NAV CANADA

MANAGEMENT'S DISCUSSION AND ANALYSIS

ON FORM 51-102F1

THREE AND SIX MONTHS ENDED

FEBRUARY 28, 2014

April 10, 2014

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MANAGEMENT'S DISCUSSION AND ANALYSIS
Q2 FISCAL 2014
(in millions of dollars)

CAUTION CONCERNING FORWARD-LOOKING INFORMATION

This management's discussion and analysis (MD&A) contains certain statements about NAV CANADA's future expectations. These statements are generally identified by words like "anticipate", "plan", "believe", "intend", "expect", "estimate", "approximate" and the like, as well as future or conditional verbs such as "will", "should", "would" and "could", or negative versions thereof (see "RESULTS OF OPERATIONS – Outlook: Revenues", "RESULTS OF OPERATIONS – Outlook: Operating and Other Expenses", "RESULTS OF OPERATIONS – Outlook: Other Loss (Income)", "RESULTS OF OPERATIONS – Outlook: Rate Stabilization Account" and "RESULTS OF OPERATIONS – Outlook: Cash Flow"). 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, 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 2013 Annual Information Form dated October 17, 2013 (fiscal 2013 AIF). The forward-looking statements contained in this MD&A represent our expectations as of April 10, 2014 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 MD&A relates to the unaudited consolidated financial condition, results of operations and cash flows for the three and six months ended February 28, 2014 (Q2 fiscal 2014) of NAV CANADA and its subsidiaries (also referred to in this MD&A as we, our, us or the Company). It should be read in conjunction with our unaudited consolidated financial statements for Q2 fiscal 2014, our audited consolidated financial statements and the accompanying notes for the year ended August 31, 2013 (fiscal 2013) as well as our fiscal 2013 AIF. Additional information about the Company, including our financial statements for Q1 and Q2 fiscal 2014 and fiscal 2013, and our fiscal 2013 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 Part V – Pre-changeover accounting standards (Canadian GAAP). Our Audit & Finance Committee reviewed this MD&A and the board of directors of the Company (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.

The core business of the Company 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 customer service 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 prevents us from setting customer service charges higher than what is needed to meet our financial requirements for the provision of air navigation services. Pursuant to these principles, the Board of Directors approves the amount and timing of changes to customer service charges. Our aim is essentially to achieve breakeven financial results on an annual basis. Due to seasonal and other fluctuations in air traffic and given that our costs are predominantly fixed in nature, our quarterly financial results may have an excess of expenses over revenues and other income or an excess of revenues and other income over expenses. This is illustrated in the table under the heading "SUMMARY OF QUARTERLY RESULTS – Quarterly Financial Information (unaudited)".

As noted above, customer service charges are set based on the Company's financial requirements, which take into account estimated air traffic volumes and planned expenditures. Since actual revenues and expenses will differ from these estimates, methods to accumulate the variances are 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, which consists of maintaining rate regulated assets and liabilities. These balance sheet accounts are adjusted with a corresponding impact described as "rate stabilization" adjustments on the statement of operations as explained hereafter.

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 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 balance in the rate stabilization account, adjusted "notionally" for the non-credit related portion of the fair value adjustments that have been provided on investments.

When determining the level of customer service charges described above, the Company considers the Company's current and future financial requirements, the rate stabilization mechanism, the "notional" balance of the rate stabilization account and the balance of the accrued pension benefit asset (net of its regulatory liability) (see "RESULTS OF OPERATIONS – Revenues – Customer Service Charges" , "RESULTS OF OPERATIONS – Changes in Rate Stabilization Account" and "RESULTS OF OPERATIONS – Amounts Considered for Rate Setting Purposes"). In 2008, the Company approved a policy by which the fiscal 2008 balance of pension contributions made in excess of pension expense would be expensed over a period no longer than 15 years (see "LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation – Pension Plan Expenses"). In addition, effective September 1, 2010, the Company approved that if at the end of a quarterly reporting period the "notional" balance of the rate stabilization account is greater than the target balance, the excess over the target will be recorded as additional pension expense in the reporting period. This results in accelerating the recovery of the accrued pension benefit asset (net of its regulatory liability), which represents contributions previously made to the pension plan that have not yet been recovered through customer service charges.

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 prudent approach that balances the interests of our key stakeholders while complying with our statutory and contractual obligations.

(in millions of dollars)

Financial Highlights for the three months ended February 28, 2014

The Company has achieved positive financial performance in Q2 fiscal 2014 as compared to its approved budget, as reflected by the favourable variances from planned results shown below:

	Three months ended February 28		
	2014	2013	Change
Before rate stabilization			
Revenue	$ 281	$ 277	$ 4
Expenses	318	308	(10)
Other loss (income)	(11)	(15)	(4)
	(26)	(16)	(10)
Rate stabilization adjustments:			
Favourable variances from planned results	(12)	(19)	7
Initial approved drawdown	(2)	4	(6)
Additional drawdown related to pension	7	2	5
	(7)	(13)	6
Excess of expenses over revenue and other loss (income)	$ (33)	$ (29)	$ (4)

For the three months ended February 28, 2014, expenses exceeded revenues and other income by $33. The second quarter normally has the lowest air traffic levels of the fiscal year. Given that our costs are predominantly fixed in nature, an excess of expenses over revenue is expected for this quarter. Excluding rate stabilization adjustments, expenses exceeded revenues and other income by $26, primarily due to higher than planned net pension expense (discussed below), partially offset by higher than planned positive fair value adjustments on investments, and higher than planned customer service charges and other revenue.

Based on favourable variances with respect to budget totalling $7 (before fair value adjustments not considered for rate setting purposes), the Company recorded an additional $7 of pension expense in order to accelerate the recovery of pension contributions previously made that had not yet been recorded as costs for rate setting purposes (see "LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation – Pension Plan Expenses"). Rate stabilization drawdowns (adjustments) are described under "RESULTS OF OPERATIONS – Changes in Rate Stabilization Account".

(in millions of dollars)

Financial Highlights for the six months ended February 28, 2014

The Company has achieved positive financial performance in the first six months of the fiscal year ending August 31, 2014 (fiscal 2014) as compared to its approved budget, as reflected by the favourable variances from planned results shown below:

	Six months ended February 28		
	2014	2013	Change
Before rate stabilization			
Revenue	$ 589	$ 578	$ 11
Expenses	629	606	(23)
Other loss (income)	(20)	(23)	(3)
	(20)	(5)	(15)
Rate stabilization adjustments			
Favourable variances from planned results	(26)	(33)	7
Initial approved drawdown (adjustment)	(5)	8	(13)
Additional drawdown related to pension	17	4	13
	(14)	(21)	7
Excess of expenses over revenue and other loss (income)	$ (34)	$ (26)	$ (8)

For the six months ended February 28, 2014, expenses exceeded revenues and other income by $34. Excluding rate stabilization adjustments, expenses exceeded revenues and other income by $20, primarily due to seasonally low air traffic volumes compared to our predominantly fixed costs and higher than planned net pension expense (discussed below), partially offset by positive fair value adjustments on investments of $17.

Based on favourable variances with respect to budget totalling $17 (before fair value adjustments not considered for rate setting purposes), the Company recorded an additional $17 of pension expense in order to accelerate the recovery of pension contributions previously made that had not yet been recorded as costs for rate setting purposes (see "LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation – Pension Plan Expenses"). Rate stabilization drawdowns (adjustments) are described under RESULTS OF OPERATIONS – Changes in Rate Stabilization Account".

The following items have significant financial importance to the Company:

1. Rate Stabilization Account

At February 28, 2014, the rate stabilization account (see "RESULTS OF OPERATIONS – Changes in Rate Stabilization Account") had a liability balance of $67 and the "notional" balance of the rate stabilization account was a liability balance of $93, which is equal to its fiscal 2014 target (see "RESULTS OF OPERATIONS – Amounts Considered for Rate Setting Purposes").

The rate stabilization account improved by $14 during the first six months of fiscal 2014. This improvement is primarily due to higher than planned positive fair value adjustments of $13 and other variances from planned results of $13, and the $5 initially approved adjustment to the rate stabilization account. This improvement is offset by the Company recording an additional $17 of pension expense during the first six months of fiscal 2014 in order to accelerate the recovery of pension contributions previously made that had not yet been recorded as costs for rate setting purposes (see LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation – Pension Plan Expenses"). Rate stabilization drawdowns (adjustments) are described under "RESULTS OF OPERATIONS – Changes in Rate Stabilization Account".

2. Air Traffic and Customer Service Charges

During Q2 fiscal 2014, air traffic volumes increased by 3.2 per cent year-over-year. For the six months ended February 2014, air traffic volumes increased by 2.8 per cent year-over-year.

The Company does not intend to increase customer service charges at this time. We continuously monitor our financial requirements, including air traffic and revenue, and will on a quarterly basis consider the need for a change in rates. Any change in customer service charges would be implemented in accordance with the ANS Act.

3. Pension Plan

The Company continues to meet the funding requirements of its defined benefit pension plans in accordance with the regulations of the Office of the Superintendent of Financial Institutions Canada (OSFI). Actuarial valuations for funding purposes are performed annually as at January 1 and are required to be filed with OSFI by June of the same year. The funding regulations require actuarial valuations to be performed on both a going concern and a solvency basis. The Company funds the pension plan based on the most recently filed actuarial valuations; accordingly, contributions for the annual period beginning July 1, 2013 are based on the January 1, 2013 actuarial valuations. These funding valuations, which were filed with OSFI in June 2013, reported a going concern surplus of $188 and a statutory solvency deficiency of $629.

The Company is currently meeting its statutory pension solvency funding requirements with letters of credit. As at February 28, 2014, the Company has put in place letters of credit totalling $239 to meet its cumulative pension solvency funding requirements. Because the Company funds the pension plan based on the most recently filed actuarial valuations, the letters of credit (for pension funding purposes) will increase to $282 by June 2014, after which contributions and letters of credit for the annual period beginning July 1, 2014 will be based on the January 1, 2014 actuarial valuations.

The amount of required Company contributions and additional letters of credit for the remainder of fiscal 2014 and future years will be dependent on the investment experience of plan assets, the discount rates and other assumptions that will be used in future actuarial valuations to determine plan liabilities, as well as any changes in plan design or pension funding requirements that may be enacted.

On a very preliminary basis, going concern pension contributions for the fiscal year ending August 31, 2014 are estimated to be $98 (fiscal 2013 – $84) including $17 (2013 – $nil) of going concern special payments. This preliminary estimate takes into consideration the potential impact of revised mortality assumptions described below.

In February 2014, the Canadian Institute of Actuaries (CIA) released its final report summarizing the results of a Canadian pensioner mortality study. The CIA's final report reflects comments received and additional information following the release of its draft report in July 2013. The 2014 Public Sector Mortality Table included in the CIA's final report is consistent with the results of the Company's recent study of its own limited pensioner mortality experience. An estimate of the impact of adopting these unadjusted base mortality rates and improvement scales contained in the 2014 Public Sector Mortality Table is an increase in the pension plan's going concern liabilities of approximately $265 and an increase in the pension plan's solvency liabilities of approximately $380. The Company is currently reviewing pensioner mortality and other economic and demographic assumptions, to be adopted for use in the January 1, 2014 actuarial valuations of the pension plan. The actuarial report will be finalized in the coming months and filed with OSFI in June 2014.

The Company's pension plans had an accounting deficit of $889 as at the annual measurement date of May 31, 2013. This accounting deficit at May 31, 2013 decreased from a deficit of $1,006 at May 31, 2012, primarily due to positive investment experience on plan assets partially offset by past service costs incurred.

The differences in the reported surplus or deficit position between the accounting and funding valuations (going concern and solvency) are primarily due to: (a) different discount rates to value the obligations of the plan based on each valuation's required actuarial methodology; (b) the use of three year averaging of solvency ratios to determine the statutory solvency deficiency for funding purposes, whereas the going concern valuation includes asset smoothing over five years, while the accounting valuation is based on market values of assets and liabilities at a point in time (as of the measurement date); and (c) the different dates at which the valuations are performed.

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".

4. Investment in Space-Based Aircraft Surveillance through Aireon LLC

On November 19, 2012, the Company entered into agreements (the November 2012 agreements) setting out the terms of its participation as an investor in Aireon LLC (Aireon). Aireon's mandate is to provide global satellite-based surveillance capability for air navigation service providers (ANSPs) around the world through Automatic Dependent Surveillance-Broadcast (ADS-B) receivers built as an additional payload on the Iridium NEXT satellite constellation, which is expected to be launched by Iridium Communications Inc. (Iridium) within the 2015-2017 time period.

Under the terms of the November 2012 agreements, the Company's overall investment in Aireon is expected to be implemented in stages for up to a total of $150 U.S. ($166 CDN) by calendar 2017 (including $55 U.S. ($61 CDN) excluding transaction costs invested in fiscal 2013). If all investment stages are completed, the Company will have purchased preferred interests which, upon conversion to common equity interests, will represent 51 per cent of the fully diluted common equity of Aireon. The preferred interests provide for a 5 per cent dividend (except for the second stage investment described below that provides for a 10 per cent dividend), calculated from the date of issuance, and will be redeemed for cash in three annual instalments beginning on November 19, 2020 (in the event the preferred interests have not been converted to common equity or redeemed by that time).

