A Competitive Framework for Canadian Aviation

AIAC Annual General Meeting

Calin Rovinescu

President & CEO Air Canada

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Thank you Marc for that kind introduction. It is a pleasure to be asked to speak with you today.

As the chief executive of an airline, I bring a slightly different perspective to your conference. We are not a manufacturer, but an end-user. Yet, our activities are deeply intertwined as our needs help determine the products you make and your products in part determine our capabilities and what we as an airline can ultimately do.

We have a strong partnership with many members of the companies represented here today and when I look at the many familiar faces in the audience I see engines, I see simulators, I see airframes, I see software, I see electronics – when you look at me you undoubtedly see $$$ signs.

We therefore have many common interests and goals. Like you, we also put a high value on innovation, but it is the theme of this conference – the strategic and economic contribution of your industry to the Canadian economy that resonates best with me. Transportation is one of four sectors that are critical for the economy to function – along with finance, telecommunications and energy. So the airline industry, like the aerospace industry is a strong driver of economic activity in this country, something that is not adequately recognized or leveraged in Canada.

But at Air Canada, we are committed to finding innovative new ways to operate. And that extends to shaping a more competitive framework for the Canadian aviation sector, whose overall well-being is essential for your industry and ours. While I know all of you are familiar with Air Canada and many of you are our regular customers, I'd **first** like to provide you with some context.

Let me begin with some basic statistics. Air Canada is the 15th largest airline in the world based on traffic – and there are almost 1,000 airlines in the world. Significantly, we have grown to this size even though Canada is only about 36th in terms of population among the world's countries. So as a nation we certainly punch above our weight in aviation.

Each day, we operate more than 1,300 flights, which equates to an Air Canada flight taking off somewhere almost every minute of every day. We have a fleet of more than 200 aircraft that includes Embraer 175s and 190s, our Airbus 320 and 330 families, and from Boeing we have the 767 and two versions of the 777. We also have 37 firm orders for 787 Dreamliners which are due to start arriving in the second half of 2013. And I would be remiss in not reminding this audience that our regional partner Air Canada Jazz operates a fleet of 128 Canadian-made Bombardier Dash 8 and CRJ aircraft, a number of which are owned directly by Air Canada.

Furthermore, Jazz is planning to add 15 Bombardier Q400 aircraft to its fleet beginning this May. And we have leased five Q400s to start our Toronto Island Operation.

The average age of our fleet is about 10 years, making it one of the youngest among North American legacy carriers. We have also refurbished our older aircraft, so all of them have state-of-the-art interiors, including seatback video at every seat and lie-flat seats in our Executive First international business class. In fact, we were the first North American network carrier to offer lie-flats throughout our entire long-haul fleet.

Air Canada has annual revenue of nearly $11 billion and we employ 26,000 people, making us one of the larger private sector employers in this country. We directly spend more than $9 billion each year on goods and services. This includes nearly $1.3 billion on aircraft maintenance, so, humour aside, we are one of your very good customers.

As Marc mentioned in his introduction we worked through significant challenges threatening Air Canada's very survival last year but at the same time we vowed to win the customer back. And we did just that – as we ended the year 2009 Air Canada was named Skytrax's Best Airline in North America in a survey of 17 million frequent travelers worldwide. And 2010 has been a pretty good year so far.

- Our stock price has almost tripled since the start of the year.
- Passenger revenues for the first half of the year increased $340 million over the same period in 2009.
- Over the past nine months, traffic is up more than 8 percent overall with growth in all of our markets – led by a 22 percent growth in the Pacific. And remember that Canadian GDP growth this year is expected to be less than 3%.

- We are getting more efficient – this past summer we flew 3700 more flights or 12,630 more hours and carried 400,000 more customers with the same fleet that we operated last year.

- And industry-wide business is slowly improving - IATA estimates profits of $8.9 billion for the industry in 2010 but this represents a razor-thin margin of less than 2 per cent.

While the first priority when I assumed the CEO role at Air Canada last year was to stabilize the airline, it quickly became clear to me that we needed both a new strategy and a new vision to move the airline to sustained profitability and then to winning on a global scale.

Following a luncheon discussion I had with a group of other Canadian CEOs some time ago I started to challenge the organization to see if we have what it takes to be a Global Champion. These are companies that not only excel, but consistently excel from year-to-year.

