Notes for remarks to the

The Aviation Club of the UK

Robert Milton

Chairman, President & CEO,

ACE AVIATION HOLDINGS INC

London

February 8, 2006

Good afternoon ladies and gentlemen.

Thank you for that kind introduction.

It's always great to be back in London – not only because being in London means arriving at Heathrow, a place I spent hours – actually countless hours, well, truthfully, probably countless weeks – at as a child watching aircraft but also because some of my fondest childhood memories are of the time I lived here in England in Weybridge.

Of course, a lot has changed since then – for someone who spent some time here in the early 1970s to see what has taken place is nothing short of spectacular.

The mood, the business climate, the relationship with Europe and the world – and most importantly – the food.

I can still recall the meals at the Wallop School in Weybridge but because we have all just eaten, I'll save everyone from a description of what we were fed…suffice it to say there was a particular fish lunch we'd be served where motion within the fish was visible, but that's a whole other story.

I can only confirm that the food of England today is far superior to the food of the England of the 1970s!

A lot has indeed changed in England over the past 30 or so years. England in 2006 is a far more friendly place to do business.

When I lived here as a child, Harold Wilson was Prime Minister and things were challenging to the point that television would go off the air early just to conserve energy – so who could have imagined back in 1970 that I'd be saying all this about the UK today under a Labour government – albeit a "New Labour" government.

I am no stranger to England, so you might imagine just how genuinely happy I was to accept your invitation to address the Aviation Club of the UK.

It was just a couple of weeks ago that Martin Broughton, Chairman of British Airways – one of the world's greatest airlines – was speaking at the Wings Club in New York. At the beginning of his speech, he assured his audience that he would not "whinge".

While some members of the Wings Club are still trying to figure out what exactly "whinge" means, I'm sure everyone appreciated the sentiment. Likewise, today, let me assure you that I will not "whine" – as we say in North America - about everything that is wrong with the airline industry.

However, it is true that airlines are generally in a bad mood these days. I recently saw a list of aviation news headlines on a website. It went something like this:

Ryanair chief slams watchdog

Emirates slams Qantas

Broughton slams Americans

IATA slams CDG fee increase

There's no doubt about it. This is an industry in a very bad mood. There are plenty of issues and plenty of challenges ahead and I want to talk about that but first I want to go against the grain and report on a good news story. It's about the successful transformation of Air Canada and the creation of a new aviation services company called ACE Aviation.

Although the Air Canada transformation is a story which takes place in Canada, it really isn't just a Canadian story but rather an international one because many of the key issues and challenges facing airlines like Air Canada, transcend borders and because many of the opportunities – and difficulties – facing our industry are global.

When I talk about the rise of low-cost carriers, high fuel prices, financial restructuring and the burden of airport fees, I could easily be talking about almost any part of the globe.

Here in the UK and Europe for example, low cost carriers continue to make headlines with no signs of slowing down.

Ryanair, which claims to be Europe's largest low fares airline, has announced fare cuts of nine percent as of March and has firm orders for 125 new aircraft.

Meanwhile, over at Easyland, easyJet says it's adding 14 new routes across its European network and plans to take delivery of nine new Airbus A319s this spring.

According to IATA, low cost market penetration now stands at 35 per cent in Europe, compared with 45 percent in the US.

All this low cost growth and competition makes me feel right at home as this is the environment in which we've been operating in for some time.

But despite the low-cost invasion now present on both sides of the Atlantic, there are some important differences to the challenges faced by airlines in Europe and North America.

Most European legacy airlines have long-standing and expansive international route networks and operate out of well-established hub airports. To a degree, these international networks and hubs at airports like Heathrow and Paris' Charles De Gaulle, have proven to be an effective insulator against the advent of low cost competition, economic pressures and high oil prices. While intra-Europe business may be a cut-throat nightmare, international long haul revenues can still help mitigate the low cost revolution.

In North America, there's no place to hide. The financial bloodbath has been mostly on the domestic stage. No U.S. carrier has the advantage of operating in an airport hub environment such as Heathrow – the greatest airport franchise in the world and a major contributor to British Airways' ability to continue holding its own despite the aggressive assaults of Ryanair and other carriers in their intra-Europe market.

In this context, I also want to take at least some exception to what Martin Broughton said about the use of Chapter 11 in the U.S. airline industry. It is extremely hard to measure the impact that September 11 had on U.S. airlines – unless you were in North America at that time – and the fact is the U.S. industry has seen failures both before and after September 11.

