7	6	8	165
Total contractual obligations		\$ 3,801	\$ 650	\$ 391	\$ 385	\$ 124	\$ 124	\$ 2,127

Based on very preliminary estimates of the funded status and economic assumptions applicable for the actuarial valuation of the pension plans as of January 1, 2010, pension contributions are expected to change from \$ 109 million in fiscal 2009 to approximately \$ 90 - 140 million in fiscal 2010. Depending on the effective date of regulations resulting from the federal government's October 2009 proposals regarding pension solvency funding, the requirement to post letters of credit during fiscal 2010 may vary between \$ nil and \$ 85 million. The letter of credit requirement for pension solvency requirements (related to temporary solvency funding relief in 2006) has decreased from \$ 69 million to \$ 27 million by January 1, 2010.

- (1) Payments represent principal of \$ 2,250 million. The Company intends to refinance principal maturities and bank loans at their maturity dates. The Company may choose to repay a portion of these maturities with available cash.
- (2) Further details on interest rates and maturity dates on long-term debt are provided in Note 9 to these consolidated financial statements.
- (3) Payments include long-term obligations for asset retirement, post-employment benefits and accrued benefit pension liability for the Company's supplemental pension plans.



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Capital Expenditures

Planning capital expenditures in respect of systems and technology forms part of our annual budgeting process. As part of this planning process, the Board of Directors reviews proposed capital expenditures against safety, financial and business needs justification criteria, considering NAV CANADA's unique status as a provider of essential safety-critical infrastructure.

During Q1 fiscal 2010 we invested \$ 36 million in capital projects compared to \$ 20 million in Q1 fiscal 2009. The increase is due primarily to the increase in capitalization of directly attributable internal labour and travel costs by \$ 13 million in accordance with our new accounting policy, which was effective September 1, 2009. Investments were made in systems enhancements, functional upgrades, equipment upgrades or replacements, facility replacements or refurbishment and other projects to meet safety and other operational requirements.

To November 30, 2009 we have spent approximately \$ 351 million on CAATS – the Canadian Automated Air Traffic System. CAATS has been commissioned and is operational in all seven area control centers. Full implementation for our northern non-radar airspace at one of our area control centres is planned for completion in the spring of 2010.

We anticipate spending approximately \$ 145 million on capital projects in fiscal 2010, including approximately \$ 45 million of directly attributable internal labour and travel costs.

Capital Management

The Company is a non-share capital corporation and, as discussed in note 1 to our consolidated financial statements, must not set customer service charges higher than what is needed to meet its current and future financial requirements for the provision of air navigation services. The Company plans its operations to essentially result in an annual financial breakeven position after recording adjustments to the rate stabilization account. The Company views capital as the sum of its issued long-term debt, retained earnings, rate stabilization account and other regulatory liabilities, less the accrued pension and other benefit assets, as depicted in the following table. This definition of capital is used by management and may not be comparable to measures presented by other companies.



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	(millions)	
	November 30 2009	August 31 2009
Long-term debt (including current portion)	\$ 2,241	\$ 2,241
Retained earnings	22	28
Rate stabilization account liability	2	1
Regulatory liabilities	153	108
Accrued pension and other benefit assets	(432)	(390)
Accumulated deficit	(255)	(253)
Total capital	\$ 1,986	\$ 1,988

In addition to tracking its capital as defined above, for purposes of managing capital adequacy the Company also takes into consideration known contingent exposures and off balance sheet obligations such as funding obligations of its registered defined benefit pension plans.

The Company's main objectives when managing capital are:

- (i) to safeguard the Company's ability to continue as a going concern;
- (ii) to provide funds for the ongoing acquisition of systems and equipment necessary to implement and maintain a modern, cost-efficient ANS technology platform;
- (iii) to ensure the funding of working capital requirements and reserve funds; and
- (iv) to maintain the Company's credit ratings to facilitate access to capital markets at competitive interest rates.

Management's responses to managing capital during the current difficult economic period, including declining air traffic and pension funding requirements, have been addressed in other sections of this MD&A.



