

AMERICAN BAR ASSOCIATION

Forum on Air & Space Law

**Conflicting Regulatory Approach to Aviation:
An impediment to the Industry's Viability and Growth**

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Good afternoon ladies and gentleman. Thank you [Name] for that kind introduction.

On behalf of Air Canada, I wish to extend greetings to those of you visiting Montreal, which is home to Air Canada, the most bi-cultural city in this country with nearly 400 years of history.

I am delighted that our recent labour issues did not disrupt your travels to Montreal. You should know that we settled our labour dispute so you could get here. The last thing I needed was a gaggle of ABA Air and Space Lawyers on my back. In fact in the run up to the conference and as a reformed lawyer myself, I've had this recurring nightmare of a treble damage, punitive damage, pain and suffering class action law suit against me by this audience as a result of the loss of enjoyment of this luncheon address.

Seriously, I certainly do hope that some of you have tried our service recently.

However, I do not wish to presume so let me begin with a brief overview of our company, which should serve as a good segue to the subject I want to discuss today -- that while many global carriers, including Air Canada, benefit from an outstanding global franchise, there continues to be quite a conflicting regulatory approach to aviation worldwide, that serves not only to confuse policy objectives, but also can be a real impediment to the industry's sustainable viability and growth.

We will be celebrating our 75th anniversary next year – one of the few airlines that have survived this long anywhere in the world. Air Canada is the largest airline in Canada and among the top 20 carriers by traffic in the world. Originally a government-owned, Crown corporation, we have been a public company since 1989. With 26,000 employees, we fly about 32 million customers annually – a number equal to nearly the entire population of Canada. We had revenue of nearly \$11 billion in 2010.

We fly to 175 destinations on five continents. Our fleet consists of more than 350 aircraft (including our regional carrier) and is one of the youngest among North American carriers. We offer fully lie-flat suites in all of our international executive class seats and complimentary seatback on-demand video throughout our mainline fleet. Our on-board service and amenities are one reason Air Canada has been named Best International Airline in North America for two consecutive years by the influential Skytrax World Airline Awards.

Of particular interest to our American colleagues in the audience and those who do business in the U.S. regularly is the evolution of our US transborder service following Open Skies some 15 years ago. Air Canada moved quickly to capitalize on Open Skies and we now offer the most comprehensive service between our two countries. Along with our regional affiliates, we operate more than 400 non-stop flights per day on over 100 routes to and from 52 U.S. and six Canadian airports. We extend our reach within the U.S. by offering customers flights on a codeshare basis with our Star Alliance partner United to more than 55 additional cities in the U.S.

Through our major hubs of Montreal, Toronto and Vancouver, we have also been establishing ourselves as an attractive option for passengers travelling between the U.S. and either Europe or Asia. In many cases, especially from secondary U.S. cities, the fastest elapsed travel time for Americans going overseas is through Canada. Over the past year or so, we have seen a doubling of U.S. connecting international traffic to places like Beijing, Shanghai, and Sao Paolo. And those of you who flew to Montreal for this conference likely noticed we have a brand new wing at the Montreal Airport dedicated to US transborder travel.

Our focus on international connecting traffic is a key element of our global strategy. It is one way Air Canada differentiates itself, and indeed, has a shot at competing against both established legacy carriers and better capitalized, newer and lower cost players.

As all of you know, the economics of the legacy airline business in North America are extremely challenging. It cannot be repeated frequently enough that our industry is fragile. And all of us who work in it are ever-mindful of its uncertain nature. Earlier this week, IATA raised its previous airline profit forecast for this year of US\$4 billion, made in June, to US\$6.9 billion. But it expects a 29% drop in global industry profit in 2012 to US\$4.9 billion due to the global economic uncertainties.

If correct, 2011 profits translate into a 60 per cent drop from the net profit our industry made in 2010 after a couple of disastrous years of losses that wiped out industry profits for the previous decade.

A \$6.9 billion profit for our entire industry represents a 1.2 per cent margin. Moreover, our industry's two most recent profitable years were preceded by a \$9.4 billion loss in 2009 and a \$16.8 billion loss in 2008. As I like to say, I hope you all enjoyed the 2010 boom – our industry's stellar 3% profit margin year!

