Issue No: 113

Aviation Strategy

March 2007

The new EU-US Treaty and the Intercontinental airline consolidation battle

Two of the biggest issues in the industry, the new EU-US aviation Treaty and discussion of possible industry consolidation, are closely related. Both topics are a bit complex, and subject to both misconceptions and arguments designed to serve the agendas of interested parties. This article will review the issues and negotiations leading up to the preliminary Treaty agreement, and the industry merger/consolidation activity of recent months.

Part One: The five-year EU-US fight over "cross-border investment"

On March 2, EU and US negotiators announced agreement on a comprehensive EU-US bilateral treaty. The long negotiating process dates back to a 2002 European Court of Justice ruling invalidating historical aviation treaties that did not grant rights equally to all EU airlines. The judicially mandated need to establish new treaties allowed the US to press for its main aeropolitical objective, the extension of "open skies" to the UK and the other three EU countries that still had bilateral restrictions on entry, pricing, airport access and codesharing. The EU countered with demands to allow increased cross-border investment and management integration, including the ability of EU citizens to own and control US airlines. A five-year stalemate ensued with little progress on the US demand for increased access to Heathrow, or the EU demand for more increased foreign ownership of US airlines.

The US negotiating position was enhanced by having only one major objective: Chief US negotiator John Byerly described the 1977 US-UK "Bermuda II" bilateral as "one of the greatest crimes in aviation history". While there was some tension on the US side between the Heathrow "haves" (AA/UA) and "have nots" (CO/US/DL), conflict was limited since no one had an easily workable solution to Heathrow's capacity constraints. No US carrier had any interest in owning EU airlines, and none invested any effort fighting for greater opportunities for foreigners to invest in US airlines. EU negotiators had to deal with two divergent sets of interests. The UK carriers were focused on "Fortress Heathrow", which needed to be either protected, or traded for new benefits of similar magnitude. The French and Germans had no privileges or protections at risk, but wanted to strengthen Air France and Lufthansa as global airlines. The French and Germans saw their carriers playing a leading role in global alliances, and demanded closer integration with their US partners, which

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could eventually include direct shareholdings and management control.

The EU's solution was the 2003 Open Aviation Area (OAA) proposal, and its claim to "go beyond" open skies by permitting capital to flow freely anywhere in the US-EU "area" without regard to national borders. OAA encompassed both the British approach to cross-border investment (the freedom for Virgin to start a new domestic US airline, or for BA to acquire an existing one) and the French/German approach (cross-ownership and management integration between alliance partners).

The EU claimed OAA would be the catalyst to a major aeropolitical revolution, leading to the worldwide elimination of "national" barriers to airline efficiency, even though the EU was doing nothing to change the entrenched web of safety, legal and regulatory processes based on "national" airlines. The EU made a series of totally unbelievable claims about consumer benefits that would be unleashed by EU-US cross-ownership, for example that they would generate €15bn in incremental revenue (more than the combined totals of Northwest and Southwest) and 80,000 new jobs (more than the combined totals of Delta and Continental).

It is one thing to forecast lower fares due to the elimination of cartel-type pricing, or dramatic growth from major new entry or productivity breakthroughs, but the North Atlantic had enjoyed intense, open competition for 20 years, and it was ridiculous to argue that this particular market had huge efficiency/overpricing problems, and even more ridiculous to claim that cross-shareholdings or mergers would drive massive service expansions and fare cuts. Since the EU did little to create credibility or support for its approach within the US industry, critics dismissed OAA as a tactic to prevent serious negotiations over Heathrow.

A draft agreement was reached in November 2005, but the EU Council of Transport Ministers refused to ratify it after intense British lobbying, demanding further concessions on foreign ownership and management control of US airlines. Congressional action to permit the EU objective of 49% foreign ownership was politically impossible, and the DOT proposed new internal rules with more liberal guidelines for how it would interpret the statutory requirement of 75% "actual control" by US citizens. This proposal was actively opposed by the large US airline labour unions and politicians from both parties. No US carrier publicly supported the DOT approach; Continental aggressively attacked it and threatened legal challenge. The DOT, recognising that a proposal that had received almost no support under a Republican Congress was not going anywhere with the Democrats in control, withdrew the proposal last December. The Europeans sharply criticised the DOT, and claimed that "reform of American policy on control of airlines" was still the prerequisite to any future progress, and so many observers were surprised by the EU's recent agreement to a treaty within the traditional 75% ownership/control rules.

