Speaking Notes For

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Air Canada

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Good afternoon ladies and gentlemen. It's a pleasure to be here and I thank the Calgary Chamber of Commerce for inviting me to join you today. I want you to know that there are people who try to discourage me from speaking in Calgary. Who knows? Maybe, after the next 20 minutes, you'll be amongst them. Nevertheless, my view is that it's important to let you, the business leaders of this city, know what is going on in our complex industry, what Air Canada is doing and why - and how that affects this city.

That is particularly important at a time when the North American airline industry, in general, is suffering, like it has never suffered before. Instead of reeling off numbers and statistics, and at the risk of sounding too pessimistic, I thought I would start with a recent excerpt from a Reuters news report about the US airline industry:

"How much uglier can the picture get for U.S. airlines? Industry watchers are ready to call in the plastic surgeon." I guess the plastic surgeon is better than the undertaker.

North American airlines recorded losses of approximately U.S. $8 billion in 2001 and that is after $5 billion of direct U.S. government cash aid. In 2002, most observers expect that U.S. industry losses could exceed that. In the third quarter alone, US Airways filed for bankruptcy, United Airlines is on the brink and others are in dire straits.

From airline to airline in the U.S., revenue is down because of low fares and less traffic, while costs – particularly labour and jet fuel – are dramatically up. Margins, which are wafer-thin at the best of times, have evaporated.

Last week, United Airlines posted a third quarter loss of nearly US$900 million and is targeting $5.8 billion of labour concessions. American Airlines, the largest and most powerful airline in the world, lost US$924 million in the quarter (more than US$3 billion to date) and has publicly admitted that its revenue and pricing models no longer work. Delta posted a quarterly loss of US$326 million (more than $900 million since January 1, 2002) and announced 8,000 additional layoffs. Continental, America West and NorthWest announced aggregate losses of $114 million. And that is just last week's news.

The U.S. industry estimates that higher airline insurance premiums and government security mandates will cost the industry U.S.$4 billion this year, not including $2.5 billion in lost revenues from passengers who won't fly because of the hassle factor or fear.

The US majors are laying off more employees. They are closing maintenance bases. They are cutting prices and reducing capacity. They are selling their product below cost. They are seeking more government aid.

Suffice it to say that this continues to be an industry in crisis and we have our hands full. Despite what WestJet would have you believe, we don't sit up nights and devise devious plots to damage the "little carrier that could". That would be a luxury we can ill afford.

Air Canada has chosen to take another route out of this crisis and that's what I want to talk to you about today. We have decided to bring in a surgeon, but not, as the Reuters report suggests, just a plastic surgeon. We're undergoing radical surgery and the result is the most dramatic transformation in the history of Air Canada and perhaps in the full service North American industry.

That's why you're seeing new brands like Tango, Zip and Jazz. That's why we're changing everything we do in every facet of our operation including pricing, markets, products, costs and technology.

That's why we have committed to drive hundreds of millions of dollars of costs out of our operation annually, utilizing tools such as Six Sigma. That's why we are creating separate profit-driven business units with our loyalty program, our maintenance repair and overhaul operation, our on-line travel services company, etc.

As we previously reported, we are the only international carrier on this continent to return to profitability and record a net profit last quarter. We are the first amongst the North American majors to dramatically improve operating margins, change portions of our revenue model and revenue strategy and attack our costs faster albeit somewhat unconventionally by re-designing our product through our branding and process re-engineering. Processes with many inefficiencies have been built into our company over 65 years of existence and we do not have the leisure of being a start-up such as Jet Blue or WestJet with no historic commitments.