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LEGAL PROCEEDINGS

The Company has been named in a class action by certain passengers, named in actions by certain other passengers and given notice of potential claims by certain other passengers who were on board an Air France aircraft that was unable to stop on the runway and was thereby destroyed at Lester B. Pearson International Airport in Toronto, Ontario on August 2, 2005. The class action alleges \$ 150 million in damages, and alleges negligence against several parties including NAV CANADA. All of the defendants other than NAV CANADA in the class action have agreed to settle with the class action plaintiffs for approximately \$ 14 million plus interest. The Ontario Court has approved some of these amounts and will likely approve the remainder as a fair and reasonable partial settlement of the class action claims. The class action suit against NAV CANADA continues. As a certified class proceeding, certain claimants may opt out of the certified class action and proceed with their own actions. Forty-five passengers have opted out of the class action. Certain of those passengers are currently pursuing separate actions alleging negligence against NAV CANADA and others, claiming damages totalling \$ 405 million. Air France has also named the Company in an action arising from the incident. The action by Air France against the Company and others alleges negligence and seeks damages of \$ 178 million (relating to the destroyed aircraft) and compensation for any money Air France is required to pay out. The Government of Canada is also a defendant in that lawsuit and claims indemnification for damages and costs from NAV CANADA and others if it is found liable. The Greater Toronto Airport Authority has also named the Company and others in an action arising from the incident, claiming damages of \$ 1 million for damage to the airport property. The Company believes that these actions and these potential claims against NAV CANADA are without merit and will defend against them. Having reviewed the allegations and other known relevant factors, including the availability of insurance, the Company does not expect these proceedings to have any material adverse effect on the consolidated financial position or results of operations of the Company. No provision has been made in the Company's consolidated financial statements for any potential liability relating to these actions and potential claims.

CHANGES IN ACCOUNTING POLICIES

Effective September 1, 2009, the Company adopted CICA Handbook Section 3064, Goodwill and Intangible Assets which replaced Section 3062, Goodwill and Other Intangible Assets and Section 3450, Research and Development Costs. This Section establishes guidance on the recognition, measurement, presentation and disclosure of goodwill and intangible assets. Commencing September 1, 2009, capital assets have been presented and disclosed as two separate categories, namely property, plant and equipment and intangible assets. Intangible assets include the air navigation right and computer software. These reclassifications have been applied retroactively in accordance with the transition provisions of the standard. As a result, software with a net book value of \$ 278 million previously included in land, buildings, systems and equipment have been reclassified to intangible assets, resulting in a reclassification of the comparative balances as at August 31, 2009.

Effective September 1, 2009, the Company adopted the amendment to CICA Handbook Section 1100, Generally Accepted Accounting Principles (GAAP) that removed a temporary exemption pertaining to the application of the Section to the recognition and measurement of assets and liabilities arising from rate regulation. As permitted by Canadian GAAP, the Company has applied standards issued by the Financial Accounting Standards Board in the U.S. as another source of Canadian GAAP. The U.S. Statement of Financial Accounting Standards No. 71 – "Accounting for the effects of certain types of regulation" (FAS



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71) allows for the recognition and measurement of rate regulated assets and liabilities. Consequently, regulatory liabilities relating to special pension contributions and long-term disability contributions collected through customer service charges have been reclassified and disclosed separately. As at November 30, 2009, the regulatory liabilities relating to special pension and long-term disability contributions amounted to \$ 144 million. In addition, the Company changed its policy for capitalizing internal labour costs that are directly attributable to qualifying capital assets under development. Previously, capitalization of internal labour costs had been limited to significant internally developed systems meeting certain criteria. Changes related to the adoption of this amendment to Section 1100 have been applied prospectively in accordance with the transition provisions of the standard. During the three month period ended November 30, 2009, the Company capitalized \$ 14 million of internal labour and travel costs (November 30, 2008 - \$ 1 million).

Future accounting pronouncements:

In January 2009, the Canadian Accounting Standards Board (AcSB) issued Handbook Section 1601, Consolidated Financial Statements and Section 1602, Non-controlling Interests, which replace Section 1600, Consolidated Financial Statements. Section 1601 establishes the standards for the preparation of consolidated financial statements while Section 1602 establishes the standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. Sections 1601 and 1602 will apply to interim and annual consolidated financial statements relating to periods commencing on or after January 1, 2011. The Company does not expect the adoption of these Sections to have a material impact on the consolidated financial statements.