The Company's investment is expected to be made in five stages, each subject to the satisfaction of various operational, technical, commercial, regulatory and financial conditions. The staged investments are contingent upon the successful achievement by Aireon and Iridium of certain specific milestones with respect to, among other things, development of the ADS-B payload, deployment of the Iridium NEXT satellite constellation, marketing Aireon's ADS-B service to potential ANSP customers, and regulatory approvals of the technology's use. The final stage of the investment is scheduled for late in calendar 2017.

The payment for the first stage investment of preferred interests amounting to $15 U.S. ($15 CDN) and representing, on a post conversion basis, 5.1 per cent of the fully diluted common equity of Aireon was made in November 2012. In June 2013, the Company made the payment for its second stage investment in Aireon preferred interests in the amount of $40 U.S. ($42 CDN), representing, on a post conversion basis, an additional 13.6 per cent of Aireon's fully diluted common equity, bringing its total interest, on a post conversion basis, to 18.7 per cent of Aireon's fully diluted common equity (see note 5 to our Q2 fiscal 2014 financial statements).

In December 2013, the November 2012 agreements were modified to provide for the making of an aggregate investment of $120 U.S. ($133 CDN) in Aireon by three additional major ANSPs, namely ENAV (Italy), the Irish Aviation Authority (IAA), and Naviair (Denmark) (the Additional Investors). The investment in Aireon by the Additional Investors is expected to be made in four stages between the 2014 and 2017 calendar years, as key milestones are met, in exchange for preferred interests in Aireon. It is expected that in calendar 2018, a portion of Iridium's existing common equity interest in Aireon will be redeemed for a payment from Aireon of $120 U.S. ($133 CDN) to finalize the ownership interests of all of Aireon's investors. Upon this redemption and the related conversion of all preferred interests into common interests, NAV CANADA will hold 51 per cent of the fully diluted common equity interests of Aireon, ENAV will hold 12.5 per cent, and each of IAA and Naviair will hold 6 per cent, with the remaining 24.5 per cent being retained by Iridium.

In February 2014, the Additional Investors made their first stage investment in Aireon. As a result, the Company's total fully diluted common equity interest on a post conversion basis was reduced from 18.7 per cent to 17.29 per cent.

In April 2013, the Company signed a long-term commercial data services contract with Aireon, making the Company Aireon's first customer. The ADS-B data will enable the Company to deploy this new satellite-based surveillance capability in its North Atlantic airspace operations – the busiest oceanic airspace in the world with some 1,200 flights per day. The Company estimates customer fuel savings on the North Atlantic alone of over $125 per year as a result of this new capability, as well as reduced greenhouse gas emissions of 328,000 metric tons of CO_2 equivalents annually starting in 2018. Aireon has since signed long-term commercial data services agreements with the Additional Investors discussed above, as well as with NATS, the United Kingdom's provider of air traffic control services, and has signed a memorandum of understanding with NAV Portugal to become an early customer of Aireon.

(in millions of dollars)

The Company may at any time and from time to time elect to convert all or a portion of its preferred interests in Aireon into common equity interests. This right has been identified as an embedded derivative. Prior to the investment by the Additional Investors, the Company considered that amortized cost measurement represented the most reliable measure of the value of its investment in Aireon, as Aireon is a private company in start-up phase without any operations; accordingly, fair value could not be determined reliably for the embedded derivative. The price paid by the Additional Investors in February 2014 is considered to be a reliable estimate of the fair value of Aireon, and the Company has used this valuation to measure the embedded derivative in its financial statements as at February 28, 2014. During the quarter, there has been an increase in the future income tax liabilities due to the increase in the fair value of the embedded derivative.

The balance sheet impact of the Company's investment in preferred interests of Aireon is comprised of the following:

	February 28 2014	August 31 2013
Regulatory asset	$ 16	$ -
Investment in preferred interests	62	59
Embedded derivative on investment in preferred interests	41	-
Long-term dividend receivable	4	1
Regulatory liabilities		
Embedded derivative on investment in preferred interests	(41)	-
Unrealized foreign exchange gain on the investment	(4)	(1)
Accrued dividend on preferred interests	(4)	(1)
Future income tax liability	(16)	-
	$ 58	$ 58

The net balance sheet impact of the Company's investment in preferred interests of Aireon above reflects the actual amounts paid for the Company's investment in Aireon (at the exchange rates prevailing on the dates of the transactions and including unamortized transaction costs). As at February 28, 2014 the net regulatory accounting liability balances of $33 (August 31, 2013 – $2) comprised of a regulatory asset of $16 (August 31, 2013 – $nil) and regulatory liabilities of $49 (August 31, 2013 – $2) above, defer the accounting recognition of transactions related to the Company's investment in Aireon on the Company's consolidated statement of operations. As a result, there is no impact on the Company's consolidated statement of operations for the six months ended February 28, 2014 related to the Company's investment in Aireon. These amounts are not considered for rate setting purposes until realized in cash.

5. Settlement of Collective Agreements

Since the start of fiscal 2014, four collective agreements (listed below), representing approximately 23 per cent of our unionized workforce, have been finalized. This, in addition to agreements finalized in fiscal 2013 with CATCA – CAW Local 5454 (CATCA), and Air Traffic Specialists – CAW Local 2245 (ATSAC), represents 84 per cent of our unionized workforce for this round of bargaining.

On September 24, 2013, the Company received an arbitration decision that provides a binding conclusion for a three year collective agreement commencing on July 1, 2013 with Unifor Local 1016, which represents approximately 260 employees working as Air Traffic Operational Specialists and Operational Training Specialists in Area Control Centres as well as a variety of positions in the Ottawa area involved with Aeronautical Information Services, Flight Billing, NOTAM and the National Systems Control Centre. The award provides for salary increases of 1 per cent on July 1, 2013 and January 1, 2014, followed by a 2 per cent increase on each of July 1, 2014 and July 1, 2015.

On November 14, 2013, the Company announced that members of the Association of Canadian Financial Officers (ACFO), representing approximately 24 employees, had ratified a new three year collective agreement. The award provides for salary increases of 1 per cent on each of February 7 and August 7, 2014, followed by a 2 per cent increase on each of February 7, 2015 and February 7, 2016.

On November 29, 2013, the Company announced that members of the Canadian Federal Pilots' Association (CFPA), representing approximately 32 employees working as pilots who perform design work and flight inspections, had ratified a new three year collective agreement. The award provides for salary increases of 1 per cent on each of May 1 and November 1, 2013, followed by a 2 per cent increase on each of May 1, 2014 and May 1, 2015.

On December 23, 2013, the Company announced that members of International Brotherhood of Electrical Workers (IBEW), representing approximately 620 employees working as Air Navigation Service Technologists who are responsible for the planning, installation, proof of performance on electrical systems/equipment and who maintain Air Traffic Management (ATM) and Communication, Navigational Aids and Surveillance (CNS) systems, had ratified a new three year collective agreement. The agreement provides for salary increases of 1 per cent on each of January 1 and July 1, 2014, followed by a 2 per cent increase on each of January 1, 2015 and January 1, 2016.

Other premium adjustments and productivity enhancing changes have been incorporated into some of the finalized collective agreements noted above. Consistent with the collective agreements for CATCA and ATSAC, the four collective agreements finalized in fiscal 2014 also included certain changes to the Company's defined benefit pension plan which, subject to their approval by OSFI, will assist in sustaining the pension plan on a long term basis. There is a risk that OSFI may not approve all of the pension changes that are described below.

The collective agreements for CATCA, ATSAC, CFPA, ACFO, IBEW and Unifor Local 1016 representing 84 per cent of our unionized workforce include the following significant changes in the pension area:

(a) All new employees will, effective January 1, 2014, be required to join Part B of the NAV CANADA Pension Plan (NCPP), which has a non-contributory defined benefit design. Previously, new employees have had the alternative of joining Part A of the NCPP, which is contributory and under which pension benefits are automatically indexed to inflation. Part B of the NCPP provides for a lower level of benefits that are not indexed. Part B was introduced effective January 1, 2009 and has been mandatory for new non-unionized employees since that time. The Company expects that its current service pension costs will decline significantly over time, as new employees join Part B of the NCPP.

(b) In the unlikely event of plan termination, the automatic Consumer Price Index (CPI) indexing of pension benefits for active (non-retired) members under Part A of the NCPP will be replaced by fixed rate indexing to the extent that surplus assets would remain. Therefore, automatic CPI indexing for these members will no longer be considered as part of the annual actuarial valuation of the NCPP's solvency liabilities. However, automatic CPI indexing of pensions will continue to be paid to all current retirees and to all plan members who retire under Part A, as long as the NCPP remains in operation. The arbitration decisions and/or settled agreements also require that CATCA, ATSAC, CFPA, ACFO, IBEW and Unifor Local 1016 would have to agree to the termination of the NCPP before such a termination could occur.

    This change should not have any effect on employees or pensioners; however, it will significantly improve the solvency position of the NCPP, thereby reducing the Company's required solvency funding requirements, which are currently being met with letters of credit. Further information on the Company's going concern and solvency funding requirements of the NCPP is discussed under the heading "LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation – Pension Plan".

(c) Other pension changes have been introduced that (i) effective January 1, 2014 remove, for future service, the automatic CPI indexing of pension benefits between members' pre-retirement departure dates and pension commencement dates; and (ii) restore as pensionable the 1 per cent non-pensionable wage increase that had been agreed to in the 2005 CATCA and 2006 ATSAC rounds of bargaining and certain non-pensionable wages that had been agreed to in the 2011 IBEW round of bargaining.

The Company has communicated with OSFI, and on a preliminary basis OSFI has indicated that they are likely to agree with (a) and (c) above, but not with (b). The Company will continue pursuing this with OSFI in the coming months. The arbitration decisions acknowledge that union leadership has joined the Company in the past in making representations to OSFI to support the changes in (b) above and will continue to do so at any future meeting with OSFI, or subsequent related processes.

Should OSFI approve (b) above (which formed part of the arbitration panels' decisions as well as the negotiated settlements referred to above), CATCA, ATSAC, CFPA, ACFO, IBEW and Unifor Local 1016 shall then be entitled to a wage re-opener. That is, the parties would return to the bargaining table and discuss whether or not additional compensation is appropriate. In most instances, an arbitration panel would retain jurisdiction over the matter should the parties be unable to agree on an appropriate outcome.

6. Treasury Management:

In December 2013, the Company entered into three letter of credit facilities totalling $375 for pension funding purposes; these facilities will expire on December 31, 2014, unless extended. As at February 28, 2014, $239 was drawn from these new facilities for pension solvency funding purposes (see "LIQUIDITY AND CAPITAL RESOURCES – Working Capital Requirements").

(in millions of dollars)

RESULTS OF OPERATIONS

	Three months ended February 28			
	2014	2013	Change	%
Revenue	$ 281	$ 277	$ 4	1%
Initial approved rate stabilization drawdown (adjustment) [1]	(2)	4	(6)	
Rate stabilization	(2)	2	(4)	
	277	283	(6)	(2%)
Expenses before rate stabilization	318	308	10	3%
Rate stabilization	3	7	(4)	
Additional rate stabilization drawdown related to pension [2]	(7)	(2)	(5)	250%
	314	313	1	-%
Other loss (income) before rate stabilization	(11)	(15)	4	
Rate stabilization	7	14	(7)	
	(4)	(1)	(3)	300%
Excess of expenses over revenue and other loss (income) after rate stabilization	$ (33)	$ (29)	$ (4)	

	Six months ended February 28			
	2014	2013	Change	%
Revenue	$ 589	$ 578	$ 11	2%
Initial approved rate stabilization drawdown (adjustment) [1]	(5)	8	(13)	
Rate stabilization	(3)	8	(11)	
	581	594	(13)	(2%)
Expenses before rate stabilization	629	606	23	4%
Rate stabilization	10	20	(10)	
Additional rate stabilization drawdown related to pension [2]	(17)	(4)	(13)	
	622	622	-	-%
Other loss (income) before rate stabilization	(20)	(23)	3	
Rate stabilization	13	21	(8)	
	(7)	(2)	(5)	250%
Excess of expenses over revenue and other loss (income) after rate stabilization	$ (34)	$ (26)	$ (8)	

(in millions of dollars)

(1) The Company approved an $11 transfer to the rate stabilization account to be recorded in fiscal 2014 in order to achieve planned breakeven results of operations. The $11 adjustment is being transferred from revenue evenly throughout fiscal 2014. With respect to fiscal 2013, the Company approved a $16 drawdown of the rate stabilization account that was transferred from revenue evenly throughout the year.

(2) In accordance with the Company's financial strategy to accelerate the recovery of pension contributions previously made, the Company recorded an additional $17 for the six months ended February 28, 2014 (six months ended February 28, 2013 – $4). Also see "LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation – Pension Plan Expenses".