The rationale is simple. The traditional, full service network airline model which we all grew up with just doesn't work anymore. It's broken. The cost structure is broken, with unrealistic labour costs, rigid, uneconomic and inefficient union work rules and out-of-control governmental and para-governmental taxes and charges, which I will come back to later. The revenue model is broken with the multiplicity of fare structures and the "fences" that have created employment for yield management actuaries but served to frustrate many travelers. The distribution infrastructure, which relied heavily on costly computer reservation systems and travel agency interface, is now largely redundant as the internet matures. Network carrier infrastructure, such as interlining is seen as unnecessary for the price conscious traveller, who is also not prepared to indirectly subsidize business class seats he doesn't use, lounges he never visits, frequencies he doesn't need or cancellation flexibility, he rarely relies on. It's like Eaton's. A great institution and a strong franchise. But it became obsolete because customers changed and wanted something different. New retailers like Walmart were there to step in. Not just with a new name and a new store, but with new technologies, new economies and a new approach.

The airline industry is just now learning these same lessons. At Air Canada, we recognized the wake-up call early in the game. Just as the high tech bubble was bursting in December 2000, we saw our business travel start to dry up. We knew then that we would have to do something different. We knew that shrinking the airline was not a viable answer in itself to the changes going on in the marketplace. We started to seriously undertake the re-engineering of the airline into a completely different enterprise. September 11 then created the dramatic urgency to achieve that transformation in real time – with revenues drying up, with our debt burden and with labour costs on the rise, we did not have the luxury of waiting several years.

To transform Air Canada's business model, we need to do much more than cut costs. Our challenge is not just about economics. It's a combination of entrepreneurship, new technology, different market segmentation and customer habits, which make traditional airline thinking obsolete.

The foundation of Air Canada's transformation is built on four principles:

- Technology and distribution;
- Market segmentation and re-branding;
- Exploitation of ancillary businesses as profit centers; and
- Dramatic cost reductions and process redesign.

One of the most dramatic changes we have seen in our industry is the use of the Internet.

Internet distribution is something which many in the airline industry have become passionate about because no other single tool has allowed us to lower the cost of distribution so significantly. Air Canada’s distribution costs exceed $1.5 billion per year – for travel agents, call centers, CRS, credit card fees, etc.

But the Internet has also placed the power of distribution right in the hands of consumers and new start-up carriers. The advantages of traditional airline distribution channels have been eclipsed by the stroke of a key and the click of a mouse.

As a result, one of the common elements of Air Canada’s transformation is the way in which 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. Dealing directly with our customers on line allows us to greatly simplify our pricing and our ticketing while improving the customer relationship through more personalized service, which in turn drives loyalty. In just over one year, we have moved Air Canada from only 4% on-line distribution to some 15% with Tango experiencing 80-90% on-line bookings.

The second part of our transformation involves market segmentation and rebranding. The old paradigm, where a full service airline provides one service product to everyone, is just not what the consumer wants. This is the case around the world. Price conscious consumers have told network carriers in no uncertain terms by choosing not to buy from them, but from other vendors who have what they want, namely lower fares, simpler products, fewer fences, no frills, etc.

The core of our market segmentation strategy is to recognize that changed reality and offer consumers a portfolio of brands under the Air Canada banner. To provide self-service where the customer wants self-service. To provide lounges, concierge services, multiple frequencies and refundable tickets only where the customer is willing to pay for them. To provide connectivity and interline services only where required.

This is certainly not a new idea.

In many other industries, companies have created sub-brands to serve the diverse needs of their customers. Take a look at the hotel business and you see a good example of what Marriott calls ‘brand tiers’. Those tiers include: Fairfield Inn, Courtyard, Residence Inn, Marriott, Ritz Carleton and so on. Each brand serves a specific and segmented customer base.

I will be the first to tell you that Air Canada now has a lot of brands for you to choose from. Some people say we have <u>too</u> many brands. Tango, Zip, Air Canada, Jazz, Jetz. And, I must emphasize, that they’re <u>all</u> available right here in Calgary. People want to know “What’s the difference between Tango and Air Canada?” “Should I fly Zip or Tango?” “What’s the better deal?”