The March 2007 agreement suggests a major EU shift from the British to the French/German position. The British position meant stalemate, since there was no possibility of Congress changing the ownership and control laws, although stalemate also blocked the threat of new competition at Heathrow. Had the EU not been obligated to comply with the 2002 ECJ ruling that stalemate might have continued indefinitely. French and German interests are clearly concerned that if the British once again convince the Council of Ministers to reject the US Treaty, the ECJ will quickly invalidate the existing aviation treaties, and the US will retaliate by suspending antitrust immunity for the North Atlantic alliances. North Atlantic competition could function perfectly well without immunised alliances, but they are critical to Air France and Lufthansa's ambitions of a central role in global aviation.

Cross-border investment: Virgin in America

Virgin's application to start a domestic US airline quickly became central to the EU-US debates over cross-border investment. Supporters pointed to a consistent, logical pattern of Virgin-branded startups in different countries, and the economic illogic of blocking pro-competitive, pro-consumer investments on narrow grounds of shareholder nationality. Critics argued that while Virgin America may have made business sense five years ago, the window of opportunity for significant new US LCC market growth had passed, and it was not clear how Virgin America could make money in

Aviation Strategy
is published 10 times a year
by ***Aviation Economics***

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ISSN 1463-9254

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today's environment. These critics argued that the entire EU demand to own and control US airlines was simply a ruse to protect Heathrow. The Virgin America application gave the British demands credibility.

On 27 December 2006, the DOT rejected Virgin America's application for a US operating certificate. US law requires 75% of the voting interest in US airlines to be held and controlled by individual or financial entities deemed to be US citizens. The DOT found that 94% of Virgin America was held and controlled by non-US partnerships, and its show-cause order included a five-page flow chart tracking the ownership/citizenship breakdown of each investment group. Even if one believes that rules regarding cross-border airline ownership should be eliminated, there is little doubt that Virgin's original application did not meet the statutory requirements. Virgin submitted a revised ownership plan to the DOT on 17 January that weakened some of the foreign investors control and protections, but did not appear to create the reality of a 75% US-controlled entity.

All six Legacy carriers, led by Continental, and two major employee unions filed objections to Virgin's application. While United has advocated eliminating barriers to cross-border investments, it clearly wanted the old barriers to block Virgin's plan to compete with United in San Francisco. Continental was determined to fight any proposal that did not provide increased access to Heathrow slots. While the opposition of these carriers and unions may have been motivated by narrow self-interest, the DOT's decision was clearly based on the law and precedent, and there is no reason to believe that a proposal owned and controlled by US investors would have been rejected, even with Virgin brand licensing and Board participation.

Despite many complications, the Virgin America case illustrates the critical role of market entry to cross-border airline competition, and the ease with which traditional national ownership rules can be used to repel new entrants and any other threats to the status-quo industry structure.

Short-term impact of Treaty approval

The Treaty clearly establishes EU-wide Open Skies, the major US negotiating objective, although the eventual impact on the US-London market is far from clear. The short-term advantage would appear to be with BA and BMI who will have full flexibility to move flights within their current slot portfolio, while competitors will have no Heathrow access unless they purchase slots in a highly inflated market. Some incumbents may have been hoping that the increased demand might provide the ideal opportunity to realise a big windfall from slot sales, but expected prices may not be compatible with profitable flights to the US. Competitive forces will eventually sort things out, but it is likely to be a slow process.

