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CANADIAN CLUB OF MONTREAL

Porter Airlines rises above an industry crisis

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Merci, Clemens. Bonjour, Mesdames et Messieurs.

It's my pleasure to be here in Montreal and to take advantage of this opportunity to address the Canadian Club. Since my days at McGill almost forty years ago, this city has always been close to my heart.

On a previous visit back a year ago, I reported that I expected Montreal to be Porter's number one market within the foreseeable future. I'm pleased to tell you that we achieved this result early in 2008.

In fact, when you consider Montreal, Quebec City and Tremblant, Quebec is the best-served region in our current network.

To give you a sense of the growth and strong support we're experiencing, monthly sales have shown a phenomenal surge. As of June, the last full month before the summer season, year-over-year growth across the network is up almost 100 per cent.

This type of passenger response and growth gives us the confidence to look toward the future with plans for increasing flight frequencies between Montreal and Toronto from the current nine roundtrips a day to as many as 15 next year, providing hourly service from Montreal to downtown Toronto.

We're also in the midst of planning for additional U.S. destinations, purchasing new Bombardier Q400 aircraft and hiring additional employees. Our next new destination, Chicago, will be starting this fall. But, how is this possible for an airline today?

It's a sharp contrast from the broader industry that is being devastated by high oil costs. The price of jet fuel is almost 60 per cent higher than one year ago, which represents an added cost of \$91 billion U.S. for airlines worldwide. The effect of this was most recently illustrated in Canada by the demise of Zoom.

From bankruptcies to mergers and with the price of oil having almost gone through the roof before its more recent pull-back, airlines have seen rapid changes this year and there is rarely a day when something new isn't happening.

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...Coming from an aviation family, I might even claim to hear more of those types of stories than would normally be the case.

We all have our own recollections of issues with baggage, weather and cancellations. It's a part of air travel that happens, but the best airlines minimize disruptions and deal with those that occur professionally. 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 does tend to put airlines under unusual scrutiny.

I think that you would be hard-pressed to find a day without some mention of airlines in the local papers, not to mention other media around the world. There are entire sections devoted to travel each week and, as I mentioned, the news has not been good recently.

IATA (International Air Transport Association) released its most recent projections last week predicting a \$5.2 billion loss for the global airline industry. Words like “toxic”, “bleak” and “poison” are used to describe the situation.

When you look at the numbers closely, though, \$5 billion of the total loss is assigned to North American carriers. That’s almost the entire global loss centered in one region. It’s actually even worse when you realize that the main Canadian carriers are currently profitable and the focal point for losses is almost entirely in the U.S.

Canadian airlines are certainly working hard to maintain these results, but the philosophies are entirely different.

WestJet has found success as a low-cost operator, offering low fares appealing to leisure travelers. Having largely saturated this market, it only recently started searching for ways to attract regular business flyers by varying its product offering and expanding its reach through alliances.

Air Canada struggled for years with a high-cost structure that was partially resolved by filing for bankruptcy protection five years ago in order to cut labour costs, break unfavourable aircraft leases and refinance outstanding debts. Its costs are still higher than those of WestJet and Porter, but Air Canada has also become the world airline leader in passenger fees. Everything from food to frequent flyer points, and baggage fees to insurance can be bought or opted out of in a confusing process of buying one's ticket.

In addition to that, Air Canada finds itself in the unenviable position of facing tough labour negotiations next year with an employee group that feels like it has sacrificed enough already.

Our success to date at Porter is due largely to the unique market niche we identified and are filling, serving regional markets targeted to time-sensitive business travelers and others looking for a service-oriented experience that provides value.

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 flight 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 of jet fuel. Turboprop sales are now approaching those of regional jets and I expect this trend to continue.

It's 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 two or three decades, especially when it comes to noise levels, speed and comfort.

At Porter, we're certainly pleased that our order for 20 of Bombardier's Q400s two-and-a-half years ago puts us farther along the delivery line than many of the more recent converts.

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

Published figures for a typical regional route show the Q400 as 30 per cent more efficient than a Next Generation Boeing 737 and 18 per cent better than its closest turboprop rival.

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 this year by Horizon Airlines.

The Q400 has helped Porter be profitable since June 2007. Last month also marked our first full fiscal year of profitability and in June of this year we achieved a net income margin that put us among the best performing carriers in the world. As oil prices rise, Porter's competitive advantage actually increases.

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

Delta and Northwest continue moving closer to implementing a merger. If all goes according to plan, it will become the world's largest airline. Others are finding comfort in new alliances, such as Continental's more recent decision to move to the Star Alliance.

Similar scenarios are unfolding in Europe and old trans-Atlantic adversaries are looking for anti-trust exemptions to take advantage of new Open Skies agreements.

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. This is despite the fact Air Canada no longer has any ownership position in Jazz, which 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 having its proverbial chain yanked.

If you have 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 short-term 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 and in some instances has occurred even before we actually started flying. 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. This inability to be flexible and take advantage of opportunities is probably one of the main reasons we're seeing the current wave of consolidation. There just isn't much left for them to try.

And to quote U.S. airline analyst Adam Pilarski:

“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 they haven't tried before. U.S. Airways merged with America West back in 2005, and this pairing was again actively in play earlier this year because they have not been able to make it work. Many of Air Canada's troubles can also be traced to its takeover of Canadian Airlines.

At least one positive development arising out of this consolidation from the business side is the reduction in capacity, particularly in the U.S. 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.

Porter is fortunate in many ways:

- We've established a strong brand which has become synonymous with speed, convenience and service – all rather rare commodities among airlines today

- The Q400 is an ideal aircraft on its own, but even more so with high fuel prices
- And passengers are starving for competition

People are responding to the Porter Experience and spreading the word.

However, the cutbacks seen on a wider scale are non-existent on the routes Porter flies. Old carriers resort to the same old tactics whenever someone new shows up, despite what common sense might dictate. Lower fares and consistent or increased capacity are the orders of the day.

It's competition we relish and are ready for with each new market we enter.

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 IATA 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 stay focused on niche markets, have a much better chance of long term sustainability than those who don't.

Merci. Thank you for your attention, ladies and gentlemen. I look forward to answering some of your questions.