Remarks of
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Good afternoon ladies and gentlemen. It's a pleasure to be here in Washington among so many friends and colleagues. I want to start by telling you about a recurring nightmare of mine. It involves a McLaughlin Group special about the airline industry – something which the PBS addicts in this audience can probably relate to. Just as one of the major airline executives – I won't tell you which one – is about to explain that the current industry downturn is just cyclical and how we shouldn't be worried, John McLaughlin cuts of the airline executive and says "Wrong! Next topic!"

In many ways, that's what it feels like in the airline industry in 2002. Far too many of us are continuing to grasp at claims of a cyclical downturn soon to be followed by a return to normalcy. But as John McLaughlin would say, that theory is just plain wrong.

What I am going to talk about today is how Air Canada has adapted its strategy to respond to this fundamental market shift, and what we – as the industry and governments, working together – need to do in order to get through these extraordinary times.

These times are indeed extraordinary. Last year, the North American industry lost more than

$7.7 billion — despite US federal compensation of $5 billion. In 2002, most observers expect that losses could exceed that.

According to the Air Transport Association, industry revenues are off a solid 20 per cent from their already depressed 2001 levels. Something on the order of $16 billion less revenue is being generated and that revenue shows no sign of soon returning.

As Carol Hallett says every new loss ‘means the industry must attempt to borrow more just to continue operating.’

It’s a depressing situation and the only solutions out there right now are band aids. They come in the form of more financial aid and the prospect of financial restructuring.

Yet, there are areas of growth in this bleak industry landscape, there are success stories which stand out. The low-fare sector of the market has grown, and the classic example of this is Southwest. Although some of my industry peers don’t seem to like to be reminded of this, Southwest makes money year in and year out. Year-end results for 2001 marked Southwest Airlines’ 29th consecutive year of profitability. And they’ll do it again this year!

You’ve got to love their consistency!

That’s not the only example but it’s the best example. For years, full service carriers have been in denial about low cost carriers.

We have become the best in the world at explaining away the successes of JetBlue or Southwest or WestJet or Ryanair.

- We insist that low cost carriers operate by a set of different rules than the rest of us.
- Or, we say that the low cost model doesn’t work for a full service carrier.
- Or just wait and watch them fall flat on their faces when they start buying new equipment or flying transcon or go into major airports.
- Or we say it’s impossible to match the low cost operators because we don’t have the flexibility to reduce labour costs.
- Or that low cost carriers are just a passing fad.

Well through the years, they’ve adapted to everything that’s come their way; they haven’t skipped a beat and they aren’t going to.

I think it’s time to change the record, to throw away the band aids and do something different. We have to articulate a new vision for the North American network airlines as sustainable and profitable businesses. Once and for all, we’ve got to recognize that Southwest has made money every year for 30 years in a row and network carriers have been inconsistent in their profit performance through that same period.

We have to ask ourselves where we want to be in five or ten years and actively work to create the kind of marketplace and the kind of economic environment which generates growth in air travel.

Let's start with a fresh look at the airlines themselves. At the heart of the problem is the business model which full service carriers – including Air Canada — have used to generate revenues for over five decades. With the advent of the internet, providing consumers real time access to the cheapest available inventory right up to departure and the encroachment of the low cost carriers, that model just doesn't work anymore.

The lifeblood of the full service carriers has always been the premium traveler and for anyone still in denial, let me be clear: they're not coming back. At least not in the way we knew it in the late nineties. That's why some observers don't think full service carriers can make money until at least 2005. In fact, the US majors' domestic revenue historically has ranged between .69 and .71 percent of US GDP. As of the end of last year that figure has plummeted to .51% of domestic GDP, and is showing little sign of recovery. We are seeing a wholesale contraction of our industry – not just a short term blip.

Clearly, the time had come to try something different – to take the status quo and turn it on its head.

That has been the response at Air Canada and it has led to what I believe is the most dramatic transformation of a full service carrier in the history of any airline perhaps anywhere.

It started in October 2001 with the launch of Tango, our low fare, no frills brand. Tango is an experiment founded on common sense. We adopted the successful elements of a no-frills carrier – on-line booking, paperless ticketing, optimal seat configuration, simple pricing, simple food product, maximum aircraft utilization and a closed network - meaning no interlining, even for Air Canada – and learned from the experiences of other mainline airlines who tried to get a low fare carrier off the ground.

We combined these ingredients with the reputation and quality of Air Canada, but gave it an entirely different brand and image to avoid any confusion as to whether a ticket on Tango meant you would be flying on a full service Air Canada flight. This approach came out of the Continental Lite fiasco.