Revenues

The following table provides a breakdown of our revenues by category. Our fiscal 2013 AIF and the notes to our financial statements for fiscal 2013 provide more information about the different categories of our customer service charges.

	Three months ended February 28			
	2014	2013	Change	%
Revenues before rate stabilization				
Enroute	$ 135	$ 130	$ 5	4%
Terminal	109	108	1	1%
Daily / annual / quarterly	17	14	3	21%
North Atlantic and international communication	10	10	-	-%
Total customer service charges	271	262	9	3%
Other	10	15	(5)	(33%)
	$ 281	$ 277	$ 4	1%

Other revenues consist of conference and accommodation rentals at our 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.

Revenues before rate stabilization adjustments for Q2 fiscal 2014 were $281 compared to $277 for Q2 fiscal 2013. The $4 increase is primarily due to:

- a $9 increase in customer service charges arising from an increase of 3.2 per cent in air traffic volumes during Q2 fiscal 2014,

partially offset by

- a $5 decrease in other revenue due to lower revenue from development contracts for the sale of air traffic management technology solutions.

(in millions of dollars)

	Six months ended February 28			
	2014	2013	Change	%
Revenues before rate stabilization				
Enroute	$ 293	$ 282	$ 11	4%
Terminal	220	218	2	1%
Daily / annual / quarterly	35	31	4	13%
North Atlantic and international communication	21	21	-	-%
Total customer service charges	569	552	17	3%
Other	20	26	(6)	(23%)
	$ 589	$ 578	$ 11	2%

Revenues before rate stabilization adjustments for the first six months of fiscal 2014 were $589 compared to $578 for the first six months of fiscal 2013. The $11 increase is primarily due to:

- a $17 increase in customer service charges arising from an increase of 2.8 per cent in air traffic volumes during the first six months of fiscal 2014,

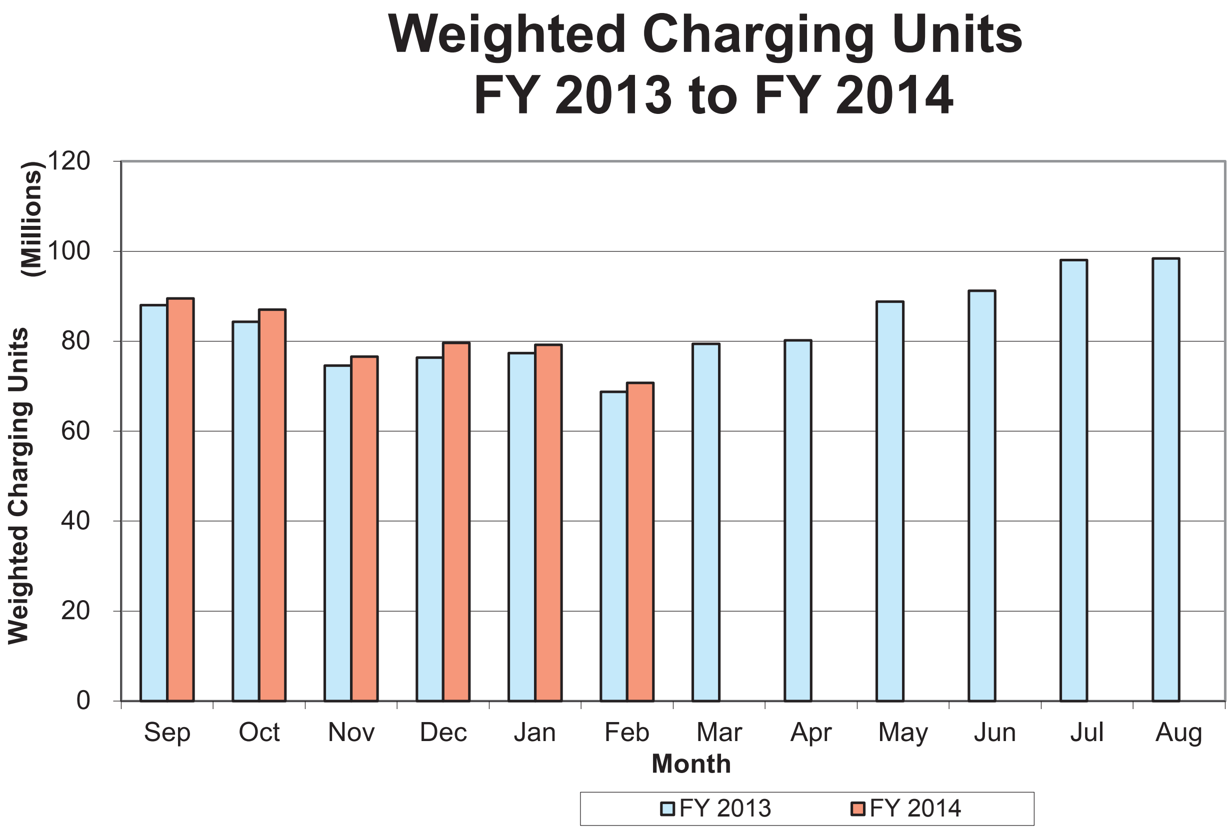
partially offset by

- a $6 decrease in other revenue due to lower revenue from development contracts for the sale of air traffic management technology solutions.

Air Traffic

Air traffic increased by 3.2 per cent in Q2 fiscal 2014 when compared to Q2 fiscal 2013. This increase is illustrated in the following chart showing air traffic by month since September 2012.

The chart illustrates the seasonal variations in traffic. The chart shows traffic in "weighted charging units", which reflect the number of flights, aircraft size and distance flown.



Overall, air traffic growth is comparable to the Company's fiscal 2014 budget. Traffic, as expressed in weighted charging units, is higher in the first six months of fiscal 2014 than in the comparable period in fiscal 2013.

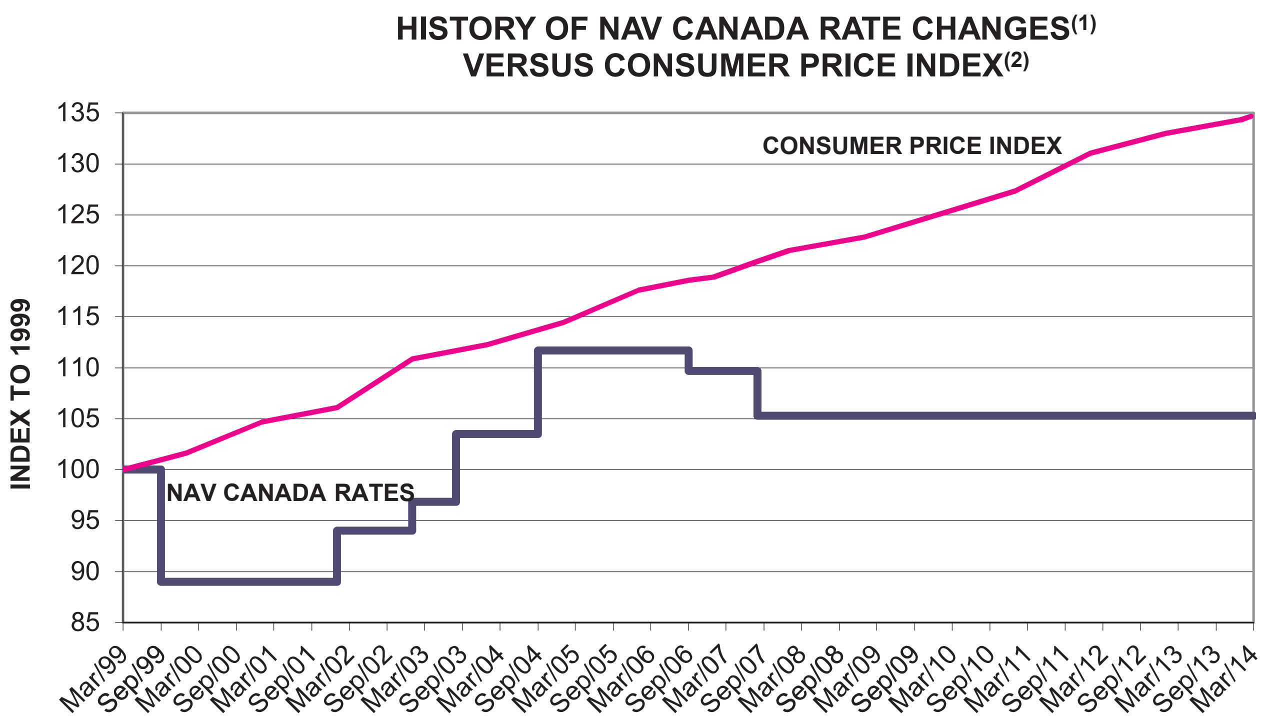
Future air traffic volumes may be influenced by several factors, including the rate of economic growth or decline, changing air passenger demand, aircraft capacity utilization levels, fuel costs, air carrier competition, airline restructurings and insolvencies, terrorist activities, epidemics or pandemics, 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, the "notional" balance of the rate stabilization account (see "RESULTS OF OPERATIONS – Amounts Considered for Rate Setting Purposes") and the balance of the accrued pension benefit asset (net of its regulatory liability).

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 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 5 per cent higher than they were when fully implemented over fourteen years ago in March 1999, which is approximately twenty nine 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.



1. AVERAGE CHANGES SINCE CHARGES WERE FULLY IMPLEMENTED ON MARCH 1, 1999
2. CONSUMER PRICE INDEX - GROWTH ASSUMED TO BE 1.5 PER CENT FOR 2013

As can be seen in the chart above, the Company has not had an overall rate increase in the past nine years, and has had two rate decreases since then.

The Company does not intend to increase customer service charges at this time, given our assessment of the Company's financial requirements and the acceptable "notional" balance in the rate stabilization account (which is described under "RESULTS OF OPERATIONS – Changes in Rate Stabilization Account").

We continuously monitor air traffic levels and consider on a quarterly basis the need for changes in rates. Any change in customer service charges would be implemented in accordance with the ANS Act.

(in millions of dollars)

Outlook: Revenues

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

Total revenues before rate stabilization for fiscal 2014 are expected to be higher by approximately $23 from $1,231 in fiscal 2013 due to growth in air traffic that is expected to approximate 2.4 per cent, partially offset by lower other revenues. See also "LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation" and "RESULTS OF OPERATIONS – Revenues – Customer Service Charges".

In the Q1 fiscal 2014 MD&A, the Company had disclosed anticipated revenues of $1,248 for fiscal 2014. The $6 increase in our revenue outlook to the end of fiscal 2014 is mainly due to higher revenue from development contracts for the sale of air traffic management technology solutions anticipated for the remainder of fiscal 2014 that has been taken into consideration in our current forecast.

Operating Expenses

	Three months ended February 28			
	2014	2013	Change	%
Operating Expenses before rate stabilization				
Salaries and benefits excluding pensions*	$ 170	$ 165	$ 5	3%
Pensions*	33	26	7	27%
Technical services	27	30	(3)	(10%)
Facilities and maintenance	16	15	1	7%
Other*	12	12	-	-%
	$ 258	$ 248	$ 10	4%
* In arriving at the amounts shown, operating expenses have been reduced by the following amounts allocated to capital expenditures:				
Salaries and benefits excluding pensions	4	7	(3)	
Pensions	-	1	(1)	
Other	1	1	-	
	$ 5	$ 9	$ (4)	

Salaries and benefits expense (excluding pension expense) in Q2 fiscal 2014 increased by $5 compared to Q2 fiscal 2013 due to increases in compensation levels, and lower salary costs capitalized to projects, partially offset by savings achieved from the active management of staffing levels.

The $7 increase in pension expense in Q2 fiscal 2014 is primarily due to $7 additional regulatory pension expense that was $5 higher than that recorded in Q2 fiscal 2013. This is discussed further under the heading "LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation – Pension Plan".

(in millions of dollars)

The $3 decrease in technical services in Q2 fiscal 2014 was primarily due to lower equipment and development costs related to the sale of air traffic management technology solutions.

Facilities and maintenance and other expenses were similar to Q2 fiscal 2013.

	Six months ended February 28			
	2014	2013	Change	%
Operating Expenses before rate stabilization				
Salaries and benefits excluding pensions*	$ 331	$ 321	$ 10	3%
Pensions*	68	53	15	28%
Technical services	54	57	(3)	(5%)
Facilities and maintenance	31	28	3	11%
Other*	25	27	(2)	(7%)
	$ 509	$ 486	$ 23	5%
* In arriving at the amounts shown, operating expenses have been reduced by the following amounts allocated to capital expenditures:				
Salaries and benefits excluding pensions	10	16	(6)	
Pensions	1	2	(1)	
Other	2	2	-	
	$ 13	$ 20	$ (7)	

Salaries and benefits expense (excluding pension expense) in the first six months of fiscal 2014 increased by $10 compared to the first six months of fiscal 2013 due to increases in compensation levels and lower salary costs capitalized to projects, partially offset by savings achieved from the active management of staffing levels.