In January 2009, the AcSB issued Handbook Section 1582, Business Combinations, which replaces Section 1581, Business Combinations. This Section will apply, on a prospective basis, to future business combinations for which the acquisition date is on or after January 1, 2011. Earlier adoption is permitted as of the beginning of a fiscal year provided Section 1601, Consolidated Financial Statements and 1602 Non-controlling Interests are also adopted at the same time. This new standard effectively harmonizes the accounting for business combinations under Canadian GAAP with International Financial Reporting Standards (IFRS). The Company does not expect the adoption of this Section to have a material impact on the consolidated financial statements.

In June 2009, the AcSB issued amendments to Handbook Section 3862, Financial Instruments Disclosures, to improve disclosures of fair value measurements and liquidity risk. The Company will adopt these disclosure requirements prospectively commencing with its consolidated financial statements for the year ended August 31, 2010. The Company does not expect the adoption of these amendments to have a material impact on the consolidated financial statements.

International Financial Reporting Standards (IFRS)

On February 13, 2008 the Canadian Accounting Standards Board (AcSB) announced the adoption of IFRS for publicly accountable enterprises for interim and annual financial statements, effective for fiscal years beginning on or after January 1, 2011. IFRS will be adopted by the Company commencing with its 2012 fiscal year. Hence, the Company's IFRS transition date is September 1, 2010, due to the requirement for one year of comparative figures.



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The following information is presented pursuant to the October 2008 recommendations of the Canadian Performance Reporting Board relating to pre transition communications about IFRS conversion and to comply with Canadian Securities Administrators Staff Notice 52-320, Disclosure of Expected Changes in Accounting Policies Relating to Changeover to IFRS. This information is provided to allow users of the financial statements to obtain a better understanding of our IFRS changeover plan and the possible effects on our financial statements resulting from such conversion.

The Company's IFRS conversion project consists of three phases: scope and plan, analyze and design and implement and review. The Company has substantially completed the first two phases of the project.

The scope and plan phase involved developing an IFRS transition plan based on the results of a high-level preliminary assessment of the differences between IFRS and the Company's current accounting policies. This assessment has provided insight as to the more significant areas of potential impact to the Company, including rate-regulated activities, property plant and equipment, intangible assets, employee benefits and financial instruments. During the scope and plan phase, the Company established an IFRS Steering Committee with a mandate to oversee the transition process, including any impacts on financial reporting, business processes, internal controls and information systems. Regular reporting is provided by the project team to senior management, the IFRS Steering Committee and the Audit Committee of the Board of Directors.

The analyze and design phase of the project involved the analysis and determination of accounting policies based on available IFRS standards and identification of related changes to accounting and reporting processes, IT systems, internal controls and other business processes. During this phase, accounting policy analysis and evaluations of alternatives were completed for several standards and a detailed implementation plan was developed and approved. Final accounting policy selections will be made at the beginning of the project's final phase due to the significance to the Company's financial reporting of the International Accounting Standards Board's (IASB) ongoing projects, particularly its project on rate-regulated activities.

In December 2009, the Company began work on the final phase of the project. This phase will include the finalization of policy determinations and the implementation of required changes to accounting reporting processes, information systems, internal controls and other business processes to effectively comply with dual recording requirements by the beginning of fiscal 2011 and IFRS reporting requirements in fiscal 2012.

The Company continues to monitor standards development as issued by the IASB and the AcSB, as well as regulatory developments as issued by the Canadian Securities Administrators, which may affect the timing, nature or disclosure of the Company's adoption of IFRS.

The transition from current Canadian GAAP to IFRS is a significant undertaking that may materially affect the Company's reported financial position and results of operations. Since final accounting policy selections remain outstanding, the Company is unable to reasonably estimate the impact of transition on the Company's financial reporting at this time. The areas of significance identified above are based on available information and our expectations as of the date of this MD&A and thus are subject to change for new facts and circumstances.



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Progress towards completion of our IFRS transition plan

The following table outlines certain elements of the Company's IFRS transition plan, and an assessment of progress towards achieving them. Certain project activities and milestones could change.