The Treaty provides tangible movement towards the EU objectives of cross-border investment and tighter alliance integration. US law limiting foreign control to 25% would be partially overridden by Treaty terms specifying that shareholdings up to 49% would not be deemed "controlling" and shareholdings above 50% would be considered on a case-by-case basis. Antitrust immunity rights would be extended to all EU carriers, with new expedited procedures for ATI approval and coordination of all antitrust oversight. EU carriers would have unlimited access to US routes from almost any country with an Open Skies Treaty, including many non-EU countries. Codesharing rights would be virtually unlimited, wetleasing of EU aircraft will now be permitted, and franchising and joint branding programs would be not be subject to competitive review. The Treaty establishes a joint committee to arbitrate ownership and control issues, and the Europeans have been promised a specific timetable for moving to a "Second Stage" agreement on deeper cross-border investment rights.

The Treaty explicitly sanctions new grants of alliance antitrust immunity, although it is not clear whether AA-BA could expect immunity as soon as the Treaty takes effect, or whether it mibht be withheld pending actual developments at Heathrow. The two carriers have a huge share advantage over all other US-London carriers in an environment where (even under Open Skies) normal competitive forces will remain highly constrained.

The DOT appears to have delayed final review of Virgin's application pending the new US-EU Treaty, but one would expect a quick final decision soon thereafter. If approved, one would expect the DOT to expedite the application, and the Treaty would clearly allow the DOT to apply

much less stringent measures of foreign control.

If the new Treaty is approved it would take effect in October. Lufthansa and Air France have been actively campaigning for Treaty approval, while British interests have launched a campaign attacking it. Opposition could also come from US unions opposed to any relaxation of the 75% ownership rule.

Part Two: Update on airline consolidation activity

Despite fevered discussion throughout 2006 of an inevitable trend towards consolidation, there is no longer any serious merger activity underway in the US. The events leading to the collapse of USAirways' bid to acquire Delta at the end of January are described at length in the analysis beginning on page 10. AirTran's proposal to acquire Midwest Express has gone nowhere since October and is currently slated to expire on 11 April (see also, Briefing pages 16-21). The world's most rumoured merger is United-Continental, reflecting United's Chairman Glenn Tilton's aggressive campaign on behalf of "industry consolidation" and the relative compatibility of the two carriers' route networks. While the two carriers have held talks, there is no evidence they have ever gone beyond the informal discussions all Legacy carriers conduct periodically.

The urgent need in the US market is for further restructuring of hopelessly unprofitable capacity. Last year's strong profit improvement was almost entirely driven by unit revenue gains resulting from bankruptcy-related capacity cuts. However, the industry is still not at a point where it can earn profits over a full business cycle and more cuts are still needed.

Many of those quoted in the press as favouring "more consolidation", such as USAirways' CEO Doug Parker, and former Continental Chairman Gordon Bethune, are in fact advocating "more restructuring". Parker's bid to acquire Delta out of bankruptcy, like his earlier merger between America West and USAirways, were fundamentally restructuring exercises, not mergers.

The economics were entirely based on capacity and cost cuts that are only possible during a court administered bankruptcy process. There were some scale economies and network synergies, but these alone could not have justified the merger implementation costs and risks. Parker believed that Delta management's reorganisation plans were inadequate, and that a more aggressive plan would provide stronger returns for Delta's creditors as well as profit/growth opportunities for USAirways. No one has proposed a merger to take Northwest out of bankruptcy because Northwest's standalone plans have already included extremely aggressive cost and capacity restructuring.

Mergers that may be good for shareholders (and restructurings that may be good for creditors) may threaten employees, managers and politicians fearful of losing local service. The failure of DL/US illustrates that merger/restructuring implementation is very difficult and easily sabotaged; the employment/service guarantees (and big management buyouts) needed to keep everyone happy can easily wipe out the benefits that the shareholders were hoping to achieve. Those expecting a wave of merger activity have clearly underestimated the non-economic barriers protecting status quo arrangements.