Since it first started accepting bookings in October 2001, Tango has proven widely popular with customers. And this experiment has continued to go from success to success. After just one year, Tango will soon be carrying its two millionth customer.

Before we started Tango, we heard all the warnings and all the nightmare stories about full service carriers that had ventured into dangerous low-fare territory. But given the fundamental changes that have rocked the marketplace and the dire condition of the industry, we adopted the view that "thinking outside the box" posed relatively little downside. In fact, we saw more downside to following a course of "business as usual" than we did in pursuing a course of action others had discounted. On the upside we were in the position to avoid the mistakes of those that had gone before us and ultimately we have proved that we can offer an air service at a much lower unit cost than before and make money charging customers very attractive fares.

Tango has since become the template for radical change in our thinking. It's not rocket science. It boils down to two guiding principles which can be applied to other airlines to some degree: simplification and specialization.

Simplification addresses the need to offer consumers what they want, when they want it, at the price they're willing to pay. It also addresses the compelling need for airlines to cut costs – not by shrinking - but by actually re-designing the operation to run more efficiently and more economically.

Ultimately, if full service airlines don't figure out ways to radically reduce cost and thereby sell seats to consumers for less, they are destined to shrink further and further as the low cost carriers grow at their expense.

Simplification extends to the fleet as well. You all know the 'one-aircraft type' mantra of Southwest. It makes sense and saves money. It's not possible for Air Canada to operate an all –737 fleet, but it is possible to move in that direction and we have. In our case, this means making the Airbus 319, 320 and 321 family the backbone of our narrow body fleet saving us millions each year.

Simplification applies to everything we do – including the way we distribute our product. That's where Internet distribution fits in. No other single tool has allowed us to lower the cost of distribution so significantly.

As a result, we have leveraged the use of the Internet from a bit player in the old Air Canada, to a central component in our new business ventures. In just over one year, we have moved Air Canada from only 4% on-line distribution to some 15%, with Tango experiencing over 80% on-line bookings.

These are just a few examples of the direction we're taking. As we move forward, we are committed to driving hundreds of millions of dollars of costs out of our operation annually.

Year over year, we have already eliminated hundreds of millions of dollars of costs, resulting in a 5% year-over-year unit cost reduction and a 10% improvement in employee productivity, the best improvement amongst network carriers in North America and perhaps amongst all world carriers.

So, what's next?

We're continuing the simplification process by unbundling the airline and creating separate business units for our non-core activities, and allowing them to seek out new revenues. That applies to our Aeroplan loyalty program, our maintenance repair and overhaul operation and our on-line travel services portal.

This initiative is effectively turning old cost centers into new profit centers and letting our people run smaller profit-focused businesses on their own, as entrepreneurs.

Along with simplification, we are also embarking on a process of product specialization.

Specialization addresses the need for airlines to stop offering typical two or three class full service flights and a network product to all customers, and instead cater to specific market segments. This is not just about slapping on a new paint job and dreaming up new names to introduce in the marketplace. It is about market segmentation and addressing consumer requirements in a much more targeted and sophisticated fashion.

The core of our commercial strategy offers consumers a portfolio of brands and an expanded choice of products under the Air Canada banner. This is certainly not a new idea. In many other businesses from hotels to detergent, companies have created sub-brands to serve the diverse needs of their customers.

Marriott, for example, offers consumers a wide range of product and brand choices ranging from Fairfield Inns to Residence Inns to the mainline Marriott brand to Ritz Carlton. Through their brand and market strategy Marriott caters to every price point and demographic combination while giving their customers precisely what they are looking for.

At Air Canada, we've decided to do take that model and apply it to air travel. We've designed and launched a number of brands and products targeting different market niches from low fare with Tango and Zip; to shorthaul regional with Jazz; to two-class domestic and international network service with Air Canada mainline; to specialty charter with AC Jetz. Through these brands,

Air Canada is responding to what our customers are looking for.

I would be the first to tell you that Air Canada now has a lot of brands in play. Some people say we have too many brands. Some say this can only work in Canada. I'm not at all bothered by all these views.

We have learned that our customers no longer fit into marketing pigeonholes. We believe that there is no longer such a thing as a premium traveler or a discount traveler. Consumers choose different products at different times for different reasons. If they're buying what we're selling, then we must be doing something right. And our financial results bear that out. Air Canada reported net income of $125 million for the quarter ended September 30th. Operating income was $168 million, up $226 million from 2001. And given that we've pushed our unit costs downward to the point that we are now the lowest unit cost operator amongst North America's international carriers, we're tremendously well positioned for healthy profits when revenues return.