Key activities	Key milestones	Status
<i>Financial statement preparation</i>		
Identification of differences in Canadian GAAP/IFRS accounting policies and choices: <ul style="list-style-type: none"> ▪ Select IFRS policies. ▪ Select IFRS 1 optional exemptions. ▪ Benchmark findings with peer companies. ▪ Prepare financial statements and related note disclosures to comply with IFRS. ▪ Quantify effects of change on disclosures and fiscal 2011 comparatives. 	Selection of IFRS accounting policies and IFRS 1 exemptions by August 31, 2010 Development of opening balance sheet and pro forma financial statements by November 30, 2010.	Completed in-depth analysis of most IFRS requirements in order to develop and document IFRS accounting policy alternatives and identify impacts on the business.
<i>Information technology (IT)</i>		
<ul style="list-style-type: none"> ▪ Identify system changes necessary for new data requirements, for dual recording year and for IFRS 1 calculations. ▪ Identify program upgrades/changes. ▪ Identify changes to budget/forecast process. 	Confirm that systems can address fiscal 2011 dual recording requirements by the third quarter of fiscal 2010. Confirm that business processes and IT systems are IFRS compliant by the end of fiscal 2011.	Identified the system impacts and requirements. Currently coordinating implementation of IT system changes to support accounting and reporting process changes and new data requirements.



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Key activities	Key milestones	Status
<i>Internal controls over financial reporting (ICFR)</i>		
<ul style="list-style-type: none"> ▪ Revise existing internal control processes and procedures to address significant changes to existing accounting policies and practices, including the need for dual record-keeping during fiscal 2011. ▪ Design and implement internal controls with respect to one-time changeover adjustments and related communications. 	<p>Make changes to controls by August 31, 2010.</p> <p>Update CEO/CFO certification process by August 31, 2010.</p> <p>Conduct management evaluation of new or revised controls throughout fiscal 2011.</p> <p>Independent reviews of the project to be conducted during the analyze and design and implement and review phases.</p>	<p>Internal Audit and the Manager, Internal Controls have been involved in the project plan to ensure ICFR requirements are addressed.</p> <p>Independent review of the analyze and design phase of the project completed in August 2009.</p>
<i>Business impacts</i>		
<ul style="list-style-type: none"> ▪ Identify business impacts relating to accounting policy choices and implement required changes. 	<p>Manage business impacts on an ongoing basis throughout the project.</p> <p>Confirm that business processes and IT systems are IFRS compliant by the end of fiscal 2011.</p>	<p>Identified business impacts and requirements in most areas. Analysis of business impacts will be completed in conjunction with the in-depth analysis of remaining changes to IFRS requirements.</p>



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Key activities	Key milestones	Status
<i>Disclosure controls and procedures (DC&P)</i>		
<ul style="list-style-type: none"> ▪ For changes to accounting policies and practices identified, assess the DC&P design and effectiveness implications. ▪ Monitor and update MD&A communications. 	<p>Change management plan (incorporating communications to internal and external stakeholders) to be finalized by March 2010.</p> <p>Analyze and publish the effects of IFRS on the financial statements throughout the project.</p>	<p>Communication requirements have been identified.</p> <p>IFRS disclosures in the MD&A will be updated throughout the project.</p>
<i>Training and communication</i>		
<ul style="list-style-type: none"> ▪ Obtain and/or develop IFRS expertise within the working group, Audit Committee and IFRS Steering Committee. ▪ Engage subject matter experts to assist in the transition. ▪ Communicate progress of changeover plan to internal and external stakeholders. ▪ Develop a detailed end-user training plan. ▪ Ensure a process is in place to manage and respond to IFRS-related queries. 	<p>Change management plan (incorporating communications to internal and external stakeholders) to be finalized by March 2010.</p> <p>Resource requirements determined for each phase of the project – use of in-house expertise and professional advisors.</p> <p>Targeted training to be delivered to the Audit Committee during all phases of the project. Project status and qualitative impacts of IFRS to be presented to the Board of Directors in June 2010.</p> <p>End-user training to be delivered by August 2010.</p>	<p>Communication and training requirements have been identified.</p> <p>Training for project team members has occurred throughout the project</p> <p>Resource requirements for the implement and review phase have been determined.</p> <p>Targeted IFRS training provided to Audit Committee members to date.</p>



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CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of revenues and expenses during the period, the reported amounts of assets and liabilities, and the disclosure of commitments and contingencies at the date of the financial statements. These estimates are based on historical experience, current conditions and various other assumptions that are believed to be reasonable under the circumstances. Because these estimates involve varying degrees of judgment and uncertainty, the amounts currently reported in the financial statements could, in future, prove to be inaccurate.

The following accounting estimates are based on management's judgments and are considered to be critical as they involve matters that are highly uncertain. Any changes from those estimates could have a material impact on our financial statements.