AirTran's bid for Midwest Express reflects the unique situation of those two companies and has no broader implications for industry restructuring or consolidation. America's "LCC" sector has found profits squeezed on the one hand by oil prices and a shrinking cost advantage versus those network carriers that have aggressively restructured, and growth opportunities squeezed on the other hand by unprofitable capacity still operated by the network carriers that have been slow to restructure. AirTran has more aircraft (737-700s) being delivered in the short term than it can profitably deploy in its current network. In bidding to acquire Midwest Express, AirTran argued it could immediately use those aircraft to replace Midwest's older MD-80s, achieve cost savings by integrating the two carriers' 717 fleets (87 and 25 respectively), and also diversify and improve the two networks. Midwest's Board and management clearly wish to remain independent and claimed that AirTran's $345m offer "significantly undervalues" the airline. They have refused to either discuss the possibility of merger with AirTran, or to publicly explain why their shareholders will be better off by refusing AirTran's offer.

AirTran-Midwest is a classic example of a

"synergy/efficiency" merger, and in fact would be easier to implement than most. Mergers between larger airlines would face much greater obstacles, including incompatible IT systems, union jurisdictional conflicts, cross-border complications, or antitrust/political issues. The synergies and efficiencies are real, but much, much smaller than one would find in quasi-restructuring cases. As with DL-US, incumbent managers and employees have substantial ability to protect the status quo. If the economic benefits from mergers aren't high enough to justify huge takeover premiums and the payoffs to incumbents, then mergers won't happen very often. The argument that cost savings and network synergies could drive a major trend towards industry consolidation just doesn't hold water.

Continental has never indicated the slightest interest in acquiring United, and one presumes that it would take an enormous premium over their current $4bn market capitalisation to get Continental to take a United bid seriously. A merger would force both carriers to reopen their union and supplier agreements, and would face implementation risks exponentially greater than cases like AirTran-Midwest or USAirways-America West. Using traditional capital market criteria, United would need to (at a minimum) double the value of Continental's assets in order to justify the financial risk. The two route networks would mesh well, but linking them would not create $4bn in new corporate value. Continental, Delta and Northwest, who also have compatible networks, have explored a variety of merger scenarios over the past decade, but have never come up with an economic justification for moving forward.

No general trend towards consolidation

Despite the steady drumbeat of press coverage of industry consolidation, there has never been any justification for the claim that the world-wide aviation will inevitable move towards fewer, bigger airlines. A previous analysis (see Airline Consolidation: Myth and Reality, *Aviation Strategy*, November 2006) discussed the underlying economics and argued that while mergers make good sense under certain conditions (such as restructuring cases), they are inherently very risky, and have an extremely poor historical track record. The US merger boom of the late 1980s, was a dismal failure, and did nothing to improve the overall efficiency of the industry. There is no evidence that industry consolidation is under-way, and most sectors have been steadily expanding. There is no reason to expect any "natural" trend towards consolidation since aviation is not a mature industry with declining demand or stagnant technology.

Recent activity illustrates that the scale economies and network scope efficiencies used to justify most mergers are much too small to justify a general trend towards consolidation, and that there are still huge non-economic barriers to mergers and restructuring efforts that make a general trend even less probable. The importance of scale and scope has been steadily declining; most of the industry trends of recent years (simplified LCC business models, internet distribution, new IT technologies, improved supplier/outsourcing capabilities, alliances) have made it much easier for smaller airlines to compete profitably.

Qantas - betting $8bn on an aeropolitical revolution?

In December, Qantas' Board accepted an $8.7bn (A$11.1bn, €6.7bn) takeover offer from an investment group led by two Australian groups (Allco Equity Partners and Macquarie Bank), and two overseas groups (Texas Pacific (US-based) and Onex (Canadian). The offer represented a 33% premium over Qantas' previous share price, and will be financed by A$3.5bn from the equity partners, and A$10.6bn borrowed from a consortium of banks. The investor group said they fully supported Qantas' current strategy and management team and promised "business as usual". In contrast to the transaction-based wealth being amassed by the top executives at the bankrupt US carriers, CEO Geoff Dixon pledged all earnings from the new owners' management incentive scheme to local charities.