In Air Canada's case, we operated more flights to the U.S. that the rest of the world's airlines pre-9/11 and we felt the effects of that day head on. No other foreign carrier could even come close. For years, Mr. Broughton's airline benefited from the policies of the British government. From a golden share to protection of route rights and slots at Heathrow, BA is not one to talk about the advantages that U.S. carriers have today as a result of Chapter 11. Unlike U.S. carriers, BA was able to, in many ways, reset the clock somewhat less dramatically with privatization in 1987 – not quite a Chapter 11 but a fresh start nonetheless – and from that point on has benefited from the power of Heathrow.

But between the two extremes of North America and Europe, the Canadian industry has emerged as something of a hybrid. Yes, we have extensive low cost competition in the North American marketplace, but, at the same time, Air Canada has managed to leverage a rapidly growing international network and we've led the industry in transforming our business model to allow us to compete successfully as a full service airline in a low-cost environment. .

So whilst the majority of North American carriers are on life support and many international carriers are struggling to reduce their legacy cost structures as they inevitably must, Air Canada emerged from its own financial restructuring 15 months ago as a strong viable carrier able to compete effectively and profitably both at home and on the international stage.

But getting there wasn't easy. It took a tremendous amount of focus, hard work and sacrifice to get to where we are today.

Unlike the U.S. carriers, we also chose a different path. Instead of focusing on wage reductions, we zeroed in on enhancing productivity approaching the levels of the LCCs to the point where non-pilot wage reductions at Air Canada average just 3% versus pre-restructuring wages with much of that reduction made up through profit sharing.

Unlike the U.S. carriers, we also protected pension plans making us one of only two North American carriers to offer employee pensions today.

On the corporate side, we created ACE Aviation Holdings Inc. ACE is an umbrella company for all our airline-related businesses including:

Jazz: Canada's second largest airline;

Aeroplan: Canada's premier loyalty program;

Air Canada Technical Services: our full service maintenance repair and overhaul operation;

Air Canada Cargo: Our air cargo business unit which manages our cargo activities worlwide;

And of course,

Air Canada: Canada's largest domestic and international airline, and the world's 14th largest.

ACE was created to reposition the old Air Canada for sustained profitability under a new corporate structure, to break out the various units that made up the old Air Canada and allow each one of them to focus on their core competencies and their profitability.

In June 2005, ACE successfully completed the first-ever monetization of an airline frequent flyer loyalty program in the world, Aeroplan.

Market response to the IPO resulted in equity valuation in excess of $2 billion for Aeroplan and ACE raised almost $300 million for its divestiture of just under 15% of a company which started out just 10 years ago as a handful of individuals working in Air Canada's Marketing Department.

It's an encouraging start and we intend to grow our other business units to maximize the value of all our businesses for the benefit of shareholders.

The monetization of Aeroplan was followed by another highly successful initial public offering of units of Jazz, our regional airline. Market response to this last IPO which closed last week, resulted in equity valuation of over $1.2 billion for Jazz and ACE raised $235 million for its divestiture of 19.1% of Jazz.

Of course, a shift in corporate structure is only part of a larger equation. Our management team also decided that we had to permanently compete not just against the restructured legacy carriers, but more importantly, against the low cost carriers.

To do that, Air Canada had to change fundamentally and today, Air Canada is an airline that has the cost structure to compete with low cost carriers on price, while offering services and products which discount carriers simply can't match. In this way, we are leveraging our new competitive cost structure while highlighting the strengths we have built up as a longstanding, high quality carrier including a frequent flier program, an extensive worldwide network, two classes of service, and more.

This is a key part of our longer term strategy. We have already reduced unit costs by nearly 20 per cent but we now must continue to look at ways to take more unnecessary costs out of our system.

To do that, we need to continue to move aggressively to new technologies.

Today, we distribute over 60% of our domestic sales via the Internet. No other legacy carrier comes even close. To make it work, we had to simplify our product line by rebuilding the trust of our customers in buying directly from us with full transparency. Our lowest fares are available at all times, you pay only for the desired one-way ticket type you want, starting from the lowest commodity fare and paying consecutively higher prices for premiums such as priority seating, Aeroplan points or return-date flexibility that you chose to add on. We started in Canada and the US and now we're doing it right here in the U.K.

This is just the beginning.

Having emphasized the importance of Air Canada's effort to reposition itself as a major global carrier, it should come as no surprise that we see the need for free and fair competition, open market access and a modernized regulatory environment.

These are unsettled days for our industry.

One perfect example of this is the rapid rise of airlines like Emirates. Emirates has expanded rapidly and continued to make significant inroads into established markets around the world. They are also turning longstanding aviation rules on their head.