Post-Employment Benefits

We account for pension, other post-employment benefits and long-term disability benefits as required by the CICA accounting recommendation for employee future benefits, and we have included a recovery of pension solvency contributions and long-term disability contributions described in (b) and (c) respectively below.

- (a) Under the accounting recommendation, the amounts reported in our financial statements are determined using actuarial assumptions regarding the estimation of future benefit obligations and investment performance of plan assets. These assumptions include the discount rate used to estimate the future benefit obligation, the expected long-term rate of return on plan assets, the rate of compensation increase, health-care cost trends and expected average remaining years of service of employees. For benefits other than long-term disability benefits (where differences are recognized in the period in which they arise), deferred recognition of differences between actual results and those assumed is an underlying principle of the standard. This approach allows for a gradual recognition of changes in benefit obligations and investment performance over the expected average remaining service life of the employee group covered by the plans.

While these assumptions reflect management's best estimates, differences in actual results or changes in assumptions could materially affect employee benefit obligations and future net benefit plan costs.

The two most significant assumptions used to calculate the net costs of our employee benefit plans are the discount rate used to determine employee benefit obligations including pensions and the expected long-term rate of return on plan assets.

The discount rate is the interest rate used to determine the present value of the future expected cash flows that will be needed to meet employee benefit obligations. It is based on the yield on long-term high quality corporate bonds, with maturities matching the estimated cash flows of the plan.



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The expected long-term rate of return on plan assets is determined based on estimates of long-term investment returns and the asset mix of the plan.

- (b) The funding of the pension plan's deficit has resulted in pension contributions significantly higher than pension benefit expenses charged to the statement of operations. The Board of Directors has approved a plan, whereby pension contributions in excess of annual pension expenses are funded with available cash or borrowed in the short-term, to be recovered from customers in future years. Up to November 30, 2009, the cumulative amount by which Company contributions to the pension plan have exceeded costs amounted to \$ 417 million, of which \$ 132 million has been recovered through customer service charges. Pension expense for fiscal 2010 is estimated to be \$ 133 million, consisting of pension benefit costs of \$ 15 million and \$ 125 million relating to the recovery of special pension contributions through customer service charges (see note 10 (E) to our financial statements), less \$ 7 million included in the cost of capital assets as a result of the Company changing its policy for capitalizing internal labour costs directly attributable to capital assets under development effective September 1, 2009.

Our estimates for future pension contributions are discussed above under the heading "LIQUIDITY AND CAPITAL RESOURCES - Treasury Management and Financial Risk Mitigation - Pension Plan".

- (c) The funding of the long-term disability plan has resulted in contributions higher than long-term disability expenses charged to the statement of operations. Up to November 30, 2009, the cumulative amount by which Company long-term disability contributions have exceeded long-term disability costs amounted to \$ 12 million which is recorded as a regulatory liability on the balance sheet.

Investments in notes received upon restructuring of ABCP

See "INTRODUCTION – Financial Highlights for the three months ended November 30, 2009" and "LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation – Liquidity Risk" and "Credit Risk on Investments".

Investments in notes received upon restructuring of ABCP under the Montreal Accord are carried at fair value in accordance with our accounting policy (as described in note 2 (f) to the financial statements). The Company has determined the fair value using a discounted cash flow approach incorporating available information regarding market conditions as at the measurement date. The majority of ABCP investments were converted into new financial instruments with maturities matching the underlying assets and bearing interest rates commensurate with the nature of the underlying assets and their associated cash flows. The Company has determined that the fair value of these notes is \$ 158 million below their face value. This estimate is subject to measurement uncertainty and is dependent on market conditions as at the measurement date, as well as expectations of future credit losses. A change of 50 basis points in the market discount factor used to determine the value of the notes would impact the fair value adjustment by approximately \$ 7 million. There is no assurance that the value of these investments, including the estimate of expected credit losses, will not change in subsequent periods. Any such changes could be material and would be reflected in the statement of operations as they occur.



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As of November 30, 2009, an active market had not developed for the restructured notes. If an active market for the restructured notes were to develop in the future, the Company will change its valuation technique to determine the fair value of its notes using quoted market prices.

Salaries and Benefits

Approximately 89 per cent of our workforce is unionized. Collective agreements have, at times, expired before new agreements have been reached. Generally accepted accounting principles require that we reflect on a current basis our best estimates of the ultimate salary costs as employees render service.