To meet national ownership rules (which in Australia allow a 49% foreign shareholding), the new owners were forced to establish a complex governance structure. Allco, which provided 35% of the equity, will get 46% of the voting shares, while US-based Texas Pacific will get only 15% of the voting shares despite contributing 25% of the financing. The foreign investment quickly

raised political hackles, even among "pro-business" conservatives. The government could have blocked the acquisition on "national interest" grounds and withheld approval until the new shareholder promised that headquarters and management/technical staff would remain on Australian soil.

Prior to the unexpected takeover bid, Qantas was valued at $5.5bn. If the new owners refloat or sell Qantas in three years they would need to realise roughly $15bn to justify the risk of their investment. Qantas is widely perceived to be well managed, thus it seems unlikely that huge profit improvements will come from asset, marketing or operating opportunities that current management had somehow missed. It would be dangerous to assume that Qantas' recent earnings growth (largely due to reduced/stabilised competition in its key US, UK and domestic markets) can be easily extrapolated into the future. In January Qantas announced that it would take a minority stake in Pacific Airlines, a small Vietnamese operator, but investments of this type are very risky, and are not likely to be the foundation of Qantas' growth strategy.

It is implausible that the new owners actually expect that a "business as usual" approach will produce strong returns on their $8.7bn. It appears that this is (at least in part) a wager on future consolidation among the large Intercon airlines, and the Texas Pacific/Onex investment would appear to be a perfect example of the cross-border capital movement that Glenn Tilton has been advocating. Under this theory, shareholders could enjoy a huge windfall if governments decide to change the rules restricting cross-border ownership and operations, especially if the airline (like Qantas) has a strong brand and network franchise. Opportunities might arise to either profitably acquire weaker franchises or to sell out to someone building a true global airline. But it is not clear why one would expect the required aeropolitical revolution to occur anytime soon, or to produce conditions favourable to Qantas. There is absolutely no public or political support for cross-border consolidation, and the knee-jerk political response to Qantas' new shareholdings illustrates how easy it is to mobilise a campaign against any threatening "foreign" deals.

Under the status-quo aeropolitical system, international airlines are blocked from certain types of cross-border investments, growth opportunities and mergers, but as highly visible "national champions" also benefit from many special advantages. Canberra has protected Qantas many times in the past, for example reneging on an open skies Treaty with New Zealand, thwarting Singapore Airlines efforts to invest in the domestic market or to serve the Australia-US route, and strictly limiting the capacity growth of Emirates and other new long-haul competitors. If one weakens or eliminates the "flag airline" concept, Australian politicians become much more receptive to the lower fares that SQ/EK-type competition would bring, and these points were raised by local politicians in response to the Texas Pacific/Onex foreign investment. If Qantas invests in airlines competing with the flag airlines in Singapore and Vietnam, it is difficult to block foreigners from doing the same in Australia, and in early February, Tiger Airways (49% owned by SIA) announced its desire to obtain an Australian operating licence in order to challenge the Qantas-Virgin Blue domestic duopoly. If Qantas pursues "global airline" mergers, landing rights in countries like Japan and India are put at risk, and Australia's leverage over carriers like Emirates is lost.

The Qantas/United approach appears based on hope that governments will grant their shareholders new freedom to pursue advantageous cross-border transactions while fully maintaining all of the entry barriers and special advantages that "national champions" have always enjoyed. Such a shift in government policy could create an enormous windfall for current shareholders, since capital markets would quickly appreciate the value of mergers between highly protected companies. But if these aeropolitical shifts do not occur, Qantas' new owners will need to return to the question of how to triple the value of the company within a "business as usual" environment.

Part Three: Intercon merger and consolidation politics

Intercon competition realities

The competitive dynamics of the Intercon and "non-Intercon" sectors are totally different and it would be dangerous to consider Intercon

competition by the same standards as most domestic and regional airlines. Most short-/medium haul, narrowbody airline markets around the world are highly liberal and enjoy healthy competition, even though many operations cross national borders. Safety and economic regulation only involves dealing with local governments or a limited set of bilaterals with neighbouring countries. In a simple, familiar environment, governments are more comfortable letting "market forces" dictate airline competition. Carriers can react more quickly to demand and competitive changes.