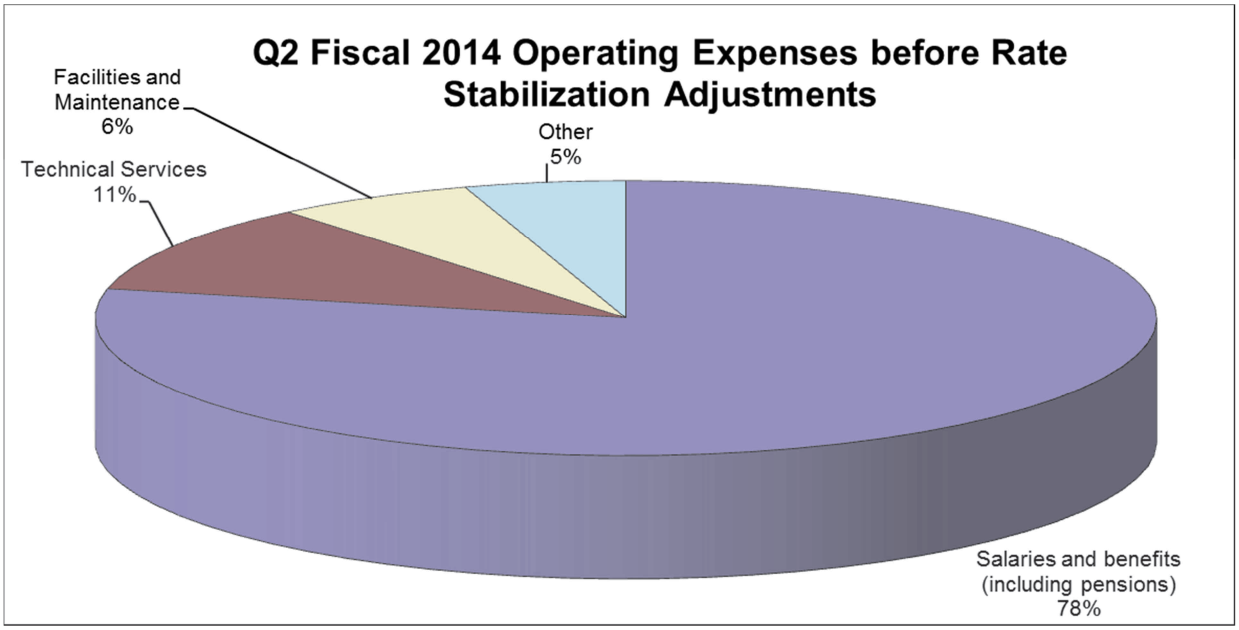
The $15 increase in pension expense in the first six months of fiscal 2014 is primarily due to $17 additional regulatory pension expense that was $13 higher than that recorded in the first six months of fiscal 2013. This is discussed further under the heading "LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation – Pension Plan".

Technical services and other expenses in the first six months of fiscal 2014 decreased by $3 compared to the first six months of fiscal 2013 primarily due to lower equipment and development costs related to the sale of air traffic management technology solutions.

The $3 increase in facilities and maintenance expense in the first six months of fiscal 2014 is primarily due to increases in property taxes and utilities, partially offset by lower facilities maintenance costs.

Other expenses were similar to the first six months of fiscal 2013.

(in millions of dollars)



Other Expenses

	Three months ended February 28			
	2014	2013	Change	%
Other Expenses before rate stabilization				
Interest	$ 26	$ 26	$ -	-%
Depreciation and amortization	34	34	-	-%
	$ 60	$ 60	$ -	-%

	Six months ended February 28			
	2014	2013	Change	%
Other Expenses before rate stabilization				
Interest	$ 52	$ 52	$ -	-%
Depreciation and amortization	68	68	-	-%
	$ 120	$ 120	$ -	-%

Interest expense and depreciation and amortization expense for the three and six months ended February 28, 2014 were comparable to the three and six months ended February 28, 2013.

(in millions of dollars)

Outlook: Operating and Other Expenses

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

Total operating and other expenses before rate stabilization for fiscal 2014 are expected to increase by approximately $26, from $1,238 in fiscal 2013 primarily due to:

- increased compensation levels;
- increased operational requirements in the areas of technical services and facilities and systems maintenance as well as improvements to service delivery that will contribute to safety and other customer benefits;
- higher interest as the $250 series MTN 2010-1 that matured on April 29, 2013 was repaid with proceeds from the issuance of $350 series MTN 2013-1;
- higher pension expense; and
- the effects of inflation;

partially offset by:

- lower interest expense primarily due to the $25 annual principal repayment on amortizing revenue bonds.

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. We remain focused on cost saving measures that are consistent with safety, which is our top priority. Our efforts are aimed at managing staffing levels and discretionary expenses, as well as continuing to implement process improvement initiatives and efficiencies.

In the Q1 fiscal 2014 MD&A, the Company had disclosed anticipated operating and other expenses before rate stabilization of $1,258 for fiscal 2014. The $6 increase in our operating and other expense forecast is mainly due to the additional pension expense recognized this quarter that has been taken into consideration in our current forecast.

Other Loss (Income)

	Three months ended February 28		
	2014	2013	Change
Other Loss (Income) before rate stabilization			
Fair value adjustments, excluding interest income	$ (10)	$ (13)	$ 3
Interest income	(1)	(2)	1
	$ (11)	$ (15)	$ 4

(in millions of dollars)

Fair value adjustments for Q2 fiscal 2014 consist mainly of a $7 increase in the fair value of investments (discussed further under "LIQUIDITY AND CAPITAL RESOURCES – Restructured and Other Investments in Asset-Backed Commercial Paper (ABCP)") (Q2 fiscal 2013 – $13), $3 positive fair value adjustments on foreign exchange contracts (Q2 fiscal 2013 – $nil), and $1 of interest income (Q2 fiscal 2013 – $2).

	Six months ended February 28		
	2014	2013	Change
Other Loss (Income) before rate stabilization			
Fair value adjustments, excluding interest income	$ (17)	$ (20)	$ 3
Interest income	(3)	(3)	-
	$ (20)	$ (23)	$ 3

Fair value adjustments for the six months ended February 28, 2014 consist of $15 positive fair value adjustments to investments (six months ended February 28, 2013 – $20), $2 positive fair value adjustments on foreign exchange contracts (six months ended February 28, 2013 – $nil), and $3 of interest income (six months ended February 28, 2013 – $3).

Outlook: Other Loss (Income)

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

Other income before rate stabilization for fiscal 2014 is expected to decrease by approximately $2, from income of $29 in fiscal 2013. The expected decrease is primarily due to lower forecasted fair value adjustments by $3, partially offset by higher forecasted interest income.

The Company expects that the non-credit related fair value variances from face value on restructured and non-restructured ABCP (amounting cumulatively to $26 at February 28, 2014) will be recovered by the time the notes mature in fiscal 2017. Forecasted fair value adjustments represent the straight line amortization of the accretion of the fair value to face value less expected credit losses. There is no assurance that the fair value of our investments will not decline or that our estimate of expected credit losses will not increase.

Positive fair value adjustments on investments of $24 were recognized in fiscal 2013, as compared to $21 positive fair value adjustments estimated for fiscal 2014 comprised of $17 fair value adjustments recognized to the end of Q2 fiscal 2014 and an additional $4 in positive fair value adjustments forecasted for the remainder of fiscal 2014.

In the Q1 fiscal 2014 MD&A, the Company had disclosed anticipated other income of $21 for fiscal 2014. The $6 increase in our other income outlook to the end of fiscal 2014 is mainly due to higher than anticipated positive fair value adjustments in Q2 fiscal 2014.

(in millions of dollars)

Retained Earnings (Deficit)

The balance in retained earnings (deficit) as at February 28, 2014 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 (deficit) account at the end of each fiscal year has remained stable at $28. Any variation from this amount at the end of any interim period reflects planned seasonal or other fluctuations in revenues and expenses.

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 and 9 of our Q2 fiscal 2014 financial statements. The table below shows the changes in the rate stabilization account for the six months ended February 28, 2014.

Rate stabilization liability, beginning of period		$ 53
Variances from planned results:		
Revenue higher than planned, before approved adjustment	$ 3	
Operating expenses lower than planned, before drawdown related to pension	10	
Other income higher than planned	13	26
		79
Initial approved adjustment		5
Additional drawdown related to pension		(17)
Rate stabilization liability, end of period		$ 67

The $14 improvement in the rate stabilization account during the six month period ended February 28, 2014 is primarily due to the following:

- operating expenses that were $10 lower than planned, mainly due to lower than planned non-salary operating expenses as a result of cost mitigation initiatives implemented by management, and lower than planned salary and benefits expense due to lower than anticipated staffing levels due to active management;
- revenue that was $3 higher than planned, primarily due to higher than planned revenue from development contracts for the sale of air traffic management technology sales;
- other income that was $13 higher than planned, primarily due to higher than planned fair value adjustments on investments; and
- the planned adjustment of $5, representing approximately half of the $11 anticipated excess of revenues and other income over expenses at the time the fiscal 2014 budget was approved; and

partially offset by

- an additional drawdown of $17 to further accelerate the reduction of the balance in the accrued pension benefit asset, net of its regulatory liability.

Outlook: Rate Stabilization Account

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

The Company currently anticipates that the rate stabilization account will have a liability balance of $70 by the end of fiscal 2014, resulting from estimated revenues of $1,254 and total expenses and other loss (income) of $1,237 (excluding rate stabilization adjustments). Revenues for fiscal 2014 are estimated to be approximately 1.9 per cent higher than in fiscal 2013, reflecting an expected increase in air traffic levels of 2.4 per cent offset by lower other revenues. Total expenses and other loss (income) are estimated to increase by approximately 2.3 per cent or $28. It is anticipated that the "notional" balance of the rate stabilization account will be a liability balance of approximately $92 at the end of fiscal 2014, which is slightly below its target balance for fiscal 2014 of $93.

In our Q1 fiscal 2014 MD&A, the Company had forecast an anticipated rate stabilization account liability balance of $64 by the end of fiscal 2014. The $6 improvement in our rate stabilization outlook to the end of fiscal 2014 is due mainly to an increase in estimated revenues of $6. The increase in revenue is largely due to higher revenue from development contracts for the sale of air traffic management technology solutions that has been taken into consideration in our current forecast.

Amounts Considered for Rate Setting Purposes

As discussed under "INTRODUCTION – Financial Strategy and Rate Stabilization Mechanism", when establishing customer service charges the Board of Directors considers the Company's current and future financial requirements as well as:

a) the current and anticipated balance in the rate stabilization account, adjusted "notionally" for the non-credit related portion of the fair value variance from face value on investments, as compared to its target balance; and

b) the balance of the accrued pension benefit asset, net of its regulatory liability, representing the balance of prior years' pension contributions to be recovered.

(in millions of dollars)

The table below shows the "notional" liability balance of the rate stabilization account as compared to its target balance and the amount of prior years' pension contributions not yet recovered through customer service charges. The Company intends to recover these amounts over time. Reductions in the level of customer service charges may not occur until the accrued pension benefit asset, net of its regulatory liability, has been eliminated.

		Six months ended February 28		
		2014	2013	Change
a) Rate stabilization liability		$ 67	$ 52	$ 15
Fair value variances on ABCP investments [1]				
Fair value adjustment on ABCP investments		28	46	(18)
Face value variance on A-2 notes when purchased in fiscal 2011		3	3	-
Credit loss provisions on ABCP investments		(5)	(8)	3
Net non-credit related fair value variances from face value		26	41	(15)
"Notional" balance of the rate stabilization liability [1]		93	93	-
Target balance of the rate stabilization liability[2]		(93)	(93)	-
Shortfall of the rate stabilization liability from its target balance	A	$ -	$ -	$ -
b) Accrued pension benefit asset		$ 308	$ 403	$ (95)
Regulatory liability related to pensions		(237)	(285)	48
Prior years' pension contributions not yet recovered	B	$ 71	$ 118	$ (47)
Amount to be recovered over time through rate setting	(A + B)	$ 71	$ 118	$ (47)

As can be seen in the table above, there has been a reduction in the amount to be recovered over time through rate setting over the past year of $47. Of this reduction, $27 has been achieved during the six months ended February 28, 2014.

(1) The fair value variance from face value on ABCP investments held by the Company at February 28, 2014 of $31 includes cumulative fair value adjustments on these investments of $28 and $3 realized fair value variance on A-2 notes when purchased in fiscal 2011. The $28 in fair value adjustments have reduced the amount in the rate stabilization account. Of the fair value variance from face value of $31, the Company currently estimates that $26 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 $5. Accordingly, $26 has been added to the rate stabilization account to arrive at the "notional" balance of the rate stabilization account.

(2) The long-term target liability balance of the rate stabilization account is 7.5 per cent of total planned annual expenses net of other income, excluding non-recurring items. For fiscal 2014, the target balance is $93.

