



**THE INTERNATIONAL AVIATION CLUB
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ADDRESS OF:
WOLFGANG MAYRHUBER
DEPUTY CHAIRMAN OF THE EXECUTIVE BOARD
OF DEUTSCHE LUFTHANSA AG AND
CHIEF EXECUTIVE OFFICER
PASSENGER AIRLINES**

Ladies and gentlemen, good afternoon.

Thank you very much for inviting me and giving me the opportunity to speak to you.

Tomorrow is a great day for Germany because your president will fly to Berlin, and then he continues from there on to other important sessions. This reminds me of a visit of the very much beloved former President John F. Kennedy to Berlin when he declared himself in a speech to be a "Berliner". This made great sense in the local dialect but for me, living down in the alps at that time, it translated into something like "I am a jelly donut." That's what Berliner means in the south. So if you find a twist in some of my words in this speech, think about the jelly donut.

It's always a pleasure to be here in this marvelous country and of course it's a special treat to stay in Washington, D.C. This young and most influential capital is not only an exciting city, it's the place where policy setting, rule making, standard fixing, and R&D allocation in aviation is done. And it comes as no surprise when you look at the United States that this is the most vivid and airborne nation, worldwide. With only five percent of the world's population, the US produces about 40 percent of global civil air traffic. Although I'm not an expert in military issues, but from what I gather, you're investing roughly 70 percent of the global air and space defense budget as far as capital expenditure is concerned.

Consequently, the knowledge base is here, the manufacturing base is here, the usage is here. So the first question should be, why did we invite a European speaker? I don't know the answer, but I'm surely pleased to be here. I can probably add a different

perspective with some global touch to your view and I can add aspects representing our company, Lufthansa.

Lufthansa is not only a great Airline as many customers confirm, it is a unique aviation group, which has become a good corporate citizen also in the U.S. We employ more than 22,000 people in your country working in several of our aviation group companies who have a presence here. And we buy goods and services in the U.S.A with the approximate value of \$1 billion per annum: The money is spent from spare parts to engines, from components to aircraft, and from services to companies etc. And last, but not least, Americans are smart investors. You own already 8.9 percent of our company. Thank you for being a loyal shareholder.

What do I want to talk about, today? I would like to give you a global view of the airline industry as we see it from a European perspective and address the forces that drive or limit our industry. I will also offer a little insight on how we handle the current crisis at Lufthansa and our opinion about those issues that need to be solved in order to create a more safe and secure future. We live in a global world with connected markets and where mobility is the foundation of prosperity and democracy. And we believe in team work. As an engineer, when I studied various operations, I looked at how individual parts functioned and how families of parts worked together, how people worked together and how the systems were interdependent. I found that the single weakest part was actually dictating the strength of the whole system. A 1-dollar-screw can shut down a 10-million-dollar-engine. And now, as the C.E.O. of the airline, I find it's the same notion through the

whole network of the entire airline system. And that's why it's important that we “engineer” the whole process and do not limit our management to the internal Airline activities. We do talk and we must talk about our own problems and the shortfalls for the travelling public. Nevertheless, the bigger picture is that we should remember the proven correlation between the degree of mobility and prosperity in a country. There is no prosperous country with low mobility. And there is a correlation between prosperity, mobility and democracy, and that's what the U.S. stand for. In Lufthansa's view, mobility fosters knowledge, and we should therefore connect people in this world even in difficult and uncertain times.

At every stage of economic development through the ages, transportation has been a decisive competitive advantage, regardless whether we traveled on water, on rails, on streets or through the air. Now more than ever, time is money. With air travel you buy time and therefore save money. And that's another reason to promote and work for a swift and fast aviation.

After telecommunications, the aviation network, which is a physical network, provides the most dense and truly global network. Today 1.6 billion people fly annually, as do another 30 million tons of freight. In the U.S. 60 out of 100 people travel annually by air but in the Eastern countries in Europe, it's only 0.4 per hundred. In China, it's 0.05. All people deserve a better future and markets will open. That's why I think it's important that we prepare ourselves for profitable growth and do not get disoriented by the aftermath of September 11th. I see a great potential for growth. We catch up, and the analysts are right

to tell us that by next year, we'll be where we would have been without the sad events of last year.

There is a strong tie between the US and the European markets. Intra-US and intra-European traffic plus the connecting flow on the Atlantic account for 76 percent of global traffic measured in revenue passenger kilometers, as reported by IATA. This indicates the importance of our common responsibility, the importance of the market that we share. We simply have to get things right on both sides of the pond, and we can only achieve it jointly.

