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SPEAKERS FORUM

**The Future of Air Travel:  
Open Skies, Mergers and New Business Models**

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Thank you very much, Ron. It's my pleasure to be here this afternoon at the Speakers Forum. The long list of political, business, cultural and social leaders that have presented from this stage is impressive and humbling.

Nelson Mandela, Henry Kissinger and Jim Balsillie are just a few of the names...And how could I forget my dear friend Robert Milton?

The Future of Air Travel is a somewhat daunting subject. When the title for this presentation was set some months ago, the industry environment was very different and I could have delivered a rather different speech. It seemed like every time I considered my remarks over the last week, a new development forced an update. From bankruptcies to mergers and with the price of oil going through the roof, airlines have seen rapid changes this year and there is rarely a day when something new isn't happening.

Also, air travel is such a necessary and common part of our lives today that almost everyone is an expert. If your cousin flew to Mexico 10 years ago and the airline lost her bag, you've probably heard the story 100 times around the table at various family gatherings...And the story gets better every time.

We all have our own stories with issues like baggage, weather and cancellations. The fact that hundreds of thousands of passengers rely on air travel every day in Canada means there is significant interest in our business, but it also puts airlines under a rather unusual scrutiny.

I think that you would be hard-pressed to find a day without some mention of airlines in our Toronto papers, not to mention other papers around the world. There are entire sections devoted to travel each week.

To elaborate on my earlier point related to change, the last month alone has seen the following:

- Southwest and American cancelled thousands of flights due to maintenance issues;

- Six airlines – four in the U.S. and two that flew internationally – filed for bankruptcy protection, with the most recent announcement regarding EOS Airlines coming just yesterday;
- And while recognizing that this isn't a forum for self-promotion, I'd like to end this brief list of failures on a more positive note and mention Porter's recent startup of service to Newark; our first U.S. destination and where bookings are running a full 80 per cent ahead of projected levels.

This afternoon's discussion will focus on three main topics – New Business Models, Mergers and Open Skies. All of these are major talking points in the industry currently and have a direct impact on passengers.

Our success to date at Porter is due largely to the unique market niche we have identified and are filling. The two existing dominant airline business models are “legacy” and “low cost”, with the recent trend being for each type of operator to encroach on the other's territory.

To offer a brief explanation, full-service legacy carriers such as Air Canada, American Airlines and US Airways started out by offering passengers everything from peanuts to pillows to pajamas, and typically expensive fares to go along with it. They built up cost structures over time that were unsustainable and eventually services were slashed – often aided by bankruptcy protection.

Discount carriers became a viable option in the late eighties after industry deregulation opened the door for new players to take advantage of the high-fare environment and to cater to passengers looking for affordable flights.

This model has proven to be highly successful in many countries, but if you want a snack, you usually have to take out your wallet. If you want a pillow, you're probably out of luck. “You get what you pay for” is a literal term in this case.

Today's discount airlines are seeing their operating cost advantages shrink as their business matures and legacy carriers trim costs. In response, they're offering passenger amenities such as in-flight television and more legroom, in order to justify charging higher average fares. Both types of airlines are increasingly looking for non-air revenue such as extra fees for checking second bags, and fees for both in-flight meals and entertainment, in order to drive their growth.

Essentially, we have been seeing a slow transition towards the middle where it's becoming increasingly difficult to distinguish between traditional legacy carriers and newer discounters.

At Porter, we've often had to dispel the notion that we are a discount carrier, mainly because almost every new airline in recent years has used this model. People are genuinely surprised and

even shocked when they can wait for their flight in a lounge with leather arm chairs or are offered a complimentary glass of wine onboard.

One of the industry shifts making this possible is the emergence of large turboprops in airline fleets around the world. Just a few years ago, regional jets were very much in vogue and seen as the way ahead for airlines looking to expand their networks to smaller cities, increase service levels through frequency, and maximize operating efficiencies on short-haul routes.

Record-high oil prices are a key reason for turboprops' rise in popularity today with there being a rather interesting and direct relationship between the number of turboprops sold annually and the price per gallon or litre of jet fuel. Turboprop sales are now approaching those for regional jets and I expect this trend will continue.

This is somewhat of a back to the future scenario for the industry, but today's state-of-the-art turboprops are dramatically improved compared to those dating back several decades, especially when it comes to noise levels, speed and comfort.

The most eye-popping reason for the turboprop's rise in fortunes, though, is fuel savings of up to 40 per cent versus those of comparable regional jets.

More and more airlines seem to be falling victim to the rapid rise in fuel costs. If they aren't going bankrupt, they're parking old gas-guzzling jets or moving to all-turboprop fleets such as was announced by Horizon Airlines just last week.

High costs are also driving the current round of airline mergers.

The big recent news is the potential Delta-Northwest deal. If all goes according to plan, it will become the world's largest airline, but likely only until some combination of United, Continental, American and U.S. Airways get together as many are speculating will happen.

Meanwhile, in Canada, our only two national scheduled airlines happily promote their cozy "rational pricing duopoly". These are the actual words of their CEOs, particularly at WestJet where Clive Beddoe and his successor Sean Durfy have both used the phrase "comfortable duopoly" to describe their co-existence with Air Canada in the market place.

I deliberately didn't include Jazz in this reference since all of its marching orders still come from Air Canada. Even though it is Canada's second-largest carrier on its own, Jazz still behaves much like Air Canada's lapdog and doesn't stray far from its master without risking the proverbial "yank on its chain".