The international consultants AT Kearney publish a list of Global Champions every year and the latest list of 25 Global champions includes companies from the U.S., South Korea, Japan, Europe and even South Africa. No Canadian company made the list and none of the companies listed were airlines. What distinguished this select group is that they generated nearly 15 per cent value growth annually for the past five years.

To become a global champion requires taking some risk, seizing new opportunities, and expanding with a clear vision for the future or in other words ‘innovating”.

On the whole, Global Champions pursue a strategy that balances economic, environmental and social considerations. Size does not matter but strong leadership, staying focused on the end goal and an ability to shift gears under changing circumstances are required.

At Air Canada, we have established four priorities that I believe put us on track to becoming a Global Champion. Frankly, whether or not we are actually ever recognized as such is secondary – it is the aspiration and ethos of continuous improvement that matters to me. Already, we are seeing very encouraging results such as the awards and the more efficient flying I just mentioned. And I hope that those of you who are our customers are also seeing results of this transformation.

First, you need to ensure cost competitiveness and strong liquidity. Our Cost Transformation Program is aimed at achieving $530 million in annual cost and revenue improvements by the end of 2011 and we are right on track.

We have also shored up our capital position through monetizing aircraft and equity and debt financings, including a $1.1 billion private debt offering this summer. Our liquidity position is now strong with more than $2 B cash on hand.

Second, we are playing to our strengths rather than view our legacy as a weakness. We are therefore actively transforming the way we engage with our customers – with particular emphasis on our premium business product and the services we offer. Results are encouraging - Air Canada was preferred by 71 percent of Canadian business travelers surveyed in the 2010 Ipsos Reid Business Traveller Survey.

The third element of our transformation is what I consider our greatest challenge: changing the very culture at Air Canada. This is the most important aspect of our transformation – as a corporate culture sets the tone for everything that you do.

With the right drivers – both in terms of people and tools – Air Canada is becoming a more entrepreneurial and nimble company - a place where employees are empowered to make decisions; a place with a “Just Do It” culture that will allow it to aspire to the Global Champion mantle.

The fourth element of our transformation on our path to developing a Global Champion entails building on our position as one of the world’s leading international carriers.

Along with Canada’s advantageous geographic location, we have a vast network underpinned by an array of bilateral authorities to fly to other countries. More than this, we are a founding partner of the 27-member Star Alliance, the largest alliance of its kind. It enables us to seamlessly connect passengers with carriers that fly to nearly 1,200 airports in 180 countries. And this connecting traffic drives growth.

In addition we have implemented a revenue-sharing alliance with our partners Lufthansa and United Airlines including Continental Airlines. We sell seats on the other as if we were de facto one large airline with a single network. In effect, “metal neutrality” so that over time we should become indifferent as to which carrier is flown over the Atlantic as long as it is one of the four. I see these joint ventures as the way of the future for us as they bring much of the advantages of consolidation without undergoing complex and often very costly mergers.

Earlier this month, we announced a similar venture in the Canada-U.S. market with newly merged United Airlines, subject to obtaining anti-trust immunity. We fly to 59 U.S. cities but United flies to 210 U.S. airports, so you can easily see how this will broaden the range of routings and destinations we will be able to offer customers. Making us more competitive, more dynamic and more efficient.

Still, our focus remains on our international business. Since last year we have added new service from Canada to Geneva, Rome, Brussels, Athens, Copenhagen and Barcelona that will strengthen our European flagship routes of London, Paris and Frankfurt.

We have increased capacity to Asia dramatically year-over-year and now fly daily from Toronto and Vancouver to Beijing, Hong Kong, Shanghai and Tokyo. Our Pacific traffic was up 22 per cent over last year in the first nine months of 2010.

Put another way, we are deploying more that $2 billion in aircraft exclusively to our Asian routes. Imagine any manufacturing company building a $2 billion factory to serve just one market segment. It is indeed a significant commitment.

Becoming a Global Champion also requires supportive partners. And I strongly believe in the exponential power of partnership including that of the people in this room.

We have strong partners among the aircraft and engine manufacturers, parts suppliers, after-market service providers and other players in the Canadian aerospace industry.

Another important area where our partnership with your industry has been beneficial is with respect to the environment. While most people do not regard the aviation industry as particularly virtuous in this regard, the truth of the matter is almost no other industry has done so much to reduce its footprint as the aviation sector. Much of this success is due to the efforts of manufacturers.

In our own case, with respect to Greenhouse Gas Emission targets, through IATA we had committed to cut emissions 26 per cent from 1999 levels by 2012. We managed to do so by 2004 -- eight years early. We similarly met our National Airlines Council of Canada target of a 24 per cent reduction by 2012, five years early. That we were able to do this was due largely to better aircraft and more efficient engines.