There are, however, some distinctions. While the U.S. carriers depend heavily on intra-U.S. traffic, the European carriers depend relatively heavily on international fliers. The structure of line and charter operations and the stronger network of fast rail and autobahn systems are reasons for the smaller exposure of regional flows within the European airline community.

In North America almost 80 percent of the travel is domestic. Within Europe it's under 60 percent. But if we look at the revenue passenger kilometers again, more than 80 percent of the European traffic is international compared to 50 percent of the North American traffic. On the North Atlantic, 13 percent of the global IATA reported revenue passenger kilometers are transported. It is important in our aeropolitical negotiations building the future that you understand the great importance of international regulations for the European side.

And now I would like turn to the culturally diversified Europe, a big integrated market and a political community that's evolving gradually and steadily. Lately, with the introduction of the Euro a major milestone for common fiscal and monetary policies has been achieved. Now we have the Euro and surprisingly the former emotions of people were gone overnight. Now, the benefits emerge. And if we consider that the population of the European Community will expand from roughly 300 million to gradually 500 million because of the integration of eastern countries, the cooperation between Americans and Europeans, becomes a vital point. We need to establish a relationship that can be an aviation blueprint for the rest of the world.

On the North Atlantic, Lufthansa was the third largest carrier until August 2001, following British Airways and United Airlines. After September 11, through an appropriate capacity reduction, we fell back to rank number five, but surprisingly became the real winner. Two US operators moved in front of us, a move which obviously did not sustain but constrain their financial performance. I'll come back to that later because I think we owe to the public an answer on how we manage our business in these competitive surroundings.

This summer, Lufthansa will operate 188 flights weekly into 18 destinations in North America, 15 of them in the US. And we will almost return to the market presence of last year when we operated 193 frequencies per week, at least regarding the number of flights, not seats. And as of June 17, we will offer a unique all-Business Class executive service from Dusseldorf to New York operated jointly by Lufthansa and PrivatAir from

Switzerland. In the first quarter of 2002, the Association of European Airlines reduced, by their statistics, the capacity of the North Atlantic by 23.5 percent, while the US operators reduced it by 18.1 percent.

Travel is nourished by flow of investment and trade. The European Community is amongst your most vital trade partner. More than \$400 billion worth the goods are transferred between the EU and the US, annually. I mentioned already the population or consumers that are growing, but more important is the investment. Direct capital investment from the US is going strong in Europe, which many people don't realize. It's interesting to see the Netherlands as frontrunner, currently ahead of the United Kingdom, France and Germany, followed by Japan.

In my perspective, although I just picked a few examples, they show the great interdependence and the strong connections between the United States and the European community. I want to use this opportunity to promote a common approach when solving the challenges of our industry.

What are the forces that drive our industry besides the growing demand? I see areas for aero-political measures with a competitive environment as well as technological progress to be additional driving forces. In other words, if the customers want to fly, the regulators must make sure that we build the structure and infrastructure together with the airlines so that we can offer good services. We also must make sure that technology is used for the sake of safety, security, and efficiency. I am absolutely convinced that technology will

continue to enhance productivity, safety, and comfort, and it will decrease the ecological impact.

Check-in and flying must remain predictable. In times, where uncertainty creates burdens and standard deviation in processes we must make sure that the security issues are also treated in a way that doesn't overly inconvenience the customer. If I fly e.g. to the United States and I've already been screened by customs and security in Germany and the passenger records are advanced electronically to US Customs, I then expect not to be screened again upon arrival. We should simply make use of the technology that's there. In other words, the technologists and rule-makers must come together and organize hassle-free travel and make the most of the available technology. We must convert the current trouble into a convenience factor.

Because of growth, we have to double the safety margins, and we have to increase the overall efficiency for our customers. We will achieve that in many ways and through many areas. One example is how we make use of the time when the customers are boarding or are airborne. Lufthansa is working together with Connexion by Boeing to organize in-flight broadband communications systems.

I turn now to the aero-political environment. Deregulation and liberalization are two areas of importance. The US has always been the agent for free and worldwide trade. The US was the first in 1976 to apply the concept of liberalization and deregulation to its own aviation industry. The airlines have been allowed to use the forces of the market and to

shape the industry. The US enabled competition. The availability of services has improved enormously, while the system has become competitive, and the new business models have evolved.