But while our industry is highly sensitive to the overall economy, it is not the economy alone that our industry needs to worry about. In economics, the phrase “*Black Swan Event*” was popularized by the 2008 credit crisis. It denotes those random and unexpected occurrences that can bring severe, almost devastating, consequences when they hit.

Well, it seems our industry is a nesting ground of Black Swans. Invariably, whenever we see major, disruptive natural or man-made events erupt anywhere in the world, the airline industry finds its operations affected directly, immediately, and disproportionately.

Indeed, of all the screaming headlines that came out of Hurricane Irene several weeks ago, the cancellation of thousands of flights in the U.S. North East, came second only to the tragic loss of lives and homes.

In my own experience, in just two and a half years as CEO of Air Canada, our global operation has at one time or another been disrupted by: the global financial meltdown,

devastating earthquakes in Haiti, in Chile, in Japan, floods, volcanic eruptions in Iceland and Indonesia, blizzards, a tsunami accompanied by leaking radiation, the Arab Spring and a man with a bomb hidden in his underwear that turned global aviation upside down again. To give this picture a Biblical hue, in May we had flights delayed by swarms of cicadas (sicawdas) in Nashville that threatened to gum up our aircraft's auxiliary power unit.

I do not want to discount the human impacts of all these events, many of which caused suffering and, in some cases, loss of life, far, far more painful than anything that could result from damage to an income statement or balance sheet. Indeed, I witnessed firsthand the devastation of Haiti in the days following the earthquake. The things I saw haunt me still and remind me constantly on even the most difficult day at the office how truly, incredibly lucky we are.

The inherently unstable airline industry is routinely subject to extreme and even not-so-extreme external shocks that chip away at its already meagre profitability. For this reason, those interested in our industry – and I would argue that should include everyone who worries about the well-being of the economy - should be very concerned at the multiple and often conflicting regulators, policy makers, taxation authorities and foreign governments that interfere with the viability and operation of our industry and ultimately constrain its growth through punitive taxation or conflicting regulation.

Now I am not about to launch into an anti-regulation rant. That would be so “seventies.” I will be the first to say there are many instances where regulation is beneficial and necessary. For example, we work very closely with government regulators to maintain the highest safety standards and the results are there for all to see in the remarkable advances we have made over time and our industry’s tremendous safety record. Effective safety regulation also keeps poor operators grounded and has the overall benefit of boosting customer confidence.

We are also encouraged by the significant progress made by Governments in the area of air service agreements and bilateral treaties where there is functional reciprocity. The Canada-US Open Skies agreements of 1995 and 2007 between our two countries was a positive, watershed moment that has been a boon to both carriers and consumers. We are fully supportive of fair and balanced Open Skies with all countries where there is reciprocal demand. We’ve been competing with international carriers for most of our existence - over 60 foreign-based carriers operate at Canadian airports and Canada has bilateral air agreements with more than 80 countries.

We have welcomed liberalization agreements not only with the U.S. but more recently with 27 countries within the European Union, two of the most competitive markets in the world where there is real two-way demand with Canada. And we are actively encouraging agreements with other countries such as Japan. But liberalization in the airline industry is like any trade agreement in that it must be beneficial to both sides. For our industry, that means passenger flows must be balanced so both sides benefit.

But ill-considered regulation or regulatory intervention can and does hamper our industry's health, growth and prosperity. For example, while aviation is the most global industry in terms of markets, we are the least globalized due to foreign ownership restrictions, and laws that prevent transnational mergers that occur in virtually every other industry.

Still more troubling are cherry-picking interventions by certain legislators or regulators who wade in every so often, without having followed the full evolution of global aviation over the last 15 or 20 years and choose to selectively intervene.... While those properly charged with overseeing aviation, such as the Departments of Transport or of Foreign Affairs and International Trade, are relegated to the sidelines. Such "regulatory overreach" can lead to conflicts that are inconsistent or confusing for the industry and its financing sources, undermine public policy goals and work to the detriment of the traveling public.

This situation should be painfully familiar to the American members of the audience today. None of you, I am sure, has forgotten how the House Committee on Transportation and Infrastructure [under its former Chair, Jim Oberstar], inserted a provision in their version of an FAA Reauthorization Bill in 2009 a provision that, if it had become law, would have limited DOT's authority to confer antitrust immunity upon airline alliances.