At November 30, 2009, the accounting estimate relating to collective agreements reflects management's best estimate for the retroactive period for three expired collective agreements as noted below:

- i) The collective agreement with the Canadian Auto Workers/Local 1016, representing approximately 300 operational and training support specialists expired on June 30, 2009. Negotiations reached an impasse in November 2009 and binding arbitration is scheduled in January 2010.
- ii) The collective agreement with the International Brotherhood of Electrical Workers (IBEW) Local 2228, representing nearly 700 employees expired on August 31, 2009. Negotiations are ongoing.
- iii) The collective agreement with the Association of Canadian Financial Officers (ACFO) representing approximately 15 employees expired on November 6, 2009. Negotiations for the renewal of the agreement are underway.

Depreciation and Amortization

Depreciation and amortization of capital assets is calculated on a straight-line basis based on the estimated useful service lives of assets. Actual useful lives of capital assets could be materially different from the estimates that are used. The estimated useful life for buildings is 15 to 40 years, with existing buildings at an average of 22 years. When we acquired our buildings from Transport Canada in 1996, we estimated the remaining useful lives of the majority of those buildings to be 20 years. The estimated useful life for systems and equipment is 3 to 20 years. Air navigation systems and equipment are generally depreciated over 10 to 15 years. Business systems including software, servers and peripherals are generally depreciated over 3 to 5 years. To date, no material adjustments to depreciation have been required.

Effective September 1, 2009, the period over which the rate regulator has approved the recovery of the air navigation right through customer service charges was extended for a further 13 years, resulting in an estimated useful life of 46 years from the date of the acquisition of the rights. This change results in a \$ 16 million decrease in amortization annually (\$ 4 million quarterly).

In conjunction with completing the IFRS transition plan, the Company undertook a detailed review of the useful lives of its capital assets. As a result of this review, the Company has revised the useful lives of certain building components and computer software, effective September 1, 2009. This change in estimate is anticipated to increase depreciation for fiscal 2010 by \$ 6 million (\$ 1 to 2 million quarterly).



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Asset Retirement Obligations

Some of the Company's air navigation system assets, particularly those on leased sites, have asset retirement obligations. However, as these leases are renewed continuously to allow us to provide air navigation services indefinitely, no estimate of fair value can be made. Asset retirement obligations of approximately \$ 1 million have been established for certain assets where reasonable estimates of retirement dates are determinable.

If in the future it becomes possible to estimate the timing of retirement of air navigation system assets, the fair value cost and asset retirement obligation will be recognized at that time. This could occur through: (i) future changes in technology for the provision of air navigation services, or (ii) revisions to service levels after an aeronautical study. If such a liability were recorded at some future date, an equivalent amount would be capitalized as an inherent cost of the associated capital asset. In each subsequent period, the liability would be increased to its future value and the capitalized cost would be depreciated over the remaining useful life of the capital asset. Any future adjustment could be material, depending on the number of assets affected and/or the magnitude of asset retirement estimates.

DISCLOSURE CONTROLS AND PROCEDURES AND INTERNAL CONTROL OVER FINANCIAL REPORTING

In accordance with National Instrument 52-109 of the Canadian Securities Administrators, the Company has filed certificates signed by the Chief Executive Officer and the Chief Financial Officer that, among other things, report on the design of disclosure controls and procedures and the design of internal control over financial reporting.

Disclosure Controls and Procedures (DC&P)

The Company has designed disclosure controls and procedures to provide reasonable assurance that material information relating to the Company is made known to the Chief Executive Officer and the Chief Financial Officer, particularly during the period in which the annual filings are being prepared, and that information required to be disclosed to satisfy the Company's continuous disclosure obligations is recorded, processed, summarized and reported within the time periods specified by applicable Canadian securities legislation.

Internal Control over Financial Reporting (ICFR)

The Company has designed internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with Canadian GAAP. In designing and evaluating internal controls, it should be recognized that due to inherent limitations, any controls, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and may not prevent or detect misstatements.

Commencing September 1, 2009 the Company prospectively changed its policy for capitalizing internal labour and travel costs that are directly attributable to capital assets under development. As a result, the Company has implemented a new computer system to track time spent on capital projects as well as other associated processes. This is a change that affects our ICFR. Controls associated with the new processes have been designed and the Company is exercising due diligence to provide reasonable assurance that the



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capital costs have been accurately measured, reviewed and recorded and that relevant presentation and disclosure has been included in the financial statements in accordance with Canadian GAAP.