Over the past two decades Emirates has doubled in size, on average, every four years and is now well-established in the UK market as well as many other major markets around the world.

Who would have thought that Emirates, with a home market of just 4 million people could become a major player in the international aviation market out of the UK and Europe?

Who would have thought that cities like Edinburgh could support a daily flight to Dubai or that Manchester and Birmingham would see double daily flights or even London with 8 flights a day all destined to the Emirates hub in Dubai?

It is no secret that Emirates is well-funded, enjoys one of the world's most modern hubs, is well-served by government policy and is extremely ambitious. Emirates is also geographically blessed with its Dubai hub which allows it to be the true crossroads for most of Europe and Asia. In addition, Emirates is able to operate in a lower cost labor environment with more flexible work rules and lower pay rates employing a generally more junior workforce which allows it to average down labor costs as it grows the airline.

With all its advantages, it is easy to understand how Emirates can be relatively immune from the strenuous objections of carriers like BA and Qantas, among others.

Australia, like the UK, is getting a full dose of Emirates expansion. Margaret Jackson, who is the Chair of Qantas, has been quite vocal in criticizing the fact that Emirates doesn't play by the rules.

Meanwhile Tim Clark of Emirates says: "The main reason we have so many detractors is because they realize the game is up."

This is one indicator of an industry in turmoil where some airlines accuse others of being artificially sustained while those accused suggest their accusers are more or less over-the-hill.

No wonder the industry is so angry. But the truth is that the game is indeed up. We have to start addressing the fundamental problems of the industry if we want to survive and make money next year or ten years from now.

Thinking back to my high school years in Singapore, to get to London, our flight would stop in the Middle East, generally Bahrain or Dubai. In exchange for those fuel stops decades ago, countries around the world liberally allocated the UAE traffic rights to and beyond their countries. At the time those rights were handed out, who would have guessed that the future would see US$65 oil? Who could have dreamt of A340-500s flying between New York and Dubai or Dubai and Sydney non-stop? Who was thinking of Dubai as the world's hub?

Well, now, it's payback time and airlines and governments around the world are going to have to determine if, in the future, the face of aviation looks more like Emirates, Etihad and Qatar Airways, as opposed to the old-line, legacy, "national flag carriers" or whether the rules can be changed to allow both types of airlines to co-exist and do so profitably.

Governments have to decide whether the six daily Emirates flights between Dubai and Australia to serve the 452 passengers that only travel between Australia and Dubai or the four daily Emirates flights between Dubai and New Zealand to serve the 67 passengers that only travel between New Zealand and Dubai is right or wrong.

Ten and twenty years ago, it was okay, it seemed, on the Singapore Airlines scale and no one ever complained as loudly about Cathay Pacific or Thai. But now, the scale is altogether different and there is a lot of whinging <u>and</u> whining going on.

We don't object to the Telco's or banks playing big across international borders – so why do we object when airlines decide to do so?

We've had emerging market winners demolish mature cost businesses around the globe whether it be cars or televisions or home electronics for years – so what makes airlines so special?

Governments around the world have a choice. They can block carriers like Emirates from accessing their markets or at least a disproportionate share of their markets – something akin to blocking foreign made ovens to protect domestic made ones. Or they can open up the skies and allow airlines to operate like other businesses – free from economic and political regulation.

Emirates is running an excellent airline. We need to stop accusing companies like Emirates of breaking the rules and instead focus on changing those rules so that we can all operate on the same playing field – if that is truly possible.

In most regions of the world, consolidation is needed but it's not enough.

The next order of business is the regulatory framework. We are still bound by the antiquated rules of the Chicago convention, something that was created more than 60 years ago. In the same year that Casablanca won the Oscar for best movie, the rules governing our industry to this very day were devised. Just ask yourselves just how many cars that were manufactured at the end of the Second World War still run today without having been at least tuned up if not entirely overhauled? It may have been a good idea for airlines in the 1944. It is an outdated idea for airlines in 2006 and fails to respond to the challenges and opportunities posed by the rise of carriers like Emirates.

I'm not saying this purely out of self interest. I'm not even saying this because the current bilateral rules put Air Canada at a disadvantage. I'm saying this because the airline industry itself and the regulatory environment in which it operates are both in desperate need of a major overhaul and fast.

Rather than fighting over whether Emirates is operating in an artificial environment, the real question is whether the basic regulatory foundation of the airline industry, such as the Chicago Convention and foreign ownership restrictions, need to be not only modernized - but turned on its head.

The answer, for me, is yes.