(in millions of dollars)

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 February 28, 2014, our interest cost was $104. Consolidated earnings (after rate stabilization) before interest was $96, which is 0.92 times our interest requirement for the year and less than our one-to-one target by $8. Depreciation and amortization expense for this period was $137. Our cash flow coverage – calculated on the basis of earnings (after rate stabilization) before interest, depreciation and amortization divided by interest expense – was 2.24 times our interest requirements for this period. Under the *Income Tax Act* (Canada), NAV CANADA is not subject to income taxes and accordingly, no deduction for income taxes has been made. After the application of rate regulated accounting, the provision for income taxes related to our taxable subsidiaries is insignificant.

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 February 28, 2014, 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.

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 March 31, 2014, S&P announced that they were affirming their ratings of NAV CANADA, including the Company's AA long-term issuer credit rating. They maintained the Company's outlook at stable.

S&P stated that the Company's credit profile "predominantly reflects our view of NAV CANADA's monopoly position over an essential service, legislated ability to levy user charges on airlines to meet financial requirements, and solid debt service coverage ratios". They stated that the Company's dependence on air traffic volumes over the entire country, rather than a single region, pointed to greater cash flow stability in support of debt service obligations than that of the airport operators. S&P pointed out that the Company's average user charge per weighted charging unit has shrunk by 16% in real terms since 2000 and they feel this gives the Company "ample scope to increase revenue through user charge adjustments, if needed".

S&P also stated that in their view, the Company's "high debt burden, air travel demand exposure, and large solvency-based pension deficit constrain the ratings".

On December 20, 2013, DBRS issued a press release and rating report confirming the Company's ratings and outlook. DBRS stated that "the rating confirmation incorporates the essential nature of the services provided by the Company and the financial results it achieved last fiscal year (fiscal 2013), but reflects relatively soft traffic levels and the magnitude of NAV CANADA's pension obligations". DBRS noted that the Company expects traffic growth of 2.4% for fiscal 2014 which would lead to a stable Debt Service Coverage Ratio (DSCR). DBRS further stated that "given the continuing uncertainty of the global economic climate and relatively tepid growth, achieving this level of growth could prove challenging".

On April 17, 2013, DBRS issued a press release stating that they had assigned a rating of AA(low) with a Stable trend to the Company's $350 General Obligation Note Series MTN 2013-1 debt issue.

On April 16, 2013, Moody's issued a press release announcing that they had assigned an Aa3 rating to the Company's $350 General Obligation Note Series MTN 2013-1 debt issue.

On March 7, 2013, Moody's issued a Credit Opinion on the Company that confirmed the Company's ratings and Stable outlook. Moody's identified the following ratings drivers for the Company:

- Essential infrastructure asset for the Canadian air transportation system.
- Monopoly provider of civil air navigation services over a very large airspace.
- Legislated right to establish and levy rates and charges as needed to meet financial requirements resulting in a good degree of cash flow predictability.
- Defined benefit pension plan creates recurring calls on cash.

Moody's noted that "for the fiscal year ended August 31, 2012, weighted charging units increased by a minimal 0.6 per cent versus the previous year, and NAV CANADA expects a 1.5 per cent decrease in weighted charging units for fiscal year 2013." (The actual decrease was 0.5 per cent.) Moody's expects this to result in a shortfall of revenues versus expenses and a drawdown of the notional balance of the rate stabilization account before considering cost reductions or any rate or fee increases. Consequently, they feel this will have a weakening impact on the debt service coverage ratio. Moody's went on to note that "any inclination by NAV to use the full notional liability amount of the rate stabilization account and to create a material rate stabilization account asset in order to delay rate increases would weaken NAV's cash debt service coverage ratio quite substantially and thus create pressure on the ratings". Moody's went on to identify the widening pension plan deficit as a credit negative but they felt that the Company's solid cash position, the availability under committed credit facilities (which now include increased availability for letters of credit) and good access to capital markets should allow NAV CANADA to meet these requirements as they come due.

On November 20, 2012, Moody's released an issuer comment saying that NAV CANADA's ratings are unaffected by the Company's agreement to participate in the formation of Aireon. Moody's noted that the joint venture will result in additional funding requirements for NAV CANADA over the 2012-2017 period but that the Company's disbursements to the joint venture are tied to very specific milestones being achieved by Aireon. This "prudent" approach reduces the risk that the Company will disburse investment funds without the resulting benefit of an enhanced operational system. Moody's further stated that risk is also reduced by the amount of preparatory work and discussions that had already occurred.

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 2013 AIF contains more detailed information about the credit ratings, including each rating agency's rationale for assigning the given rating.

(in millions of dollars)

SUMMARY OF QUARTERLY RESULTS
Quarterly Financial Information (unaudited)

	Three months ended			
	Q2 February 28 2014	Q1 November 30 2013	Q4 August 31 2013	Q3 May 31 2013
Revenue before rate stabilization	$ 281	$ 308	$ 347	$ 306
Rate stabilization	(4)	(4)	2	(2)
	277	304	349	304
Operating expenses (excluding pension expense) before rate stabilization	225	216	224	228
Pension expense	33	35	27	32
Rate stabilization	(4)	(3)	-	(1)
	254	248	251	259
Other expenses (interest, depreciation and amortization)	60	60	61	60
Rate stabilization	-	-	(1)	-
	60	60	60	60
Other loss (income)	(11)	(9)	3	(9)
Rate stabilization	7	6	(4)	7
	(4)	(3)	(1)	(2)
Excess (shortfall) of revenue and other loss (income) over expenses	$ (33)	$ (1)	$ 39	$ (13)

	Three months ended			
	Q2 February 28 2013	Q1 November 30 2012	Q4 August 31 2012	Q3 May 31 2012
Revenue before rate stabilization	$ 277	$ 301	$ 337	$ 303
Rate stabilization	6	10	7	-
	283	311	344	303
Operating expenses (excluding pension expense) before rate stabilization	222	211	216	224
Pension expense	26	27	27	32
Rate stabilization	4	11	2	(2)
	252	249	245	254
Other expenses (interest, depreciation and amortization)	60	60	59	61
Rate stabilization	1	-	5	4
	61	60	64	65
Other loss (income)	(15)	(8)	(16)	(10)
Rate stabilization	14	7	13	7
	(1)	(1)	(3)	(3)
Excess (shortfall) of revenue and other loss (income) over expenses	$ (29)	$ 3	$ 38	$ (13)

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 Q2 fiscal 2014 was 3.2 per cent higher on average than in Q2 fiscal 2013.

The majority of our operating expenses are incurred evenly throughout the year. Pension expense fluctuates due to additional regulatory pension expense that is recorded in a quarterly reporting period when the "notional" balance in the rate stabilization account is greater than the target balance (see "LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation – Pension Plan").

Fair value adjustments on investments and derivative instruments have fluctuated significantly from quarter to quarter based on changes in market factors and changing expectations of credit losses. During the second quarter of fiscal 2014, the MAV II notes increased as a result of general market factors affecting discount rates and the fair value of notes.

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 our working capital requirements increase, the Company has adequate credit facilities and cash as noted below.

We establish customer service charge rates to essentially achieve a financial breakeven position on an annual basis, after considering regulatory adjustments. The inclusion of non-cash depreciation and amortization expenses in the calculation of service charge rates leads to a positive cash flow from operations. Our strategy is to use this positive cash flow to fund capital expenditures and contributions to our working capital, if required. 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, at February 28, 2014 we had $192 of cash and cash equivalents and credit facilities of $1,050 at our disposal, of which $522 was available for use as described in the table below.

(in millions of dollars)

The Company's credit facilities are utilized as follows as at February 28, 2014:

Credit facilities:		
Credit facility with a syndicate of Canadian financial institutions (1)	$	675
Letter of credit facilities for pension funding purposes (2)		375
Total available credit facilities		1,050
Less: Outstanding letters of credit (2)		253
Undrawn committed borrowing capacity		797
Less: Operations and maintenance reserve fund allocation (3)		250
Less: Capital lease transaction restriction		25
Credit facilities available	$	522

(1) The Company's credit facility with a syndicate of Canadian financial institutions in the amount of $675 is comprised of two equal tranches maturing on September 12, 2016 and September 12, 2018. The credit facility agreement provides for loans at varying rates of interest based on certain benchmark interest rates, specifically the Canadian prime rate and the Canadian bankers' acceptance rate, and on the Company's credit rating at the time of drawdown. A utilization fee is also payable on borrowings in excess of 25 per cent of the available facility. The Company is required to pay commitment fees, which are dependent on the Company's credit rating. The Company is in compliance with the credit facility covenants as at February 28, 2014.

(2) The letter of credit facilities for pension funding purposes are comprised of three equal facilities that will expire on December 31, 2014 unless extended prior to that date. Of the $253 in letters of credit shown above as outstanding at February 28, 2014, $239 was drawn from the $375 credit facilities for pension solvency funding purposes.

(3) The operations and maintenance reserve fund may be used to pay operating and maintenance expenses, if required.

(in millions of dollars)

Cash flows for the three months ended February 28, 2014

	Three months ended February 28			
	2014	2013	Change	%
Cash flow provided by (used for):				
Operations	$ 9	$ (3)	$ 12	400%
Investing	(18)	(27)	9	33%
Free cash flow (non-GAAP financial measure)	(9)	(30)	21	
Financing	(1)	-	(1)	
Increase (decrease) in cash and cash equivalents	(10)	(30)	20	
Cash and cash equivalents, beginning of period	202	121	81	67%
Cash and cash equivalents, end of period	$ 192	$ 91	$ 101	111%

As shown above, the Company experienced negative free cash flow of $9 for the three months ended February 28, 2014, which is a non-GAAP financial measure. Non-GAAP financial measures do not have any standardized meaning prescribed by Canadian GAAP and therefore may not be comparable to similar measures presented by other issuers. The Company defines free cash flow as cash generated through operations and investment activities. Management places importance on this indicator as it assists in measuring the impact of its capital spending program on the Company's financial resources.

For the three months ended February 28, 2014, cash flow from operations was $12 higher than the three months ended February 28, 2013 primarily due to higher receipts from customer service charges, higher other receipts, and lower net interest payments. This was partially offset by higher cash payments to employees and suppliers and higher pension contributions.

Our cash balance decreased by $10 in the three months ended February 28, 2014. This is primarily due to capital expenditures of $18, cash inflows from operations of $9 and an increase of $1 in our debt service reserve fund.

For the three month period ended February 28, 2013 our cash balance decreased by $30. This was primarily due to capital expenditures of $27 and cash outflows of $3 from operations.

(in millions of dollars)

Cash flows for the six months ended February 28, 2014

	Six months ended February 28			
	2014	2013	Change	%
Cash flow provided by (used for):				
Operations	$ 67	$ 59	$ 8	14%
Investing	(45)	(57)	12	21%
Free cash flow (non-GAAP financial measure)	22	2	20	
Financing	(1)	-	(1)	
Increase (decrease) in cash and cash equivalents	21	2	19	
Cash and cash equivalents, beginning of period	171	89	82	92%
Cash and cash equivalents, end of period	$ 192	$ 91	$ 101	111%

As shown above, the Company experienced positive free cash flow of $22 for the six months ended February 28, 2014, which is a non-GAAP financial measure (see above).

For the six months ended February 28, 2014, cash flow from operations was $8 higher than in the six months ended February 28, 2013 primarily due to higher receipts from customer service charges, and higher other receipts.

Our cash balance increased by $21 in the six months ended February 28, 2014. This is primarily due to cash inflows from operations of $67, partially offset by capital expenditures of $45 and other cash outflows of $1.

Cash and cash equivalents as at February 28, 2014 were $192 compared to $91 as at February 28, 2013. The $101 increase is primarily due to an increase in debt levels to fund the Company's future investments in Aireon.

For the six months ended February 28, 2013, our cash balance increased by $2. This is primarily due to cash inflows from operations of $59 and the recovery of input tax payments on the termination of a capital lease transaction of $21, partially offset by capital expenditures of $61, a $16 investment in Aireon and other cash outflows of $1.

Outlook: Cash Flow

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

Given the expected net cash inflows from operations and cash flows from investing and financing activities in fiscal 2014, the Company's cash position is currently expected to decrease to $187 at August 31, 2014. This cash outlook incorporates anticipated scheduled investments of $33 U.S. ($37 CDN) in Aireon (see "INTRODUCTION – Financial Highlights for the six months ended February 28, 2014 – Investment in Space-Based Aircraft Surveillance through Aireon LLC"), and cash outflows relating to capital assets of $90. As discussed below, the Company has adequate existing sources of financing to cover all of its anticipated requirements.

In the Q1 fiscal 2014 MD&A, the Company had disclosed an anticipated cash position of $149 by the end of fiscal 2014. The $38 improvement in our cash position outlook to the end of fiscal 2014 is mainly due to an increase in estimated revenues of $6 and a decrease of $33 U.S. ($37 CDN) in anticipated scheduled investments in Aireon in fiscal 2014 (see "INTRODUCTION – Financial Highlights for the six months ended February 28, 2014 – Investment in Space-Based Aircraft Surveillance through Aireon LLC"), which is now anticipated to be invested in the fiscal year ending August 31, 2015. The increase in revenue is largely due to higher revenue from development contracts for the sale of air traffic management technology solutions that has been taken into consideration in our current forecast.