We are counting on you through new technologies, equipment and aircraft, to help us meet our new IATA commitments, which include attaining an average improvement in fuel efficiency of 1.5 per cent per year between 2009 and 2020. We have also pledged to reduce CO2 emissions by 50 per cent from 2005 levels by the year 2050. Apart from being the right thing to do, it is something customers demand of us in our increasingly socially-responsible world. It is also good business as we spent approximately $2.5 billion on fuel last year, so any reductions we can make in this area, not only help the environment, they go straight to our bottom line.

New engines. **New airplanes**. That is how people normally think of innovation when they talk about our industries.

But if I may change gears here, I believe it is vital for our country that we also think in terms of innovative public policy and provide the right competitive framework for our industry.

Outdated policies can hobble corporations and entire countries in our globalized economy.

Even before the 2008 report “Compete to Win” by the Competition Policy Review Panel chaired by Red Wilson, there was a lot of debate around whether or not it is desirable in Canada to nurture so-called global champions. We are currently seeing this debate again with the takeover attempt of Potash Corporation.

Let me tell you. There is no such debate in Singapore as to whether or not to develop Singapore into a global trade hub or to nurture a global champion out of its pool of companies in such sectors as energy, metals, commodities, consumer and industrial products or airlines.

There is no such debate in Korea with respect to say, Samsung. There is no such debate in the United States with its “Buy American” stimulus programs.

Clearly, there is no such debate in the UAE, either with respect to the state’s ownership, control and aspirations for its ports and cargo infrastructure or, of more relevance to me, of its ownership, control and aspirations for its airlines and airports.

Companies on the Global Champion list have the benefit of a competitive framework in their home country. So in Canada, with respect to our aviation industry, we need to decide.

• Do we want a viable airline industry in and from Canada with one or more world class gateways to complement fair open skies with other countries?

• Do we want direct access from Canada to Asia, Europe and South America from multiple Canadian cities, including smaller markets such as Calgary, Halifax and Ottawa?

• Do we care about competitive aviation costs based on comparable costs, particularly south of the border in light of the North American free trade context?

We can continue to debate, but as we do so other regions of the world are actively working to create global aviation hubs and gateways. In the UAE, for example, they are currently constructing airport capacity equal to Heathrow, Frankfurt and Charles De Gaulle combined.

There is no debate as to how important aviation is to that country. Dubai Airports CEO Paul Griffiths said as recently as two weeks ago in the context of the current controversy. Some of you may find it odd that I am quoting from a Dubai Aviation source.

“Most governments around the world treat aviation as a pariah, choking its growth with costly, misdirected regulation, instead of adopting policies that recognize its considerable socio-economic benefits and support its sustainable growth.

They then compound the problem with parasitic forms of taxation that usually flow straight out of the sector. In Dubai aviation is embraced as a strategic imperative.”

Meanwhile, back in Canada, outmoded policies which preceded the current government impose significant burdens on our airlines and impede growth, which among other things means fewer aircraft for the AIAC members to build, supply and maintain.

A competitive framework means addressing costs. Canada’s aviation sector has taxation and other fiscal burdens which are a net drain of resources from this critical sector.

This is in direct contrast to places such as the UAE or, closer to home, the U.S., where carriers and air navigation services all receive fiscal support to enable them to fulfill the strategic role they play in the domestic economy and social connectivity.

Consider airport rent. Although Canada privatized its airports in 1992, the Government continues to collect nearly $300 million annually in rent for these facilities. This is something no other developed country does and it drives up our costs dramatically and unfairly, making Canada less competitive. Indeed, we increasingly see Canadians driving across the Border to Plattsburg, to Buffalo or to Seattle to get on flights because they are cheaper.
The cost to land an Airbus 320 on average in the U.S. is less than half of what it costs in Toronto.

A second concern is the Air Travellers Security Charge. The industry paid more than $380 million from this fee in 2009 and early this year it increased this charge by as much as 50 per cent.

A third issue is fuel excise taxes, from which the government received $40 million last year. While these apply only to domestic travel they still represent a significant cost for the industry given the large quantities of fuel we purchase.

Between airport rent, airport infrastructure, navigation fees and charges, and other direct and indirect taxes, Air Canada would save approximately $1 B if we were a U.S. airline with the same volume of business in the U.S. This $1B million could be reinvested to develop new routes, acquire new aircraft and create jobs.