If you had any doubts about the Air Canada-WestJet dominance, remember that they control about 93 per cent of the domestic market. It's a difficult balance for our friends Montie Brewer and Sean Durfy. When talking to shareholders and the broader market, phrases like "duopoly"

and “rational competition” sound pretty good. After all, profitability is important and necessary for survival.

When you talk to passengers, though, “rational” equals “high” when it comes to prices. That may be good for business, but it doesn’t quite work for the person trying to get a consistently reasonable fare from Thunder Bay to Toronto.

However, it’s amazing what actual competition does. The routes Porter currently flies have seen base prices drop by 50 per cent or more in almost every case. This drop in pricing is always conveniently timed with the announcement of our intention to serve a new market. Merely a coincidence, I would suggest?

Focusing, again, on the U.S. situation, you have to wonder if bigger is actually better. Once the obvious cost efficiencies are taken advantage of, you’re left with a giant organization whose various component parts might not all be pointed in the same direction.

Just look at the Delta-Northwest combination and the over \$10-billion combined loss they posted in the first quarter. That’s a deep hole to climb out of.

I’m convinced you actually lose the ability to react quickly and decisively in order to take advantage of opportunities, when you get too big. And this inability to be flexible and take advantage of opportunities is probably one of the main reasons we’re seeing the current merger proposals on the table. There just isn’t much left other than mergers for them to try.

And to quote from David Olive’s article in yesterday’s Star, which in turn quoted U.S. airline analyst Adam Pilarski of Avitas saying:

“There is no history of anything good that happens in mergers. Two drunks holding each other up is not a good idea.”

But, it’s not as if this hasn’t been tried before. Most recently, U.S. Airways acquired America West in 2005, and now this pairing may be swallowed by a bigger player because they have not been able to make it work.

At least one positive thing may arise out of these mergers though from the business side and that is the almost certain reduction in domestic U.S. capacity. Carriers were already moving in this direction through a combination of phasing out less fuel efficient aircraft, scaling back plans for new routes and using smaller planes on existing routes to coincide with a slowing economy.

Open Skies continues to be part of an ongoing evolution as far as government policy goes. The most important agreement of this kind for Canada is obviously with the United States. The most recent changes to the document, which came into effect just over a year ago, now allow carriers in each country to begin a flight in their home market, stop in the second country while picking up passengers and cargo, then fly to a third country.

For example, a Canadian carrier can originate a flight in Toronto, stop in Atlanta to drop off and pick up passengers, and carry on directly to South Africa. Even though Porter was the first airline granted a license under this new regime, I wouldn't count on us filing these types of flight plans any time soon.

The big item left on the Open Skies table is cabotage. This is a technical term meaning "air transport of passengers and goods within the same national territory" and almost no country in the world allows it. Basically, if cabotage was allowed, Porter could fly passengers between Chicago and Washington, while Continental could fly Toronto-Vancouver, just as examples.

For years, the discussion in this area has revolved around reciprocal access. If U.S. airlines can fly domestic Canadian routes, the reverse should be true.

The Competition Bureau of Canada recently suggested that this reciprocity need not be a requirement, likely with the expectation of increasing domestic competition. When you look at Canada's aviation history, though, this is one recommendation that may have some unintended consequences.

Air Canada has beaten down, purchased or outlasted almost every new entrant over the years before they could get established. WestJet is an exception and we believe that Porter has also found a long-term, sustainable niche. There are also successful charter companies, but that is a very different business model.

We've seen Air Canada's predictable tactics first hand at Porter which have included flooding the market with excess capacity and then slashing prices in an attempt to put pressure on us. Not to mention dragging us into court over a dozen times on different issues – all of which we've come out ahead on so far.

It's rather amusing to hear Air Canada's lawyers portray Porter as the big bully trying to stifle competition. Our raccoon mascot may be perceived as a pest by some, but the thought of tiny Porter doing this to Air Canada is simply laughable.

Porter has demonstrated that it's possible to introduce a new airline in a very pro-competitive manner under the current system, produce real benefits for consumers and be profitable, all at the same time.

The key for new airlines is to define a market and stick to it. Too many have tried to be all things to all people and ended up pleasing no one, or they have chosen a market that just wasn't large enough.

But, why shouldn't we allow foreign airlines into Canada if so few domestic challengers exist? It makes sense in theory that larger, established foreign airlines might be able to effectively deal with Air Canada's bullying tactics and offer sustained competition.

In reality, though, if cabotage is allowed, you will likely see some U.S. airlines test the waters on premium routes such as Toronto-Montreal and Vancouver-Toronto, but I highly doubt that St. John's-Halifax or Thunder Bay-Winnipeg will even be on their radar screen.

And why would Air Canada treat Continental, for example, any differently than Jetsgo, CanJet or Porter? International and uncompetitive domestic routes will be used to subsidize reduced fares on high-volume city pairs until the new carrier goes away.

What incentive does Continental have to get into this low yield game when they already have similar challenges on many of their existing routes? In the end, small and mid-sized markets would see no benefit, while select premium routes would likely get only temporary periods of lower fares.

The real solution to sustained competition is smart business plans by new airlines in niche areas, combined with increased bilateral agreements on international routes. While government can create an environment for competition to occur, it can't force it to happen unnaturally.

I can't predict the future, but the airline industry often seems to have trouble learning from its past mistakes. As the head of the International Air Transport Association recently put it:

“There is no secure long-term future for an industry that is constantly on the verge of intensive care.”

What I can tell you, though, is that carriers who get their fuel economics right and who stay focused on niche markets, have a much better chance of long term sustainability than those who don't.

Thank you for your attention, ladies and gentlemen. I look forward to some further discussion and to your questions.