Sources of Liquidity

As a corporation without share capital, the Company 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 $3,000. 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 separate trust indenture (the General Obligation Indenture), which established 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 February 2013, the Company filed a Base Shelf Prospectus qualifying up to $550 of general obligation notes to be issued pursuant to the Company's medium term notes program. On April 19, 2013, the Company issued $350 Series MTN 2013-1 notes in order to refinance the Company's $250 Series 2010-1 notes that matured on April 29, 2013 and to generate additional funds for general corporate and investment purposes. The Company has no other scheduled maturities or principal repayments during the twenty-five month term of the Base Shelf Prospectus other than the Series 97-2 amortizing bonds annual payment of $25. The remaining capacity under the Base Shelf Prospectus may be used to pre-fund a future maturity or to generate funds for other corporate purposes.

At February 28, 2014 we had a committed bank credit facility in the amount of $675. The facility is comprised of two equal tranches that will expire on September 12, 2016 and September 12, 2018, unless otherwise extended. On December 13, 2013 the Company entered into three letter of credit facilities totalling $375 in order to replace an expiring letter of credit facility for pension funding purposes ($275) and to provide additional capacity.

(in millions of dollars)

The table below shows our long-term debt, liquidity and investments profile as at February 28, 2014 and August 31, 2013.

	February 28 2014	August 31 2013
LONG-TERM DEBT:		
Revenue bonds and medium-term notes		
Under the Master Trust Indenture	$ 600	$ 600
Under the General Obligation Indenture	1,400	1,400
Total long-term debt outstanding	2,000	2,000
Adjusted for deferred financing costs and discounts	(8)	(8)
Adjusted for regulatory realized hedging transaction asset	(1)	(2)
Adjusted for regulatory realized hedging transaction liability	8	9
Less: current portion	(25)	(25)
	$ 1,974	$ 1,974
CAPITAL LEASE OBLIGATIONS (2)	$ 217	$ 213
LIQUIDITY (excludes ABCP, MAV II notes and ineligible asset tracking notes shown below):		
Cash and cash equivalents	$ 192	$ 171
Debt service reserve fund	112	111
	$ 304	$ 282
Undrawn committed borrowing capacity (1)	$ 797	$ 711
Capital lease obligations reserve fund (2)	$ 208	$ 204
MAV II, INELIGIBLE ASSET TRACKING AND ABCP NOTES:		
Face value *	$ 307	$ 307
Fair value variance from face value	(31)	(46)
	$ 276	$ 261

(1) $522 is available as described under "LIQUIDITY AND CAPITAL RESOURCES – Working Capital Requirements".

(2) These amounts are translated from $U.S. into $CDN at the rate of exchange applicable at the end of each quarter.

* See also "LIQUIDITY AND CAPITAL RESOURCES – Treasury Management and Financial Risk Mitigation – Liquidity Risk".

(in millions of dollars)

Restructured and Other 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 by the Pan Canadian Investors Committee. 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.

The Company holds the following investments in Master Asset Vehicle II (MAV II), Ineligible Asset Tracking notes and ABCP investments (that were not subject to the restructuring by the Pan Canadian Investors Committee) as at February 28, 2014:

	February 28, 2014		
	Face value	Fair value variances	Fair value
MAV II notes			
Class A-1	$ 191	$ (13)	$ 178
Class A-2	94	(8)	86
	285	(21)	264
Ineligible Asset Tracking notes	2	(1)	1
ABCP investments	20	(9)	11
	$ 307	$ (31)	$ 276

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 residential and commercial mortgage backed securities, corporate credit and cash equivalents. The Class A-1 and A-2 notes provide for the payment of interest on a quarterly basis provided that the three month Canadian Dealer Offered Rate (CDOR) rate is above 50 basis points.

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.

The Ineligible Asset Tracking notes track the performance and repayment of the related underlying assets that have significant exposure to the U.S. residential mortgage market.

The restructured 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 is $276 as at February 28, 2014, which is $31 below the face value of the notes. The Company is aware of a number of trades in the restructured notes that have occurred prior to February 28, 2014, but does not consider them to constitute an active market for purposes of a Level 1 valuation. 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, February 28, 2014. The estimates arrived at by the Company are subject to measurement uncertainty and are dependent on market conditions as at the measurement date. If an active market for the restructured notes were to develop in the future, the Company would change its valuation technique to determine the fair value of its notes using quoted market prices.

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 February 28, 2014 of $285. The likelihood of this occurring has been made more remote by certain features of the restructuring, including the provision of a margin funding facility, the adoption of more remote spread/loss triggers, the pooling of trades, and the retention of cash and traditional assets as collateral. At February 28, 2014, the highest index referenced in the spread/loss triggers was at 6 per cent of its trigger level.

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* was passed in the United States in July 2010. Regulations and definitions in support of this legislation were expected to be developed and enacted by July 2011 but some of the regulations have been significantly delayed. Should regulations enacted in the future apply to MAV II or to the underlying assets held by MAV II, it is possible that they will have a detrimental effect on the value of the Company's investments in MAV II notes.

There is no assurance that the fair value of the Company's investments in MAV II, Ineligible Asset Tracking notes and other ABCP will not decline or that significant deterioration in financial markets will not cause losses on the individual collateralized debt obligations 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.

Reserve Funds and Financial Instruments

Financial instruments are also discussed in notes 4 and 16 to our Q2 fiscal 2014 financial statements. Under the Master Trust Indenture, 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 in undrawn availability under our committed credit facilities. 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 February 28, 2014, 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 capital lease transaction 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 lease (see "Capital Lease Transaction Risks" below);
- the investment of the benefits that we realized through the transaction; and
- the interest earned on investments, net of payments made by the two financial institutions.

We hold and intend to continue holding benefits in reserve until certain contingent obligations arising from the lease are extinguished. This is discussed in more detail below under "Capital Lease Transaction Risks".

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, other ABCP notes and Aireon, 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 by at least two rating agencies in the top two categories for long-term debt or the highest category for short-term debt. 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. (See also discussion under "LIQUIDITY AND CAPITAL RESOURCES – Restructured and Other Investments in Asset-Backed Commercial Paper (ABCP)"). The Company's additional planned investments in preferred interests of Aireon are subject to the satisfaction of certain conditions, increasing the likelihood of the successful achievement of Aireon's mandate and reducing the Company's overall risk of a financial loss on its investment in Aireon.

Interest Rate Risk: We are exposed to the risk that net interest expense will increase as a result of changes in market interest rates. One aspect of this risk relates to the possibility that maturing bonds may need to be re-financed at higher interest rates. We mitigate this source 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
- forward dated interest rate swap agreements have been entered into in order to mitigate the impact of fluctuating interest rates on interest costs relating to certain of the Company's expected debt issues.

Secondly, as shown in note 16 to our Q2 fiscal 2014 financial statements, the Company has $580 invested in instruments that bear interest at floating rates. Thus, if interest rates were to decline, earnings on these instruments would fall. In the current low interest rate environment, the Company has positioned itself to benefit from increased earnings on floating rate assets as a result of rising interest rates without an offsetting increase in interest expense. The Company feels that the risk of further declines in short term money market interest rates is low at the present time.

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

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

As at February 28, 2014 the Company had $797 of undrawn availability under its committed credit facilities and had allocated $250 of this facility to meet its operations and maintenance reserve fund requirement under the Master Trust Indenture and $25 of the facilities for the capital lease transaction described in note 11 of our fiscal 2013 annual financial statements. The Company has investments in highly rated short-term obligations in its debt service reserve fund. The Company believes that it has sufficient available liquidity to meet its operating needs.

Based on current information, the Company does not expect the degree of liquidity of the notes received upon restructuring of third party sponsored 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 hold the notes to maturity should it continue to believe that this is the appropriate strategy to maximize the value of the notes.

Refinancing Risk: We are exposed to re-financing risk with respect to our bond maturities, including the $25 annual amortizing payment due on the series 97-2 bonds. We mitigate this risk by maintaining committed revolving credit facilities 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. The Company has in place a $550 Base Shelf Prospectus dated February 26, 2013 that is valid for a twenty-five month period. In April 2013, we issued $350 Series MTN 2013-1 notes under the shelf prospectus. There are no further debt maturities scheduled to occur during the twenty-five month period of the Base Shelf Prospectus. The remaining $200 of availability under the Base Shelf Prospectus may be used to raise funds for general corporate or investment purposes.

Foreign Exchange Risk: The Company is exposed to foreign exchange risk on sales and purchases that are denominated in currencies other than the Canadian dollar, which is the functional currency of the Company. The Company invoices and receives the vast majority of its revenues in Canadian dollars and also incurs operating expenses and capital expenditures primarily in Canadian dollars. In some cases, the Company uses forward exchange contracts to purchase or sell foreign currencies to mitigate its foreign exchange risk on contractual agreements in foreign currencies. Accordingly, the Company does not have a significant exposure to losses arising from fluctuations in exchange rates, except for assets and liabilities relating to the capital lease transaction and the investments in and contractual obligations relating to the investment in preferred interests in Aireon mentioned below.

As a result of entering into the capital lease transaction described in note 10 of our Q2 fiscal 2014 financial statements, the Company has a capital lease obligation 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.

Pursuant to the November 2012 agreements, the Company acquired preferred interests in Aireon and has agreed to acquire additional preferred interests pursuant to the terms and conditions of such agreements. These agreements were modified in December 2013 to allow the Additional Investors to invest in Aireon. The agreements are denominated in U.S. dollars. As at February 28, 2014, the Company's investment in preferred interests was $55 U.S. ($61 CDN) excluding transaction costs and the Company's outstanding commitment was up to $95 U.S. ($105 CDN) (see "INTRODUCTION – Financial Highlights for the six months ended February 28, 2014 – Investment in Space-Based Aircraft Surveillance through Aireon LLC"). The Company has entered into a hedging instrument that will limit the Canadian dollar cost related to $65 U.S. ($72 CDN) of the outstanding commitment. This instrument does not meet the requirements for hedge accounting.

Capital Lease Transaction Risks: The capital lease obligation and the assets related to its 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 capital lease transaction by entering into payment undertaking agreements with two financial institutions rated by S&P as AA- stable and A stable and by Moody's as Aa3 stable and A2 negative. 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 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 transaction if:

- the long term senior unsecured debt obligations of the Company are not rated at least A+ by S&P and A1 by Moody's; 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.

Under the capital lease transaction, we may be required to make an early termination payment if any portion of the leased equipment is removed, retired or destroyed, and we choose not to replace it. Such termination payment could be in excess of the collateral provided for this purpose. As at February 28, 2014, the early termination payment was approximately $7 below the amounts payable under the payment undertaking agreements and the invested net present value benefits retained from the transaction. We currently expect that if any equipment subject to the lease 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 capital lease transaction, 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 transaction (see "Capital Lease Transaction Risks" above). In addition, our credit facility agreements contain a pricing scale that is based on our credit ratings. If our senior debt ratings were to fall below AA (or equivalent) and/or our General Obligation debt ratings were to fall below AA- (or equivalent) our cost of borrowing under the facilities would increase, as would the commitment fees payable under the facilities. The Company's ratings were confirmed in April 2014 by S&P, in December 2013 by DBRS, and in March 2013 by Moody's and (see "RESULTS OF OPERATIONS – Credit Ratings").

Collection of Accounts Receivable: We have strong credit policies. We have established a maximum credit limit of $4 for our largest air navigation services customers and we have other credit control measures that reduce our credit exposure. Our general payment terms provide for payment periods of 30 days for air navigation services and for payment periods of up to 45 days for some other types of services, 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.

Cash Flow Variances arising from Air Traffic levels: We are exposed to unpredictable changes in air traffic volumes that directly affect the Company's cash flows, such as recessions, terrorist attacks (2001), epidemics (SARS - 2004), air carrier financial difficulties and changing weather patterns that may cause flights to move into or out of Canadian air space. Future traffic volumes could be influenced by a number of factors, including:

- Economic climate – Air traffic generally is influenced by economic growth or decline. For example, during an economic downturn, growth rates in air traffic generally decline. Since a substantial portion of air traffic is international, traffic volumes are influenced by both Canadian and global economic circumstances. On an annual basis, a 1.0 per cent change in air traffic volumes flown in Canadian airspace corresponds to approximately a $12 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 traffic 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 the Company provides air navigation services.

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 annual actuarial valuation for funding purposes performed as at January 1 (see below under "Pension Contributions (Going Concern and Solvency)"). Our latest actuarial valuation (for funding purposes) as at January 1, 2013 was completed and filed with OSFI in June 2013.

Pension Plan Accounting Deficit: The plans had an accounting deficit of $889 as at the annual measurement date of May 31, 2013. This accounting deficit at May 31, 2013 decreased from a deficit of $1,006 at May 31, 2012, primarily due to positive investment experience on plan assets, partially offset by past service costs incurred. The market-based discount rate used to determine pension obligations 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 $223. Conversely, a 0.25 per cent increase in the discount rate would decrease the deficit by approximately $208.