I’m not at all bothered by these questions. Or by a battle of the brands. We have learned that our customers no longer fit into marketing pigeonholes. We believe that there no longer is such a thing as a premium traveler or a discount traveler but rather a premium product and a discount product. Consumers choose different products at different times for different reasons.

Let me give you a brief tour of the brands and the markets they are designed to serve.

Of course, it starts with the traditional full service Air Canada product. It's a full fare, full service product with two classes of service and serves customers on medium to long haul routes.

Air Canada Jetz is a jet charter service offering a premium business service for corporate groups or sports teams or rock bands. For the right price, we'll even fly Ozzy Osbourne and his family. We'll even consider his unusual dietary preferences.

Earlier this year, we consolidated our five regional airlines under a new brand, Jazz, a wholly-owned subsidiary of Air Canada with its own fleet, headquarters and management team. Jazz is now one of the world's largest regional airlines.

Then there's Tango, our low fare, no frills brand. Tango is an airline within an airline. However, it uses the critical cost saving elements of the low-cost model to carve out its identity as a profitable, distinct brand.

It takes 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 combines it with the reputation and quality of the Air Canada brand.

Since it first started accepting bookings on October 11, 2001, Tango has proven increasingly popular with customers. Most Tango fares are over 80 per cent off full economy fares with no minimum stay or advance purchase requirement. 80-90 per cent of bookings are over the Internet. For Air Canada, all this means our unit costs are down by 25%. And this experiment has continued to go from success to success.

Tango will be welcoming its two millionth customer over the next several weeks. Somewhat fittingly, our one millionth customer last May was a Calgarian and a frequent Tango flier for both business and pleasure. Let's see if we can repeat that for the second million.

Exactly one month ago, we launched ZIP. It too is designed to dramatically lower our costs while responding to a marketplace that is demanding more options in low fare, high value air service. This proud new airline has its own management, its own operating license, its own headquarters, separate labour agreements and its own employees right here in Calgary. ZIP operates primarily on short haul routes, with service between Edmonton, Vancouver, Calgary and Winnipeg. It's gotten off to a great start, its operation is running beautifully and the team – headed by Steve Smith, - is doing a great job.

We all look forward to ZIP growing to serve additional markets in Canada and the United States.

And there's more brand business to come. Right now we're looking at the return of premium travel and contemplating a new service to meet those needs. The introduction of an elite product would see us offer luxury service on specially-configured A319s, directed at the super premium market. We'd like to introduce this brand sometime in 2003 but, like all our brand initiatives, that depends entirely on the right market conditions – we will need to see a stronger and sustainable business travel demand before proceeding.

So far, I’ve talked about Air Canada’s technology and brand strategy.

The third part of Air Canada’s transformation story is the exploitation of our ancillary businesses. We see these businesses – like Aeroplan and Air Canada Technical Services – as undervalued assets with lots of potential. Our vision is to create the conditions and structure which will see these businesses take off as stand-alone profit centers, with the ultimate goal of spotlighting them to create shareholder value. This exercise goes well beyond branding.

Aeroplan, with over six million members or one-fifth of Canada's population, is on track to become a stand-alone, solid loyalty management company in its own right with significant third party revenues, exceeding $325 million last year. It is pursuing an aggressive growth strategy by building on existing agreements in the traditional travel, entertainment and financial credit card sectors, as well as by developing new partnerships, including expansion into new consumer categories and e-commerce.

Air Canada’s Technical Services group, which is responsible for the maintenance, repair and overhaul of aircraft, has also recently been transformed into a stand-alone profit centre, generating significant third-party revenue from other airlines (last year exceeding $220 million) and is expected to be a significant contributor to our bottom line. That’s a piece of good news for Calgary which is home to a top-notch Air Canada maintenance base.