But a vision for success in our industry has to go well beyond the success or failure of individual airlines. It must include an economic environment and a market framework which allows all airlines the chance to prosper in a post 9/11 world. Starting with some outside the box thinking in order to unburden air travel through lower taxes, lower fees and fewer hassles as well as expanded market opportunities through innovative changes to bilateral agreements.

For North America's airlines, that means reforming the tax and fee infrastructure which is suffocating the industry throughout the continent.

The total increases in taxes, security-related costs, insurance rates and the revenue losses from other governmental policy decisions in the United States add up to $3.8 billion according to one recent estimate.

In Canada, we face much the same story. In fact, recently, when Tango celebrated its first anniversary by offering consumers $1 fares, the additional taxes, airport improvement fees and other surcharges brought the total up to an astounding $96 on a Toronto-Vancouver roundtrip. That includes Canada's $24-a-roundtrip Security Surcharge which is likely one of the highest security surcharges in the world.

The total which Air Canada and its passengers pay in fees, taxes and charges has skyrocketed by over 250 per cent on a unit basis over the past five years and the trends are headed in the wrong direction. I'm not sure there are any other businesses anywhere bordering on a total inability to price stimulate or even give away free samples.

The cost of doing business is killing our business and driving away our customers. And that doesn't even include the so-called 'hassle' factor, which causes passengers to simply avoid trips or find alternatives to air travel, because of the inconvenience or perceived inconvenience associated with air travel.

In Canada, the hassle factor equates to a 30% drop in traffic on routes operated by our regional subsidiary, Air Canada Jazz, where many customers are taking to the roads rather than to the skies.

Clearly, this is not a framework for success. It is not sustainable and is a recipe for disaster.

The solution to these problems lies in a changing approach by our governments with respect to the airline industry. That necessarily means two things. First, reducing the unrealistic tax burden on airlines and airline customers, and, second, updating the bilateral regime under which we operate in North America.

I'm thinking of a North American air services system specifically designed to function effectively in a post-9/11 world. A system which minimizes hassle through harmonized and consistent entry and exit processes for air travelers flying in and out of North America.

At the same time, we must also revive the liberalization process and move toward a more closely integrated North American market for air services. This would serve as a timely economic tonic by helping revive demand for air services. It would build on the success of Canada-U.S Open Skies and increase services and choices for both Americans and Canadians.

We've already seen this happen with the 1995 Canada-US Open Skies Agreement that significantly liberalized rules governing air services between both countries. It allowed airlines from both countries to develop and grow their transborder route networks and nurture alliance relationships as Air Canada has done with United Airlines.

Since the implementation of this agreement, transborder passenger traffic has grown to almost 20 million passengers per year contributing greatly to the trading relationship between our two countries.

Now is the time to let history repeat itself.

We need to recapture the spirit of Open Skies and move forward with Open Skies Version 2.0. Recent developments within the European Union may require major changes in existing bilateral relationships. The process may prove to be both complicated and time consuming. I would urge us not to “wait and see” how things evolve in Europe before we begin the critical work here in

North America. With the U.S. and Canada being free market innovators enjoying the world’s largest bilateral trade and aviation relationship, our two countries should be leading the world in air liberalization as well. We should be shaping our future, not merely responding to EU rulings.

The need to “think outside the box” is as strong in the aero-political context as it is in the commercial context. Over the past year, Air Canada has suggested an approach that would enable US and Canadian carriers to make full use of their networks by allowing them to carry the local domestic traffic of either country through their own hubs.

Regardless of the precise form our future bilateral might take, I think we need to be passionate in our pursuit for new and expanded opportunities – both in the traditional sense, and in securing new synergies for airlines and their alliance partners. If these tough economic times have taught us anything, it is the need to use alliances as a tool to maximize efficiencies.

Our bilateral relationship should permit all North American carriers — including Air Canada and United — to enhance their network integration beyond the transborder market.

Liberalization of air services has historically led to market growth, increased business activity and economic expansion – and expansion is clearly what our industry needs right now.

There’s no doubt that we have a lot of work to do, as airlines, as an industry and as close neighbors. However, despite the gloomy economic outlook, I don’t believe that this is the time to shrink from entrepreneurship or innovation or new ideas.

We can’t be held hostage to old ways of doing business – whether it’s as airlines or as governments. On the contrary, I think that we are obliged to find new ways of making the industry secure and successful in the post 9/11 world. The time has definitely come to rebuild the North American airline industry in tune with the economic and political realities of 21st century. By challenging the status quo, having the courage to take risks and remaining focused on change, I believe we can succeed in this mission and build an industry for the future which will benefit all our stakeholders.

Thank you.

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