Intercon airlines do not operate in a liberal environment; airlines viewed as "national champions" get special protections, badly run airlines are subsidised, and there are huge barriers to new entry. There are many countries that have liberalised market entry and competition in domestic/regional markets while maintaining rigid restrictions on longhaul competition (Malaysia and India for example). Even though some markets (the North Atlantic) are liberal, Intercon airlines cannot invest or organise across borders without jeopardising access to the many markets (India, Japan) that are not. In this highly multilateral environment, governments remain fearful that other governments will distort airline competition to favour their carriers, so all of them maintain close control over market entry and route rights.

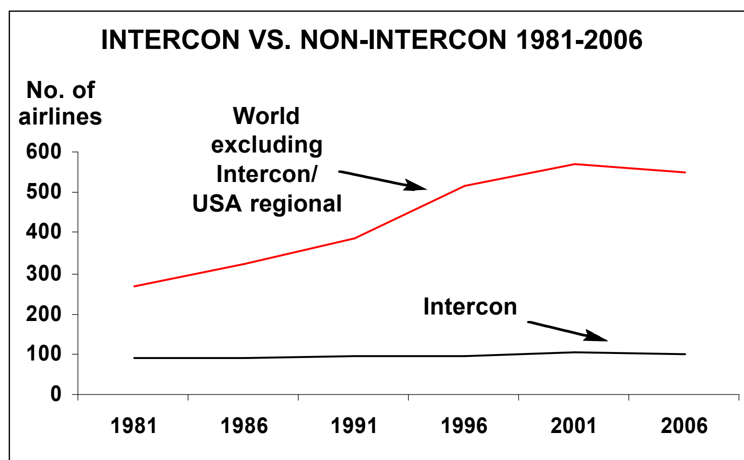
As the graph below demonstrates, the highly competitive non-Intercon sector has demonstrated dynamic growth over the past 25 years, while entry/exit barriers have left the Intercon sector totally stagnant. Non-Intercon growth results from a steady "dynamic churn" of airlines; half of the nearly 1200 carriers in this sector exited the market after merger or failure, allowing stronger carriers to grow and new carriers to enter. In a dynamic environment like this mergers have nothing to do with "consolidation", and in fact are key to driving growth. Intercon market entry has been extremely rare in the past, and remains extraordinarily difficult. Market exit is only small fraction of the non-Intercon rate, and virtually nonexistent outside America and northern Europe.

Efficient airline competition requires four conditions to hold:

• Large enough markets to support a reasonable set of competitors (each large enough to achieve efficient operating scale)
• Efficient capital market process that will reward profitable airlines and punish weak ones (shifting capital to where it can earn the highest returns)
• No artificial barriers to market entry and exit
• Full marketing freedoms (pricing, scheduling, product, branding)

No airline markets are perfect, but most non-Intercon markets fulfill all four conditions to some degree. Intercon markets are highly deficient; some markets are large, and pricing freedom generally exists, but there are huge barriers to entry, exit, and the efficient allocation of capital.

The markets with the best market conditions are obviously the US and the EU, with very liberal conditions in markets large enough to support substantial competition, and efficient capital market processes. When markets support multiple competitors, governments can focus on the interests of consumers and market efficiencies, when there is a dominant national carrier, governments are highly susceptible to lobbying to distort competition on its behalf. The worst competitive conditions are the Intercon market, and very small/developing country markets, too small to support competitive airlines at an efficient scale. It is perfectly fair to argue that the aeropolitical system of "national airlines" creates inefficiently small airlines in certain parts of the world, but it is silly to argue that because of this system Lufthansa and United are inefficient and uncompetitive. Cross-border barriers to capital may create serious distortions and inefficiencies in Peru or



Vietnam or Jordan, but there is no evidence of serious distortions in America or Europe.