The EU-US agreement represents a step in that direction. That's not enough. At a time when low cost carriers are thriving and new international airlines are no longer playing by the old rules, I believe we have to make a giant leap. We've gone as far as we can with Open Skies agreements and they have served their purpose as a bridge from restrictive bilateral agreements to less prescriptive agreements. Now we have to jump right into the free market for airline services.

In fact, when you consider Emirates, you could also easily conjure up China with its fantastic home market, stunning rates of growth and lower labor costs. Just imagine the whinging that will inevitably take place then when Chinese carriers become the next Emirates!

But in a free and open international aviation regime, perhaps a BA, an Air France or an Air Canada could, perhaps alone or, more likely, jointly with a local partner build the Chinese Emirates much in the same way GE today manufactures fridges in China.

This idea is not as far fetched as some would think. Today, in Europe we already have the fascinating evolution of carriers of one country, developing markets throughout neighbouring countries. Interestingly, legacy carriers aren't participating in this picture, and the opportunities are being developed exclusively by LCC's with the cost structure and nimbleness to do it. Ryanair of Ireland at Stanstead, or Hahn, and Easyjet at Geneva.

Elsewhere, there are few examples of this trend. Perhaps you can point to Virgin's activities in Australia and, soon in the United States, but there are also others such as Gol in Mexico, Qantas with Jetstar in Singapore, and Korean Air Lines with Okay Airways in China, just to name a few.

Last year, I wound up being quoted as saying what Emirates was doing in Australia was "outrageous". But my complete statement was that what they were doing in Australia was outrageous in the context of what any carrier had ever done in a market in the history of commercial aviation, especially when there was no under-lying demand between Australia and Dubai.

Like in Australia, where the debate centres on more access for Emirates as well whether Singapore Airlines should be given access to Sydney-LA, or here in the UK where there has been some discussion of Singapore Airlines as well as Cathay Pacific flying London- New York, governments around the world will be forced to decide whether they are going to open up markets – which I view as inevitable – or attempt to keep outdated restrictions in place to keep the likes of Emirates at bay, which I consider an exercise in futility.

Rather than countries acting individually and at varying paces, I envision a broader, more comprehensive process so that the rules for all countries and airlines can be established fairly, openly and for everyone.

But how do we get there from here?

With collective will and vision, a new international aviation regime is possible.

So how do we get there from here?

With collective will and vision, a new international aviation regime is possible. Call it Chicago Convention 2. A shared template for modern air services which is predicated on a truly free market system beyond today's Open Skies. Under such a negotiating framework, cabotage would be on the table, ownership restrictions would be removed. Alliances and consolidation would be allowed. Safety, security and airspace sovereignty would remain strong foundations of the industry. A free and open discussion on treating the airline sector like any other sector of our economy could be pursued.

Phase-in periods could be part and parcel of such an approach to allow airlines to adapt to the changes and gear up for new competition and new ways of doing business.

In tandem with a new market-based aviation regime, it's important to address the barriers to free and fair competition including industry fees and levies – particularly at airports and by governments.

Take, for example, the decision by the French government to levy a new tax exclusively for airline customers to pay to increase development aid for Africa.

As someone who supports increased development aid, I cannot help but be puzzled by this decision.

Why should airlines and airline customers bare the sole responsibility for this program?

It seems as though governments – and not just the French government, I might add but many governments – are stuck in the mindset of the 1960s in thinking that anyone who flies has to be wealthy and that taxing airline customers is tantamount to imposing a tax on the rich.

Again – let me stress that I fully support increased aid to developing countries – but while I am all for contributing our fair share, why is it that airlines are the only ones singled out to foot the bill?

That's also why airlines around the world are uniformly angry over Aeroports de Paris and its plan to increase charges by 35% over the next five years. Unfortunately, ADP is not alone.

I'm embarrassed to tell you that Canada has now become a world leader in charging some of the highest airport fees, security fees and other government-inspired fees and charges on the planet. Imagine that – low cost Canada has become the home of the world's <u>highest</u> airport and security fees.

I can only hope that the election of a new federal government in Canada will reverse this unfortunate trend and see the airline industry for what it could be – a strong engine for economic growth.

As Chairman of IATA this year, I assure you that we're not going to sit back and take this. The IATA board is mandated to challenge airports and governments on their charges and to speak on behalf of the industry.

Free trade in aviation services <u>has</u> to go hand in hand with equitable tax regimes, air traffic control costs and airport access and fees. Once that happens, then we can truly have a market for air services on par with other global industries from financial services to pharmaceuticals. Speaking on behalf of ACE Aviation and Air Canada, I can tell you that that day cannot come soon enough.

Thank You.