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"Taking off into a new era of European aviation"

Presentation by

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Good afternoon, ladies and gentlemen!

Talking about the new era of European aviation, I would like to combine two elements. The first one, airline consolidation, I also believe it is inevitable. And why is it inevitable? Because we have to earn more money in this industry to invest in modern equipment, to invest in growth and to invest in environmentally friendly technology and products that our customers want. And we have to face the fact that demographics don't work in favour of Europe. If we want to be in this global arena we must make sure that we get the right size organised. And secondly, I would like to talk about how the airlines in Europe have to adapt to the changing requirements of our customers on the one hand and the changing requirements of the environment we work in on the other. But let me underline again that the new era that I wish to discuss is not a revolutionary one. It goes in steps and it started actually with external shocks five years ago, actually yesterday, five years ago on September 11. A truly new era began, one where we have had to learn that we should not only fly safely and properly but also make sure that security is always on our minds, and do our utmost in order to make sure that we fly safely and securely.

Aviation does indeed connect people and link industries; it empowers global manufacturing and sourcing. This brings wealth to our societies. We excel in trade and we nourish tourism. We are key to development of the economies around the world and we bring hope to emerging countries. And aviation has become a core business in itself. AEA member airlines alone transported 320 million passengers last year. More people than ever are flying and

the demand is growing. The numbers are most likely to double within ten years. This is, I guess, known to you. AEA member airlines alone in Europe employ almost 400,000 people.

We are the centre of a value chain, a complex value chain that adds up to roughly eight percent of Europe's gross national product. And we make global business possible, which is important for Europe, I think even more in the future than in the past. Forty percent of the value of goods travels by air. As the industry becomes more complex, as piece parts become smaller, as the value of what we do grows, time becomes a factor and that is why I believe not only people but also goods will travel more often on planes. To sum it up, we make our guests happy with an increasing variety of different products and affordable prices. You'll have noticed how the prices have shrunk over the years.

Secondly, we make our staff happy because we create work, jobs, and we offer an exciting variety of jobs for men and women around the world. But, so far we have failed to make a third important group happy: our shareholders, the investors.

Generally speaking, most of us don't earn the capital cost. The majority of airlines destroy value and this – in a vital industry where airlines are core to this entire industry – is a danger. A profit of roughly 800 million USD against a total revenue of 93 billion USD is not a convincing case for AEA members to invest in the future.
We need margins of roughly eight to twelve percent to earn the WACC (the weighted average cost of capital) and the impact of the variation in our business. Currently most of our airlines, even the

good ones, are far below this figure. The worldwide balance sheet looks even worse. Since 2001 the industry has lost more than 41 billion US dollars. In fact, the majority of our airlines even today don't earn money, so what is wrong with us? The main changes and challenges for us remain the same; the airlines live in a fragmented world with an imbalance in the value chain.

And secondly, the regulatory environment is heavily distorted. While airports, plane makers, part suppliers, leasing companies, computer reservation system and ground handlers all make nice margins, the airlines themselves are generally operating with low margins. Why is this? I think the barrier of entry is low while the barrier to exit is relatively high. Fragmentation creates overcapacity. Our product, the scheduled service, is by definition a perishable good – an eleven o'clock flight can no longer be sold at eleven fifteen. And while our fixed costs are over proportionally high, governments tend to foster airline competition where there is no shortage of supply but make no attempt to create capacity and incentives for the infrastructure suppliers, fuel suppliers, air navigation suppliers, etc. etc. For instance, in Europe we pay around about 6.9 billion euros for air navigation, the global total is about 9.9 billion, so only 3 billion more. You see that Europe accounts for seventy percent of the fees of global air traffic but we don't operate seventy percent of global air traffic by far. The figure is more like thirty percent.

So, two things need to be done to achieve sustainable airline profitability in Europe. We must all reduce our internal costs. Everybody should point at his own organisation first and find out that there is plenty of room to go further. But we also must have an eye on a more efficient system. If these two conditions are met we can overcome the cyclical crisis, absorb the effects of international incidents like a terrorist acts and continue to be your backbone, the backbone of Europeans' competitiveness in a globalised economy.