It also would have effectively “sunset” all existing alliance approvals after three years unless the carriers reapplied to DOT for that immunity, presumably under tougher standards. This provision – which actually passed the House – provoked an outcry from the carrier community and from governments which had entered into bilateral air service agreements with the US under the assumption that their carriers would enjoy ATI for their alliance activities. The DOT itself, which spent years developing an international aviation policy supporting cooperative arrangements between airlines, was properly vocal in its opposition to that bill.

In Canada today, we are seeing a similar situation play out, where one government agency, the Competition Bureau, is arguably working at cross-purposes with another, Transport Canada, and potentially undermining the greater policy objectives of the Canadian government.

Just over 15 years ago, the Canadian and U.S. governments officially recognized that our nations are closely intertwined and enjoy a relationship unlike any other. This closeness was reflected in our 1995 “Open Skies” agreement which served as the predicate for Air Canada to enter into an alliance with United Airlines, allowing each carrier to tap into the other’s network, and to offer consumers services that neither carrier could provide or did provide on its own.

In 2007, the U.S. and Canada concluded a broader Open Skies accord which covered third country services and all cargo services. This agreement paved the way for Air

Canada along with its US partners United and Continental, to enter into a broader, immunized trans-Atlantic air transport network, whereby Air Canada and certain of its Star Alliance partners offer enhanced services at competitive rates, between North and Central America on the one hand, and Europe, the Middle East, Africa and the Indian sub-continent on the other in order to more effectively compete in a globalized market.

These changes came about because it was recognized that the world is becoming a smaller place, where businesses and governments are being forced to adapt to a changing environment. One consequence has been that international airlines now need a *global* platform to expand their competitive reach.

For some carriers, this has meant mergers where mergers are an option. We have seen in the U.S. the combination of Delta with Northwest, US Airways with America West, United Airlines with Continental Airlines. In Europe we have seen Air France – KLM and BA/Iberia amongst the largest combinations. In South America, Lan Chile and TAM of Brazil. Elsewhere, carriers have sought to differentiate their offerings and become “niche” players.

Given these constraints, many carriers have joined global alliances to extend their scope and reach. We, along with United Airlines, Lufthansa, SAS, and Thai Airways founded Star Alliance in 1997 and have moved efficiently and relatively quickly to execute and implement joint venture arrangements, in the interest of competitiveness.

While alliances can be very successful in delivering benefits to the traveling public, their effectiveness hinges largely on their incentives to cooperate. In more basic, non-immunized forms of cooperation, the airlines may well be competitors in the market for each and every passenger. As a result, the benefits of those alliances for customers are less than they could be under a more integrated arrangement, which drives the efficiencies and cost reductions vital in today's environment.

It is for this reason that airlines are increasingly looking towards the formation of "metal neutral" Joint Ventures on certain specific markets. Such JVs are created by like-minded airlines willing to take the "next step" – not a full marriage, but think of it as "going steady with a ring". Through aligning the different member airlines' business strategies and working in tandem by providing consumers with a broader network, the JV partners are able to achieve some – but certainly not all – of the advantages of a true merger. At the same time, they also create consumer benefits through cooperation in areas such as joint pricing, sales, network planning and aircraft deployment.

Last fall, Air Canada and United announced plans to form a full Canada/U.S. transborder JV that would build on the success of our metal neutral trans-Atlantic joint venture allowing us to jointly to offer more efficient and competitive services in our home market, North America. However, Canada's Commissioner of Competition recently announced that she is challenging the JV and would bring the case before the Competition Tribunal.

The Bureau effectively chose to challenge the fundamentals of an alliance that has been firmly in place since 1997 and has served as the backbone to realizing the benefits of Canada's entire International Air Policy. In many ways, it is an attempt to return through litigation and regulatory fiat to the industry's long gone past, when competition was primarily on point-to-point traffic – a time before the recognition, globally, that the real game is in competing networks – be they over Frankfurt, Atlanta or Toronto; a time when connectivity, schedule and critical mass did not determine a carrier's commercial longevity.

This action runs counter to global trends and flies in the face of decisions by regulators the world over. In particular, the governments of the United States, Japan, Australia and the member states of the European Union have all recognized the pro-consumer benefits of metal neutral airline partnerships.

In our own case, the European Commission and even the Canadian Competition Commissioner's own agency have in the past granted approvals for Our trans-Atlantic partnership with Lufthansa and United.