Another good example is destina.ca - our Canadian answer to the success of Internet travel services portals like Travelocity, Expedia and Orbitz. We launched destina in April of this year. After just two months of operation, it had already attracted more than one million visitors, making it one of Canada's favourite online travel sites. With good reason. Destina offers low air fares and one-stop access to 53,000 hotels and 52 car rental agencies – as well as Aeroplan miles for every booking. This new business should achieve both the effect of tackling our distribution costs as well as allowing us to leverage our customer base, staying close to our Aeroplan members.

At its core, the philosophy behind our transformation is consistent and simple. It requires careful management of costs and capacity, a focus on growth markets, full exploitation of new and emerging technology and Internet applications to reduce costs, innovative partnerships, a new entrepreneurial culture and a tailored marketing approach which aggressively sells the product to the desired market segment.

The fourth component of our transformation focuses on dramatic cost reduction and process re-design. Year over year, we successfully 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. Reducing unit costs, while shrinking the airline by taking out capacity, is virtually unheard of in this industry. All signs are that this cost focus is producing encouraging results. However, while we are turning the organization inside out to save costs, looking for every dollar, we are facing a seemingly endless and irresponsible escalation in costs passed on by the government and the government-mandated monopolies, such as airports. I get the sense that there is no adult supervision.

The bottom line is that airlines and our customers are no longer able to simply accept these never ending price hikes, which is the knee-jerk response to declines in both passenger and aircraft volumes.

I agree with the Director General of IATA (Mr. Bisignani) who last week called for airports around the world to reduce fees and improve transparency. He said and I quote:
"There is something structurally wrong with our partnership between airlines and airports. If one of the partners is losing his shirt while the other is counting his money, it is no longer a partnership".

Fuel excise taxes. Airport improvement fees. Air navigation fees. Air security surcharge. Air travel in this country is subjected to more "sin taxes" than tobacco or alcohol! One can only conclude that air travel is now considered a "sin" by the powers that be.

From the $24 airport security surcharge to the 20-25% increase in year over year rates and charges at some airports to the 50% increase in airport improvement fees, to the recently announced increase in the air navigation charge, airlines and our customers are being saddled by an unbearable financial burden.

At a time when airlines around the world are expected to lose US$12 billion in 2002 following losses of US$8 billion in 2001, airline employees have lost their jobs and air travelers are paying more ancillary charges than ever, the time has come for all of us to collectively say “enough is enough.” You will hear Air Canada and the rest of the industry repeat these words frequently in the weeks to come.

As airlines, we can no longer tolerate a situation where we are forced to review the products offered to our most frequent fliers only to see those savings passed on to airport authorities in the form of higher user charges.

As airline employees, we can no longer tolerate a situation where we have to take salary freezes only to see those savings passed on to government or unregulated monopolies.

As consumers, we can no longer tolerate shouldering the entire costs of air security when in fact it is national security which is at stake.

Enough is enough.

Even though the airline business is still in crisis mode, we take our corporate responsibility seriously and Air Canada's community presence in this City through sponsorship activity remains strong. We remain the official airline of the Calgary Flames and the Calgary Stampede. Air Canada supports amateur sport, local arts (including the Calgary Philharmonic Orchestra) and dozens of community-based charities.

But here's my favourite indicator and it doesn't come from me. And it is not a public relations exercise. It comes from the people of Air Canada who live and work here.

Back in 1993, the Air Canada employees in Calgary raised enough money to send 50 disadvantaged children to Disneyland on a Boeing 767 for the trip of a lifetime. This was the birth of Dreams Take Flight Calgary. It's an event which was repeated every year – except last year following the tragedy of September 11th. Today, I'm happy to report that two Air Canada aircraft will make the trip to Disneyland carrying the kids who were scheduled to go last year – as well as this year's kids. One of those flights leaves today and the other departs tomorrow.

More than anything else that's what the people of Air Canada are all about in this community. That's why I am proud to be here and proud to have this opportunity to salute their hard work and, more importantly, their lasting commitment and contribution to Calgary as Air Canada tackles the many challenges which lie ahead.

Thank You.