In Europe, airlines know by now how to increase productivity. We have been doing that for quite some time and everybody has, of course, their own recipe. So let me directly turn to the second requirement: the system must be more efficient. As far as the airlines are concerned, this does indeed mean consolidation. Scale, ladies and gentlemen, will matter in a global competition. My company was born in Germany, its home market was Germany, its growth market was Germany. In the meantime we still are in Germany, our home market is Europe, the growth market is the rest of the world. This is a distinct difference and that is why our rulemaking, our attitudes and the way we look at the relevance of the market has changed. But consolidation does not always mean reducing the number of service providers. Not necessarily, just look at Air France-KLM. I think it is an example that you can learn a lot from. Consolidation – it is not only something that will hit the network carriers, I think it will also be something for the no-frills market. Again, it is right to say that the barriers to market entry are too low in this sector and are sometimes "artificially fertilised" by regional airports or regional governments to attract this kind travel. There will be enormous demand in the future for this segment but again, if airlines start underfunded – if they operate at margins that

would only be sustainable if they don't create the money out of the business but out of growth – there is danger at hand.

Internally in my company we always say we don't grow to cut costs. We cut costs to grow. But in many areas, especially in the no-frills area, we see the effect that people want to grow in order to generate economies of scale and cut costs, which is, if it is not sustainable, a danger.

True consolidation is necessary in a fragmented world, not only of the airlines but also in the management of airspace infrastructure. We do need a European single sky. This has been known for many years. We don't need thirty-five, we don't need forty-five, or even fifty-nine systems. One single management system to allow straight routes would be important. No more holding patterns and no more handovers from airspace to airspace that are not designed for what airplanes can do nowadays. A more efficient infrastructure will save us millions of tons of kerosene. The delays in Europe alone lead to more than one million tons of useless CO_2 emissions per year. The delays in Europe alone lead to more than 1.5 billion U.S. dollars in wasted operational costs. So here is an area where we can improve in both aims, economy-wise and ecology-wise. Lufthansa alone is wasting 115,000 tons of jet fuel in holding patterns each year. With this amount of fuel, 11 long-haul jet flights daily from Frankfurt to New York could be operated. The environment and our passengers are paying for the cost of this inefficiency. Efficiency gains could deliver annual savings of three billion euros according to EUROCONTROL's own estimate. Therefore, an efficient use of the European airspace is in our

opinion a “conditio sine qua non”. And, ladies and gentlemen, time matters. We do have the skills, we do have the technology, we do have the funding in place. But we also need the regulatory framework and the political will of the Member States to move forward together with our political leaders in Brussels.

Ladies and gentlemen, one of my AEA Chairman predecessors, Leo van Wijk from KLM, launched a study entitled “Towards an Efficient Air Transport System”. It looked at the value chain of the airlines. The study analysed the structural inefficiencies of aviation and paved the way for what now we call the AEA Action Plan. This plan spells out what needs to be done in order to create a framework for a sustainable, profitable aviation industry. We are pleased to see that the AEA Action Plan has found its way into the minds and the hearts of the key European institutions. The review of the EU Commission’s White Paper, which was recently published, re-establishes the central role played by aviation. The Commission has identified the aviation value chain as needing regulatory attention. And, above all, the EU Commission has made it clear that it wants to deal with these issues in consultation with its stakeholders, which I think is very, very important. This is an approach that has been coined the “méthode à la Barrot”, and the media have called it a “u-turn in EU transportation policy”.

Ladies and gentlemen, I believe the market has matured, but it cannot yet reward the efficient ones and penalise the inefficient ones. So what has to happen? We must enjoy a coherent regulatory framework – to create a level playing field between the airline business models, between the airlines and their service

providers, between the airlines and other modes of transport. And last but not least, between European airlines and our global competitors.

And that is about to happen. The "méthode à la Barrot" is not just a promising signal. It is the beginning of a very sensible development. With open minded European regulators on the other side of the table, the industry can now present suggestions for a good sustainable framework.

And that is what I have attempted to promote during my AEA Chairmanship.

I have focused particularly on three issues. Number one, the relationship with airports, number two, the environmental debate and number three the EU's relations with countries beyond Europe.

Let me address these issues individually.

The airline-airport relationship is changing quite fundamentally. Individual airports have recognised that they are an integral part of a product. Flying starts on the ground. An airline offering a service from A via B to C needs efficient hub structures to remain competitive globally. The network airlines and the hub airports have become system partners.

The regulatory framework we are seeking should not reduce the profitability of airports. We want to make the airline-airport relationship more competitive and thereby sustainable in its

profitability. A means of achieving this development is by setting up Golden Rules for our relationship. Jointly, we have organised a top level meeting involving the airlines, the airports and the Commission to identify what can be done to improve the system and partner relationship. I am firmly convinced that we will shortly deliver to the Commission a concrete result of our suggestions.