Between May 31, 2013 and August 31, 2013, the pension plan's accounting deficit improved to approximately $660, primarily due to a 0.5% increase in the market-based discount rate used to determine pension obligations partially offset by weak asset returns.

Pension Plan Expenses: The Company uses a regulatory approach when determining the level of pension expense that is charged to the statement of operations. The objective of this approach is to reflect the Company's cash contributions to the plans, including contributions made in the past that have not yet been expensed, which constitutes the accrued pension benefit asset (net of its regulatory liability).

For several years prior to fiscal 2008, pension expense was lower than the Company's actual contributions to the pension plan. This means that the Company had made contributions to the pension plan that had not been expensed on the statement of operations, and which therefore had not yet been included in the determination of customer service charges. In 2008, the Company approved a policy by which the fiscal 2008 cumulative balance of contributions made in excess of pension expense (totalling $292) would be expensed over a period no longer than 15 years. Accordingly for fiscal 2014, the regulatory approach for determining annual pension expense for the Company's registered pension plans included an amount equal to the Company's originally planned annual pension contributions ($83), plus an amount to reduce the net cumulative balance of recoverable pension contributions made in the past in excess of pension expense ($19) plus an amount related to supplemental pension benefits in excess of tax limits for federally registered pension plans ($3).

As the "notional" balance of the rate stabilization account was greater than its target balance at the end of each of Q1 fiscal 2014 and Q2 fiscal 2014, additional pension expense of $17 was recorded for the six months ended February 28, 2014 (six months ended February 28, 2013 – $4) to further accelerate the reduction of the balance of the accrued pension benefit asset, net of its regulatory liability.

The full amount of the Company's going concern and solvency contributions to the pension plan, as well as the balance of the accrued pension benefit asset account, net of its regulatory liability, will be recovered through future customer service charges.

(in millions of dollars)

The difference between the pension expense for regulatory purposes and pension benefit costs as determined by CPA Canada Handbook Section 3461, Employee Future Benefits is included in pension expense on the statement of operations and in the pension regulatory liability on the balance sheet. Net pension expense (charged to the statement of operations) for the six months ended February 28, 2014, was as follows:

	Six months ended February 28	
	2014	2013
Pension benefit costs (Per CPA Canada Handbook Section 3461, Employee Future Benefits)	$ 95	$ 82
Regulatory expense		
Planned regulatory decrease	(43)	(31)
Additional rate stabilization drawdown related to pension	17	4
	69	55
Less: amount capitalized	(1)	(2)
Net pension expense	$ 68	$ 53

Annual pension benefit costs can increase by approximately $23 from a 0.25 per cent decrease in the discount rate used in actuarial calculations, or decrease by approximately $21 from a 0.25 per cent increase in the discount rate. Annual pension benefit costs can change by approximately $9 for each 0.25 per cent change in the expected rate of return on plan assets.

Pension Contributions (Going Concern and Solvency): Actuarial valuations for pension funding purposes are performed annually as at January 1 and are required to be filed with OSFI by June of the same year. The actuarial valuations performed as at January 1, 2013 that were filed in June 2013 reported a going concern surplus of $188 (January 1, 2012 – a surplus of $154). The improvement in the plan's going concern position was primarily due to positive investment returns.

The regulations governing the funding of federally regulated pension plans include a solvency test, which assumes the plans are terminated as at the valuation date. The actuarial valuation performed as at January 1, 2013 reported a statutory solvency deficiency of $629 (January 1, 2012 – a statutory solvency deficiency of $509).

In October 2009, the federal government released a plan for the reform of the legislative and regulatory framework governing federally regulated private pension plans. It was announced that the funding period for solvency deficiencies would remain at 5 years but past deficits would be consolidated on a permanent basis for establishing solvency special payments, resulting in a fresh start every year. Following a transition phase, funding of solvency deficits would be based on an average of solvency ratios over the three most recent consecutive years, based on the market value of assets (statutory solvency deficiency). The funding regulations relating to the determination of statutory solvency deficiencies were adopted by the Company as of January 1, 2012. Regulations came into effect on April 1, 2011 permitting solvency special payments to be replaced by letters of credit provided the total value of the letters of credit does not exceed 15 per cent of the pension plan's assets.

The Company is currently meeting its statutory pension solvency funding requirements with letters of credit. As at February 28, 2014, the Company has put in place letters of credit totalling $239 to meet its cumulative pension solvency funding requirements. Because the Company funds the pension plan based on the most recently filed actuarial valuations, the letters of credit (for pension funding purposes) will increase to $282 by June 2014, after which contributions and letters of credit for the annual period beginning July 1, 2014 will be based on the January 1, 2014 actuarial valuations.

The amount of required Company contributions and additional letters of credit for the remainder of fiscal 2014 and future years will be dependent on the investment experience of plan assets, the discount rates and other assumptions that will be used in future actuarial valuations to determine plan liabilities, as well as any changes in pension plan design or funding requirements that may be enacted.

On a very preliminary basis, going concern pension contributions for fiscal 2014 are estimated to be $98 (fiscal 2013 – $84) including $17 (2013 – $nil) of going concern special payments. This preliminary estimate takes into consideration the potential impact of revised mortality assumptions described below.

In February 2014, the CIA released its final report summarizing the results of a Canadian pensioner mortality study. The CIA's final report reflects comments received and additional information following the release of its draft report in July 2013. The 2014 Public Sector Mortality Table included in the CIA's final report is consistent with the results of the Company's recent study of its own limited pensioner mortality experience. An estimate of the impact of adopting these unadjusted base mortality rates and improvement scales contained in the 2014 Public Sector Mortality Table is an increase in the pension plan's going concern liabilities of approximately $265 and an increase in the pension plan's solvency liabilities of approximately $380. The Company is currently reviewing pensioner mortality and other economic and demographic assumptions, to be adopted for use in the January 1, 2014 actuarial valuations of the pension plan. The actuarial report will be finalized in the coming months and filed with OSFI in June 2014.

Insurance: Our aviation liability insurance program was renewed in the amount of $5,031 U.S. ($5,572 CDN) on November 15, 2013. 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 liability claims. This insurance includes a primary U.S. $50 ($55 CDN) "war risks and allied perils" insurance coverage for terrorism-related losses. Since September 2001, the Government of Canada has maintained a program that protects the Company from a terrorist-related loss in excess of our own insurance. This program has been renewed by the Government until December 31, 2015.

(in millions of dollars)

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						
	Total	2014	2015	2016	2017	2018	Thereafter
Accounts payable and accrued liabilities	$ 176	$ 176	-	$ -	$ -	$ -	$ -
Long-term debt (including current portion) (1), (2)	2,000	25	25	475	25	375	1,075
Interest payments (2)	687	50	101	89	76	74	297
Operating leases	61	4	7	7	7	7	29
Purchase obligations	22	17	4	1	-	-	-
Other long-term obligations (3)	236	5	11	11	11	11	187
Investment in preferred interests in Aireon (4)	105	72	17	-	-	16	-
Total contractual obligations	$ 3,287	$ 349	$ 165	$ 583	$ 119	$ 483	$ 1,588

(1) Payments represent principal of $2,000. 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 or may increase the size of a re-financing to generate additional liquidity or for other purposes.

(2) Further details on interest rates and maturity dates on long-term debt are provided in note 8 to our Q2 fiscal 2014 financial statements.

(3) Includes long-term obligations for post-employment benefits, accrued pension benefit liability for the Company's supplemental pension plans and other.

(4) Payments represent contractual obligations to invest in preferred interests of Aireon subject to conditions in various agreements. It is now anticipated that, of the $72 shown above in fiscal 2014, $33 U.S. ($37 CDN) will be invested in the fiscal year ending August 31, 2015. Amounts are presented in $CDN translated using the $U.S. foreign exchange rate at the current balance sheet date.

(in millions of dollars)

Capital Expenditures and Other Investments

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

During Q2 fiscal 2014 we invested $17 in capital projects (cash outflows of $18) compared to $23 in Q2 fiscal 2013 (cash outflows of $27). Investments were made in systems enhancements, functional upgrades, equipment upgrades and replacements, facility replacements and refurbishment and other projects to meet safety and other operational requirements.

We anticipate spending approximately $90 on capital projects in fiscal 2014, including approximately $32 of directly attributable internal labour and travel costs. In addition, in fiscal 2014 we anticipate investing an additional $33 U.S. ($37 CDN) representing a portion of the third of five stages of the Company's overall investment in Aireon (see "INTRODUCTION – Financial Highlights for the six months ended February 28, 2014 – Investment in Space-Based Aircraft Surveillance through Aireon LLC").

Capital Management

The Company is a non-share capital corporation and, as discussed in note 1 to our 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 civil air navigation services. The Company views capital as the sum of its issued long-term debt, retained earnings (deficit), rate stabilization account and other regulatory liabilities, less the accrued pension and other benefits asset, 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.

	February 28 2014	August 31 2013
Carrying value of total bonds and notes payable	$ 1,999	$ 1,999
Retained earnings (deficit)	(6)	28
Regulatory asset	(16)	-
Rate stabilization account liability	67	53
Regulatory liabilities	317	303
Accrued pension and other benefits asset	(313)	(365)
Accumulated surplus	49	19
Total capital	$ 2,048	$ 2,018

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 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 reserve funds as well as working capital and liquidity requirements;

(iv) to maintain the Company's credit ratings to facilitate access to capital markets at competitive interest rates; and

(v) to minimize interest costs incurred by the Company subject to appropriate risk mitigation actions.

Given that the Company has no share capital, these objectives are achieved through a process that determines an appropriate period and level of cost recoveries through customer service charge rate setting, as well as the appropriate amount of debt and committed credit facilities. This process considers the Company's operational and capital budgeting process as well as the overall capital and economic market environment. The level of debt and committed credit facilities are approved by the Board of Directors. The Company is not subject to any externally imposed capital requirements.

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

LEGAL PROCEEDINGS

The Company is party to certain legal proceedings in the ordinary course of its business. Management does not expect the outcome of any of these proceedings to have a material adverse effect on the consolidated financial position or results of operations of the Company.

CHANGES IN ACCOUNTING POLICIES

Future accounting pronouncements:

International Financial Reporting Standards (IFRS)

In February 2013, the Canadian Accounting Standards Board (AcSB) issued an amendment dated March 2013 to the Introduction to Part 1 of the CPA Canada Handbook allowing qualifying entities with rate-regulated activities to adopt IFRS for the first time no later than interim and annual financial statements relating to annual periods beginning on or after January 1, 2015. The Company is a qualifying entity and decided to avail itself of the deferral. As this optional deferral is not reflected in National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*, the Company applied for and received from the Ontario Securities Commission (OSC), the Company's principal securities regulator, an exemption from, and deferral of, the mandatory changeover date to IFRS subject to certain conditions including, among others, the requirement to provide updated discussion in its annual and interim MD&A regarding its preparations for changeover to IFRS and, if possible, the expected effect of the changeover on its financial statements. In November 2013, the AcSB decided against permitting further deferrals of the mandatory implementation date for first-time adoption of IFRS by rate-regulated entities. Accordingly, the Company will adopt IFRS in fiscal 2016, resulting in an IFRS transition date of September 1, 2014 due to the requirement for one year of comparative figures.

In September 2012, the International Accounting Standards Board (IASB) decided to restart its comprehensive project on rate-regulated activities with a discussion paper (DP) rather than an exposure draft (ED). Restarting the comprehensive project with a DP will allow the IASB to conduct a full analysis of the accounting impacts of the various forms of rate regulation; however, it will increase the time required to complete the project. The IASB expects to publish the DP relating to a final standard in the second quarter of calendar 2014. Given the time needed to develop a final standard, the IASB decided in December 2012 to develop an interim standard, to provide temporary guidance on accounting for rate-regulated activities for first-time adopters of IFRS. In January 2014, the IASB published the interim standard, Regulatory Deferral Accounts, which essentially allows the Company to continue to account for regulatory deferral account balances under IFRS in accordance with existing Canadian GAAP. The interim standard introduces limited changes to previous accounting practices which are primarily related to presentation and disclosure. The Company will continue to monitor developments in this area.

The transition from Canadian GAAP to IFRS is a significant undertaking that will materially affect the Company's reported financial position and results of operations. The Company is actively monitoring ongoing IASB projects, giving consideration to any proposed changes by the IASB as the Company finalizes its policy determinations. The Company also actively monitors regulatory updates on IFRS adoption in Canada, as issued by the Canadian Securities Administrators and the OSC.

Following the Company's decisions to defer the adoption of IFRS from fiscal 2013 to fiscal 2016, the Company's IFRS transition plan was amended accordingly. There were no significant changes to the approved implementation strategy except for the deferral of certain project activities. The following table outlines key activities and updated milestones in the Company's IFRS transition plan, and an assessment of progress towards achieving them. Certain project activities and milestones could change between now and the first year of reporting under IFRS.