A competitive framework also means a competitive aviation infrastructure – despite decades of talk we are still years away from having a high speed link between the country's largest airport and its biggest city. Vancouver is the only city in this country wih a rapid transit link to the airport !!!

If this were all just a matter of our industry's issues, then I would not expect the public to be overly concerned. But there is a definite and well-documented correlation between air connectivity and economic growth, so any disincentive to travel de-stimulates the economy. At a time when all countries are looking to promote competitiveness and economic growth, enhancing the competitiveness of air travel should be a preferred way to achieve these twin goals.

Airlines in general are at the centre of the air transport industry. They are the focal point in an important value chain – globally and nationally, which includes these industries:

- Airframes, engines, mechanical systems, computers, electronics and software
- Aviation services including insurance, aircraft leasing/financing; telecommunications, aircraft maintenance and fuel suppliers
- Airports, catering/inflight services, Air Navigation Services;

- Hotels, restaurants, car rentals, travel agents and other tourism companies; and
- Freight forwarders, transport and warehousing companies.

According to a recent independent study for the National Airlines Council of Canada, the air transport industry directly generated $6.5 billion of Canada's GDP in 2009. The total GDP impact of the industry is estimated at $12 billion and once the aggregate economic impact (direct, secondary and catalytic) is taken into account, the impact exceeds $35 billion in GDP. Air Canada's own contribution is estimated at slightly more than 50 per cent of the Canadian industry, including that of foreign airlines operating here.

A competitive framework also means having balanced trade agreements. Let me address the elephant in the room, Air Canada is fully supportive of fair and balanced Open Skies with all countries where there is reciprocal demand.

We have welcomed liberalization agreements with the United States and most recently with the European Union, two of the most competitive markets in the world where there is real two-way demand with Canada and we are encouraging agreements with other countries such as Japan. We are not, however, supportive of demolishing our hubs and gateways or turning over our hard-earned network and flow traffic to state supported carriers of countries where there is no such reciprocal demand. Ultimately, this translates into less economic activity, fewer jobs and fewer routes served.

A competitive framework for Canadian aviation also means partnerships with airports to build strong domestic hubs that in turn become global gateways. International gateway airports are considered by economists to generate more value for their respective regional and national economies that regional hub, local hub or stub airports. And with very few exceptions, international gateway airports develop because major carriers use them

principally for their networks. The GTAA, the authority with oversight for Pearson Airport has become a strong partner working in collaboration with us to strengthen Pearson's position as a North American hub for global flow traffic. They have done good work improving processes and the infrastructure to smooth passenger flows and are reducing costs for airlines operating at Pearson, including reductions to the connecting Airport Improvement Fee and cargo aircraft landing fees.

The Canadian Airport Authorities have started to recognize airlines and airports have a common interest in growing traffic. This will help us build Toronto, Montreal and Vancouver into strong North American gateway and international hubs. And guess what? It's working. We have more than doubled since last year the number of passengers connecting via our Toronto hub between the U.S. and international destinations. And have also started new non-stop services from Calgary, Montreal and Vancouver.

Let me end on a very positive note.

We have the very best airline in North America right here in Canada. We have stabilized our financial picture. The culture of our company is changing – it's a dynamic and engaging environment. We are committed to stimulating international growth in addition to developing global gateways and we are providing direct access to the world from cities like Ottawa and Calgary.

Air carriers, including Air Canada have the potential to be one of the leading drivers, globally coming out of this recession and can yield multi-fold benefits in terms of economic return. To become a Global Champion in our sector, however, we do need a competitive framework for aviation which must address:

1) the cost structure; fees, charges, taxes etc.
2) the aviation infrastructure or our lack thereof;
3) Balanced trade agreements;

4) Partnerships with airports as in Singapore, Amsterdam, Hong Kong, the UAE; and

5) the building of strong domestic hubs which can become global gateways.

A strong Air Canada is good for Canada. It means economic growth and good jobs for Canadians working for Air Canada and in our aerospace industry at AIAC members. It also means a wider choice of services and routes for Canadian consumers.

Moreover we aspire to become a Global Champion - I know other companies represented here today either are currently or also have the potential to become Global Champions in the aerospace sector - the key, I believe, is for government to truly unleash our potential, remove barriers and give us the framework to chart our own route to global competitiveness. I hope you will join me in ensuring the message is heard loudly and clearly.

Thank you.