A second item that I would like to highlight is environmental issues. We have focused upon this this year because we know that it is not only a political but also an economical issue of high relevance. It is widely acknowledged that the emissions generated by aircraft are not currently a major contributor to global warming. Yet we take it very seriously. If all European airlines would be grounded today, the global CO_2 emissions would be reduced by less than one percent, according to Eurostat figures. But we owe it to our passengers, to our environment, and to our society to maintain the highest standards possible and develop solutions so that aviation will remain a major catalyst for economic development without being a catalyst for global warming.

That is why the environment is one of the four pillars of the AEA Action Plan. And why we have developed an Emissions Containment Policy within AEA, which highlights the technological process and progress possible. These can enable the airlines to decouple growth from increased kerosene consumption.

All members of AEA are convinced that technological, infrastructural and operational measures will reduce the problem of CO_2 emissions further, much further than any other measure.

However, we also understand that economic incentives must be investigated as well, notably the potential of an aviation which is included in the emissions trading system.

As AEA Chairman I can confirm that we want to study this system very thoroughly. We, the airlines, have not yet agreed on a solution as to how aviation could be included into such a trading scheme. We want to understand the impact first. Nevertheless, we are absolutely convinced that by working together on those four pillars we will work on the issues of technology, infrastructure in the air and on the ground, and incentives to reduce emissions in the future. We all agree that including exclusively the European industry, which flies the most modern airplanes – and not Asian or American competitors, for instance – in the response to global warming – which is not called European warming, as you know – will cost Europe its ability to grow, to compete and to continually update its fleet. We need profitable airlines to be able to invest in new products. And it will cost Europe alone jobs, which aviation cannot outsource, a fact for which it will therefore be penalised. That is why we take this issue extremely seriously and why we have, as I mentioned before, highlighted it as our top agenda item for this year.

If we go to the third item, the European single sky, we just want to reiterate that the fragmentations and the bottlenecks which we now have in the air and on the ground are both burdening the global CO_2 output. That is why we must urgently ensure that we will be able to modify – and this has already been expressed politically some time ago– our air traffic control system in a way that makes it most

efficient. In this context, I would like to add something that is a position with a truly lateral concept: the open aviation area. This will not happen overnight but we need to keep a clear focus on it. The open aviation area means our customers get choices, our customers decide who will win. The good players should gain ground, the weaker ones will get a wake-up call and the bad ones must exit the game. The open aviation area could get us closer to fair competition.

We need not only free competition but also fair competition. The different aviation policies should converge over time so that all the players enjoy a level playing field whether they are European, American or from other continents. I personally believe that such an agreement would pave the way for an agreement on security standards too. This is to me a must. Both the US and the EU authorities have developed high levels of security, which should be mutually recognised instead of duplicating unnecessary measures which add nothing to the level of security but only to bureaucracy. I am pleased to hear that the negotiations are under way and are taken not only as a serious measure but also as a joint opportunity to get closer together. European external relations should go far beyond security; they must also be about creating an level playing field internationally and this is not only true for our partners in the United States but eventually for those all around the world – because I believe that this industry goes global. In a setting of global demand, we will not have local partners over the long term on the scale that we have today. What we want is to be able to create what we need for Europe. Europe needs to be sure that we

are the ones connecting to the world and not that we are connected by others to the world.

This leads me to areas like the Gulf countries. We are pleased and happy to see that economical areas are blossoming and growing up but what we must make ensure is again that we have a playing field which is somewhat even. Ladies and gentlemen, the new era of European aviation is highly competitive. The fundamental restructuring of our industry will continue. I very much hope that the structure will be in position on time because time matters. We are probably the best of the slowest ones at adapting to new requirements. We can learn from Asia, from the United States, and also from the Gulf region that time is of the essence – and that is why I would urge everybody in this room to contribute to this industry, which is of vital importance for our future.

I would like to remind you that Europe has always been the place of innovation, the place where the pioneers came from. We have the technology, the people and the mind set to grow and to export our ideas to the world. But we also have to remember that the demographics are not working in our favor. Switzerland, a nice country in the Alps, is half the size of Shanghai; Austria – my home country – is smaller that the city of Chengdu in terms of population. The growth rates that we see in these countries are enormous. That's why it is time to really get our act together. The time to make sure that we don't only have ideas that are exported and used by others but that, for our next generation, we have the foundation ready and the cornerstones laid to be profitable, to be safe, and to be secure. And that is why we need to share a common

vision for the European aviation landscape – be it in terms of airplanes, infrastructure in the air, ground operations, and the systems that support aviation.

Thank you for your attention.