(in millions of dollars)

Key activities	Key milestones	Status
Accounting and Reporting		
Select IFRS accounting policies and IFRS 1 elections.	Complete selection of IFRS accounting policies and IFRS 1 elections by the end of fiscal 2014.	In-depth analysis of IFRS requirements and selection of IFRS accounting policies that would have been effective in fiscal 2013 and IFRS 1 elections has been completed. Selections will be reviewed closer to the transition date and will incorporate any future changes from ongoing IASB projects.
Quantify effects of transition on opening statement of financial position.	Complete calculations of opening adjustments to the statement of financial position by the end of Q2 fiscal 2015.	Work relating to the draft opening statement of financial position and disclosure of reconciliation of equity as at September 1, 2014 is expected to be completed in the first half of fiscal 2015.
Quantify effects of transition on statement of comprehensive income.	Calculate impact of adopting IFRS on the statement of comprehensive income by fiscal 2016.	Calculations of effects on transition on comparative statement of comprehensive income (fiscal 2015) to commence in Q3 fiscal 2015 and are expected to be completed by Q1 fiscal 2016.
Develop IFRS financial statement format including disclosures.	Complete draft of IFRS financial statement format, reconciliations and disclosures by the end of fiscal 2015.	Substantially completed preliminary draft of IFRS financial statement format, reconciliations and disclosures that would have been effective in fiscal 2013. Updated draft of IFRS financial statement format, reconciliations and disclosures is expected to be completed by the end of fiscal 2015.
	Monitor and assess impact on disclosures of new or changing IFRS requirements and/or new transactions.	Disclosure requirements will continue to be monitored and amended as required in fiscal 2014 and 2015. An interim standard on Regulatory Deferral Accounts was issued in January 2014 by the IASB, which will result in significant changes to the preliminary draft IFRS financial statements prepared for fiscal 2013.

Key activities	Key milestones	Status
Accounting and Reporting (continued)		
Design recording strategy for both Canadian GAAP and IFRS accounting (known as dual recording) during the transition year.	Amend strategy for impact of deferral by November 30, 2014 to prepare for external reporting in fiscal 2016.	High level dual recording strategy has been designed.
Business Impacts		
Assess impact of transition on information systems and business processes. Implement required changes.	Confirm that business processes and information systems can address currently applicable IFRS requirements.	Identified information system impacts and requirements and finalized high level dual recording strategy. Information system impacts and requirements will continue to be monitored and the strategy will be updated as required.
	Detailed implementation plans will be completed and implemented by August 31, 2015.	Completed high-level implementation plans for business process changes based on IFRS accounting policy selections that would have been effective if we had implemented IFRS in fiscal 2013.
		Implementation of business process and information system changes is ongoing.
Identify and manage other business impacts of IFRS adoption.	Other business impacts to be resolved prior to August 31, 2015.	Reviewed the impact of transition on debt covenants and hedging activities based on IFRS accounting policy selections that would have been effective in fiscal 2013. Further analysis of business impacts is ongoing.

Key activities	Key milestones	Status
Control Environment (ICFR and DC&P)		
Design and implement controls relating to significant changes in business processes and information systems.	Identify high-risk changes to controls and revised testing approach.	Analysis of changes to controls based on IFRS accounting policy selections that would have been effective in fiscal 2013 is complete. Known changes in accounting policies, business process and information systems were reviewed for impacts to ICFR and DC&P. Risks associated with each change to controls have been assessed.
	Update internal control frameworks.	High risk changes to controls have been identified. Impacts of the adoption of the new COSO framework issued in 2013 to be considered. Framework updates are expected to be completed in fiscal 2015.
	Testing of internal controls.	Testing of new controls will be performed between Q2 fiscal 2015 and Q4 fiscal 2015.
Design and implement controls with respect to one-time changeover adjustments.	Identify and implement new or revised controls over the adjustments by Q2 fiscal 2015.	High level dual recording strategy has been designed and incorporates necessary controls over the adjustments based on IFRS accounting policy selections that would have been effective in fiscal 2013. Controls over adjustments will continue to be monitored and amended as required.
Confirm that ongoing IFRS project disclosures are compliant with applicable guidance.	Perform ongoing benchmarking exercises and actively monitor regulatory updates.	Regulatory publications are considered when drafting IFRS disclosures and IFRS financial statements to ensure that the requirements are met. Ongoing benchmarking exercises relating to IFRS disclosures and IFRS financial statements are performed as needed.

Key activities	Key milestones	Status
Change Management		
Develop IFRS expertise within the project team, Audit & Finance Committee and IFRS Steering Committee. Engage subject matter experts to assist in the transition.	Training on applicable IFRS standards and potential impacts on the Company to occur throughout the project.	Training for project team members, Steering Committee and Audit & Finance Committee members has occurred throughout the project as planned. Additional training is planned for 2015.
Manage impacts on internal and external stakeholders of changes related to IFRS transition. Ensure a process is in place to manage and respond to IFRS-related queries.	Change management plan will be updated as required throughout the project.	The change management plan is being executed as planned.
Develop a detailed end-user training plan.	End-user training to be delivered by September 30, 2015.	Some IFRS training has already been provided. Further training will be provided by September 30, 2015.
Communicate progress of project and impacts of transition to internal and external stakeholders.	Regular status reports to be provided as required to the Steering, Executive Management and Audit & Finance Committees.	Project status reports and impacts have been presented as planned. Change management planning includes communication strategies for internal and external stakeholders. Previously estimated impacts of IFRS have been presented to the Board of Directors based on a September 1, 2011 transition date.
Decided to avail itself of optional deferral of the mandatory IFRS changeover date.	Board of Directors and OSC approval.	Board of Directors approved the decision to defer the Company's IFRS adoption to fiscal 2016 in April 2013. The OSC has granted the Company exemptive relief in May 2013 allowing the IFRS deferral.

As the Company has been granted exemptive relief by the OSC and is permitted to avail itself of the optional deferral referred to above, the Company is required to quantify the estimated differences between IFRS and Canadian GAAP based on an IFRS transition date of September 1, 2014. The estimated differences between IFRS and Canadian GAAP currently expected to be material to the Company's statement of financial position are in the areas of employee benefits and capital lease transactions. Although these differences are expected to be material, the Company has the ability to use regulatory accounting to offset some of these differences under the interim IFRS standard Regulatory Deferral Accounts. This assessment is based on available information and the Company's expectations as of the date of this MD&A and related financial statements and thus is subject to change based on new facts and circumstances.

<u>Employee benefits, net of regulatory liability</u>

Under Canadian GAAP, actuarial gains and losses are deferred off balance sheet and amortized to earnings before rate stabilization using a "corridor" approach. Under IFRS, the Company expects to recognize actuarial gains and losses in other comprehensive income in the period they are incurred, with no subsequent reclassification to earnings. As a consequence, actuarial gains and losses that have been deferred off balance sheet under Canadian GAAP will be recognized on the balance sheet upon transition to IFRS. This change will not affect the determination of customer service charges, as the Company uses a rate-regulated approach in determining the recovery of pension costs.

In June 2011, the IASB issued revisions to the standard for accounting for employee benefits. These revisions will apply to interim and annual consolidated financial statements (for issuers reporting under IFRS) relating to fiscal years commencing on or after January 1, 2013. This will require the Company to adopt these revisions as of the IFRS transition date of September 1, 2014. The Company is currently assessing the impact of these revisions on its consolidated financial statements upon transition to IFRS.

The impact on transition to IFRS will be based on actual balances at the date of transition. Based on the pension accounting deficit at August 31, 2013 of $660 (described in note 15 to the annual fiscal 2013 financial statements), the impact upon transition to IFRS on the accrued defined pension benefits is the elimination of the accrued pension asset of $362 recognized under Canadian GAAP, an increase in the accrued pension liability of $606 and a corresponding decrease in retained earnings (increase in the deficit) of $968. The Company expects to fully offset this impact by recording a corresponding regulatory debit (decrease in the deficit) of $968.

<u>Capital lease transaction, net of regulatory liability</u>

Final policy determinations and impact analyses have been completed for the Company's cross-border capital lease transaction. Under Canadian GAAP, capital lease obligations – payment undertaking agreement reserve funds and capital lease obligations were recognized on the Company's balance sheet upon entering into the capital lease transaction. Under IFRS, these assets and liabilities will be derecognized from the opening IFRS statement of financial position as they do not meet the criteria of an asset or liability under IFRS. There is no impact on retained earnings (deficit) as a result of these adjustments. The risks associated with this cross-border transaction will continue to be disclosed under IFRS reporting.

Although the adoption of IFRS will materially affect the Company's reported financial position, changing to IFRS will not significantly affect customer service charges. This is because the Company will continue to follow a rate regulated approach in determining the rates it charges to customers for air navigation services.

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.

Employee Future Benefits

We account for pension, other post-employment benefits and long-term disability (LTD) benefits as required by the CPA Canada accounting recommendation for employee future benefits, and we have included a recovery of prior years' pension solvency contributions and LTD 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, inflation, health-care cost trends and expected average remaining years of service of employees. For benefits other than LTD 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 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, the expected long-term rate of return on plan assets and pensioner mortality assumptions.

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.

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.

In February 2014, the CIA released its final report, summarizing the result of a Canadian pensioner mortality study. The Company is currently reviewing pensioner mortality rates and improvement scales to be adopted for use in the January 1, 2014 actuarial valuations of the pension plan and in the May 31, 2014 actuarial valuations for accounting purposes of the pension and post-employment benefit plans.

(b) Funding of the pension plan's deficits (as determined in funding valuations in accordance with OSFI regulations) in prior years resulted in pension contributions significantly higher than pension benefit expenses charged to the statement of operations. The Company has approved a plan, whereby pension contributions in excess of cumulative pension benefit expenses are recovered from customers in future years. As of February 28, 2014, the cumulative amount by which Company contributions to the pension plan have exceeded benefit costs amounted to $308, of which $237 has been recovered through customer service charges (see note 9 (e) to our financial statements). Pension expense for fiscal 2014 is currently estimated to be $119 (fiscal 2013 – $112) consisting of pension benefit costs of $191, partially offset by $69 relating to regulatory pension adjustments and $3 included in the cost of capital assets.

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 LTD plan has resulted in contributions higher than LTD expenses charged to the statement of operations. Up to February 28, 2014, the cumulative amount by which the Company's LTD contributions have exceeded long-term disability costs amounted to $5 which is recorded as a regulatory liability on the balance sheet.

Restructured and other investments in ABCP

See "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 in January 2009 by the Pan Canadian Investors Committee are carried at fair value in accordance with our accounting policy. The Company has determined the fair value using a discounted cash flow approach incorporating available information regarding market conditions as at the measurement date. At the time of the restructuring 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 $31 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 $4. 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.

As of February 28, 2014, an active market for purposes of a Level 1 valuation has not developed for the restructured notes. If an active market for the restructured notes were to develop in the future, the Company would change its valuation technique to determine the fair value of its notes using quoted market prices. In addition, a partial redemption process has been implemented for MAV II notes. The partial redemption process is expected to provide a reimbursement to note holders that exceeds the current market value of the notes. At this time, the Company does not plan to utilize this partial redemption process and accordingly has not used the expected returns from the process in valuing its notes.

Salaries and Benefits

Approximately 88 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 February 28, 2014, two collective agreements for approximately 650 employees covering 16 per cent of our represented workforce (or 14 per cent of our total workforce when non-represented employees are factored in) have expired. One of the collective agreements that expired on April 30, 2013, covering 9 per cent of our represented workforce is scheduled for mediation/arbitration in April 2014 while negotiations are currently underway for the other agreement that expired on December 31, 2013 covering 7 per cent of our represented workforce. Six collective agreements are in force.

The accounting estimate relating to the expired collective agreement reflects management's best estimate for retroactive periods.

Should OSFI approve the Company's proposal for a reduction of its solvency liabilities in respect of the pension plan (which formed part of the arbitration panels' decisions and the negotiated settlements with several other represented groups), described in "INTRODUCTION – Financial Highlights for the six months ended February 28, 2014 – Settlement of Collective Agreements", six of the Company's eight unions (CATCA, ATSAC, ACFO, CFPA, IBEW and Unifor Local 1016) shall then be entitled to a wage re-opener. That is, the parties would return to the bargaining table and discuss whether or not additional compensation is appropriate. In most instances, an arbitration panel would retain jurisdiction over the matter should the parties be unable to agree on an appropriate outcome.

Depreciation and Amortization

Depreciation and amortization of capital assets are 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 8 years. To date, no material adjustments to depreciation have been required, except as noted below.

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 for accounting purposes of 46 years from the date of the acquisition of the rights.

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 have been established for certain assets where reasonable estimates of retirement dates are determinable, which are included in current liabilities as at February 28, 2014.

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 *Certification of Disclosure in Issuers' Annual and Interim Filings*, 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 interim 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 ICFR using the framework established in "Internal Control – Integrated Framework" issued in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) 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.

There have been no changes to the Company's ICFR during the quarter ended February 28, 2014 that have materially affected or are reasonably likely to materially affect the Company's ICFR.