The model of deregulation has despite the financial distress of airlines been proven right, and it has been exported successfully. In Europe, it began with cross-national deregulation in the '90s, and we have achieved in the meantime to apply it cross-border within the whole community.

Besides exporting it, the US has consequently applied the idea of a free air traffic market in passing 56 bilateral Open Skies Treaties to date. The one with Germany has been in place since 1994. It was a good decision and it helped all of us, foremost our customers. Even though we are facing a much more mature aviation industry, the airline side remained highly fragmented on a global scale. The current structure cannot be the structure of the future.

The process of consolidation is slow. In the US, it is much more advanced than in Europe. You have currently six major carriers in an oligopolistic market structure. In Europe there has been only little consolidation to date and only on a national basis, as you can see in the case of Austria, Lauda and Tyrolean, or in France. All other attempts of cross-border mergers such as KLM and British Airways, or KLM and Alitalia so far have failed. The newest issue is now EasyJet's approach to take over Deutsche British Airways and Go.

Having said this, I'd like to turn to the alliance systems which brought a lot of merit to our industry. The formation of global alliances, such as the Star Alliance and others, initiated an important structural evolution to the Airline industry.

Our chairman, Jürgen Weber, a founding father of STAR, talked here in 1999 about the benefits of global alliances. I was reading his speech, and he was optimistic but his expectations then were modest if compared to what we have, now.

We just celebrated the fifth anniversary of Star last week, and it's amazing how 14 partners now offer a global network to 729 destination in 124 countries. Connectivity has improved, seamless travel is evolving more and more, and the customers feel and enjoy the difference. Seamless travel is a benefit and can be achieved with various cultures on a global scale.

Star competes now with four other airline systems. That competition has strengthened the participating airlines, to the benefit of their customers. At the same time, while we've formed groups, we see segmentation. It's natural that, with growth, there is space for others to fill certain niches.

We see differentiation and development of new business models that will further drive the industry in the future. Today, civil aviation is basically segmented into five provider categories: These are global network carriers, like United, Delta, Lufthansa; regional

carriers that feed into networks and at the same time serve secondary markets; charter operators mainly organized for leisure travel (more than 50 percent of the transcountry traffic out of Germany is charter); no-frills carriers; and, finally, some executive services. All of the above are bound to grow. Competition is highest at the network level.

Are there limitations to our industries? What are the limiting factors that distort us? The first is infrastructure. It seems to be easier and faster to design and build a brand-new sonic cruiser than a simple runway. I think we need to use all of our strength to make sure that adequate infrastructure is put into place on time. The contributing factor to civil aviation has always been the availability and the development of sufficient infrastructure in the air or on the ground. Infrastructure is the cheapest investment to gain efficiency and increase competition. To offer new slots is better than trading old slots. The latest approach by the FAA to reduce the minimum vertical separation between aircraft in high altitudes shows the continued dedication to further improve the infrastructure. That is good, but I am personally convinced it's not enough. We must get more and better technology for ATC in place, and we must make sure that we also organize ourselves better.

If you compare the situation in the U.S. with Europe it's very evident that it's roughly the same space that we cover. However, Europe enjoys the luxury of 47 times more ATC organizations and 22 different operating systems. We are also confronted with airports that operate at their capacity. When it comes to infrastructure development, there are political shortfalls and there's an imbalance of power in decision-making.

We just recently did a study of how the public feels about aviation and the development of airports. We were impressed by the openness and fairness of the public and their understanding. We found quite a difference between the actual opinion and the published opinion by media. I think our politicians at least now understand that, yes, the population sees the necessity even in the vicinity of airports.

I am very much in favor of intermodality, interconnecting appropriate means of transport. We want to compete but we want the customer to play out what vehicle to use. For example, between Frankfurt and Cologne, a high-speed train connected to the airport, which was our desire, has been installed. This rail line is the equivalent of 39 runways. There have been virtually no protests of building a railroad which, of course, consumes more land and that distributes much more noise than airplanes. So I think there is also an imbalance in perception. We should better advocate aviation as something good and important for us.

There is another item that's cartel regulation. In the recent past this has even led to the absurd policy of slot dispossession. Shall we accept that our success gets restricted by a regulator? Having infrastructure in place can only enhance competition, that's what regulators must work on. We should not put our effort into bartering and bargaining for slots. We should put our effort into making sure that slots are not a value item at all. Slot restrictions are a sign, in our opinion, of false infrastructure policy, and cannot be converted into tradable value assets.