With much respect for the tough job regulators have, I must say that, in this United trans-border JV case, it seems the Commissioner is not only ignoring the evolution of the industry but also disregarding the Canadian government's stated international air policy objectives.

Consider the Canada-U.S. market.

Service between the U.S. and Canada has mushroomed since 1995, when the Open Skies agreement was signed. Where there were 67 transborder routes, there are now more than 150. Moreover, To date, we and our US partners have cooperated **not** to constrain growth as the Commissioner fears, but instead to launch services to **new** gateways that the carriers could not profitably have served on their own. If successful, the Commissioner's challenge would put these enhanced services in jeopardy.

Moreover, some of the largest carriers in the world and some of the most successful Low Cost Operators, operate in North America – American Airlines, Delta, Alaska Airlines, Southwest Airlines, Westjet, JetBlue, etc. etc. Any of these carriers could enter at will, if they are not already on the transborder.

Let me digress from “ATI” to “ETS” (the European Union's Emissions Trading Scheme - this industry loves acronyms), another clear example of misguided regulatory intervention or over reach. The application of the ETS to international aviation will require airlines from all countries worldwide operating out of all airports in the EU's 27 member states to financially offset their flights' carbon dioxide emissions.

This unilateral action on the EU's part is really a direct assault not only on the sovereignty of non-EU nations, but also to the Chicago Convention and the related web of international law upon which our industry has been built.

Let me preface this discussion by saying that at Air Canada, we are certainly Going Green and are fully committed to improving our footprint. We have increased our fuel efficiency by 30 per cent since 1990. Moreover, Air Canada wholeheartedly supports the IATA published targets of capping emissions by 2020 and reducing them by 50 per cent relative to 2005 levels by 2050. And this is not only because fuel is, as most of you know, an airline's single largest expense.

However, we cannot support nor should we be made to tolerate a multiplicity of destructive extra-territorial levies in the nature of this EU ETS. So far, international airlines have been the primary parties to challenge the EU plan through both awareness efforts and, more recently, direct legal action in the form of the ATA's lawsuit. For our part, Air Canada is an intervener through the National Airlines Council of Canada and also participating through our associate membership in the ATA. But to my mind this is not enough and it is past time for world governments to step up and assert both sovereignty and clarity of a global regulatory framework for airline emissions. In particular, they should do so through the intergovernmental body that governs international aviation – ICAO.

As all in this room would know, the Chicago Convention provides that every country has jurisdiction over its own airspace and only the country of registry and ICAO may regulate aircraft over the high seas. With the ETS, the EU states are violating their own commitments to work on this issue through ICAO, and the levy aspect of the scheme

itself also violates provisions in the Chicago Convention that govern the imposition of taxes and charges by one country on the airlines of another.

But this situation also raises troubling issues regarding where the EU's authority – with respect to international aviation – begins and ends. Further, what does it say in relation to the authority and the responsibilities of individual EU member states? And where is ICAO through all this?

As a CEO of an international airline, member of IATA, in a country subject to ICAO and the Chicago Convention, I expect the regulators from both the EU and ICAO to get their acts together – regulate aviation emissions globally if you like, but regulate once and apply the levies sensibly across relevant countries.

I am glad to see various governments stating their opposition to the ETS . But countries need do more than state their opposition -- they must take real legal action. This is not only because of the inequitable nature of the ETS but more broadly because the Chicago Convention and the relevance of ICAO itself as the global regulator of aviation in the modern era are being put at risk.

Aviation is an already heavily-regulated industry. Domestically and internationally. Safety regulations. Security regulations. Air Traffic regulations. Training regulations. Route Authorities. Consumer protection regulations. Competition regulations. Etc. Etc. However, aviation is also a catalyst of global economic activity and as such is the subject

of many policy determinations by Governments around the world. Especially at a time when the world is hungering for economic growth and millions are looking for jobs.

We won't eliminate regulation or regulatory intervention or oversight, nor should we. But as an industry I suggest that we are entitled to expect a consistent and rational regulatory and policy approach, especially given the fragility of airlines worldwide. Whether that is in relation to trans-border joint ventures in furtherance of Open Skies. Whether that is in relation to Emissions Trading Schemes imposed by foreign governments. Or whether that is in relation to any one of the multitude of issues that those in this room debate, argue or defend on a regular basis as we continue to evolve so as to seize the opportunities the 21st century presents our industry today.

Thank you.