We have a little imbalance in the value chain. Aviation is not only important, it creates true value; However, the airlines are distracting value. When praising the benefits of liberalization and deregulation, one must not forget that the aviation industry is still subject to great imbalances in regard to competition in different parts of the value chain. For instance, while airports, plane and parts suppliers and leasing companies etc. are usually operating in mono- or duopolistic structures with corresponding high returns, the airlines find themselves in a fragmented and unconsolidated market with intense competition and corresponding low or negative returns. This unhealthy situation cannot last forever.

The total system creates value within the chain and at the customer base. We must not destroy the chain. We, the airline CEO's, must make sure that the weakest part of the chain – the airlines -get strengthened.

Now I come to the foreign ownership clause. The restriction of free transfer of capital and ownership are another burden in this industry. They hinder consolidation and restrict natural market forces. Even if my company is not striving for mergers or acquisitions, and even if Read van de Water's forward-looking ideas towards foreign ownership have been called back in certain aspects, we should be encouraged by the fact that there is talk on this important issue. Other distortions may arrive from uneven support granted by governments. In such areas as taxes, insurance, security issues, bankruptcy protection, there is a vast field of distortion. Lufthansa's response was pretty constant. We always wanted to be a quality supplier to this industry. We always wanted to be among the recognized global network carriers. As I said before, we define our role as a promoter and

a provider of a mobile society. We organize this through two dimensions. One is seamless travel with Star on the global side and with our team partners on the regional side. The other dimension is through seamless support, which are the businesses of the aviation group.

Passenger service is garnished by maintenance, repair and overhaul, catering, IT, logistics, etc. We stand for safety, reliability, punctuality, technical and operational competence. We strive for quality, innovation and service. And, of course, we are committed to creating a sustainable value for our investors. Through the last crisis, and the crisis before, we learned that flexibility and quick adaptation is of value and a competitive advantage.

How do we maneuver through the crisis? I don't have to explain to you the influence of September 11th. You have an in-depth knowledge and feeling of what this meant to the global world, not only to the United States. It's a fact that in 2001 the airlines lost more money than gained in the last 20 years before even though the terrible act happened only in the fall and not at the beginning of the year. If you do the math, you find out that in average every one of us granted to every individual customer of the 1.6 billion \$10 each from. That's what the total losses amount to. This must and can be stopped. One should find cost reduction of \$10 per customer inside any company to break even, and one should find another \$10 per passenger outside to make money. I am optimistic that we will move on and I am even more optimistic today , because we learned new lessons. For

us to perform, we avoided impairs on our customers. Secondly, we put full brakes onto cost.

Thirdly, we swiftly brought capacity down yet maintained flexibility to kick-start once the market returns. We did this by avoiding layoffs but asking the people to take voluntary unpaid leave, etc. We did this with our labor unions. The management also reduced their wages by 10 percent. We grounded 43 aircraft, renegotiated with suppliers and to cope with the extra costs connected to security measures, insurance measures and other elements, we introduced a security charge. Contrary to many competitors we were able to refrain from cutting prices because of the capacity reductions. We stayed cash positive during the whole period of time, and finally even increased our profitability in the downturn mode. Last week we were happy to report the positive first quarter results, and it's amazing to see that with a smaller production we doubled the profit compared to last year's first quarter. The recipe that we applied was very straightforward.

Now we need to define our position on the general role of aviation in the future. I read Leo Mullin's speech to this audience when he said, we are living on the edge. I think the situation was well described. He asked for a new policy of our industry. I am personally asking you to meet this challenge, not alone but together with your partners, also your European partners and legislators.

Now I'm going back to my engineering trade. To fly, you basically set thrust against drag, and you set lift against gravity. Now, how do we operate an airline? Do we really set market forces against regulations? Do we really set infrastructure against slot

restrictions? Do we really set capacity reduction against funding of losses? Do we really set product investment against internal spending? And do we really set technology advancement against security burdens that create hassle? And do we really set common rules or do we prefer unilateral approaches? Etc., etc.

Many of these questions need serious consideration. Without doubt, we all share, regardless in which part of the world we work, the passion for flight, the passion for aviation, and the constraints. We share the responsibility for safe and secure services. Let us preserve the value and benefits that have driven our industry in the past, and let us compete and act together with consideration and care to form a great future. Thank you for your attention.

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