The drive for oligopoly on the North Atlantic

The North Atlantic, one of the world's biggest Intercon markets is really two markets-Continental Europe (72% of the total traffic) and the UK/Ireland (28%, dominated by the huge London market). Continental European O&Ds are served by hubs on both sides of the Atlantic (including London), but the European carriers and hubs do not compete for London/Dublin traffic. The divergent US Treaty objectives of the British and French/Germans reflected this market split. Only one-third of the continental market is in O&Ds with nonstop service, while three-quarters of the UK/Ireland demand is in nonstop markets. It is impossible to compete without hubs and alliances on the continent, while the UK/Ireland markets are much more vulnerable under "open" market conditions.

The original alliances of the 90s (KL-NW, DL-SR-SN and UA-LH) created tangible consumer benefits within a highly competitive environment. Successful carriers (CO, KL) entered and expanded at the expense of weaker carriers (TW, SN), and the overall market was strongly profitable. But the EU shifted course, first allowing Lufthansa to eliminate competition with airlines from most neighboring countries (SK, OS, LO, LX, TP, TK), and then allowing Air France to acquire KLM, dramatically reducing longhaul competition. The Air France-KLM merger reduced the number of viable Continental alliance competitors from three to two, and the overall set of major competitors from five to four (counting Continental and BA connections via London). It also forced merger discussions between US carriers, since either Delta or Northwest will eventually lose the alliance capability they had since the early 90s.

Having facilitated a doubling of North Atlantic concentration between 1999 and 2006, the EU has spent the last two years fighting to make it possible for Lufthansa and Air France to exert much tighter control and (perhaps eventually) own their US partners. Lufthansa and United have virtually unlimited freedom to work together on schedules and pricing today; the only purpose of "increased antitrust immunity" and cross-shareholdings would be to eliminate any remaining tendencies to compete independently. The Treaty also appears to pave the way for antitrust immunity between BA and AA, which would give them overwhelming dominance over the next largest competitors in the US-Heathrow and the overall US-UK market.

The 2009 table column (see table, right) assumes events widely discussed in the context of "industry consolidation"-a United-Continental merger, an immunised AA-BA alliance, and that Iberia and Alitalia cease to function as independent competitors (through merger or joining an alliance). While different scenarios are possible, it is easy to see how the Continental Europe market could quickly become a 90% two-carrier oligopoly and the US-UK market could be dominated by one alliance with a 60+% share. A United-Continental merger makes no sense if one looks at scale economies or network synergies within the USA, but makes perfect sense in the context of a plan to give Star the dominant position within this 90% oligopoly. There is no way to explain Air France paying a 40% premium for KLM under the market conditions of 2004, especially given barriers to staff reductions, fleet simplification and overhead reduction. But if one views the purchase as elimination of competition and a decisive move towards this permanent oligopoly, then Air France made a wise purchase.

No single policy/aeropolitical change (transatlantic antitrust immunity, intra-European alliances, the AF/KL merger, increased EU-US cross-ownership, etc) was decisive in the shift from competition to oligopoly, but the combined effect of all of these changes has been overwhelming. The move from 20-30% concentration to 40-50%, or even 60% concentration posed few risks to consumers, and some of this was the inevitable winnowing of marginal competitors. Each isolated move was defended on the grounds that there were still many forces in the market that could constrain any anti-competitive behaviour. But one by one, each of those forces have been eliminated.

The shift from 30-50% concentration to 80-90% concentration can be regarded as strictly the result of government intervention at the behest of large airlines (merger approvals, the EU-US Treaty negotiations) and not the result of "market forces". It should also be emphasised that this governmentally engineered move

towards oligopoly did not occur in a struggling, declining market, but in an already strongly profitable market experiencing robust demand growth. It occurred in a market where there has been no meaningful market entry in decades, and where barriers to new competition (including airport capacity constraints) keep getting stronger.

Intercon consolidation and antitrust policy

A profitable market that has always had major entry barriers and competitive constraints cannot become highly concentrated unless antitrust rules are waived or manipulated. Major inconsistencies between the EU's treatment of the Air France-KLM and Ryanair-Aer Lingus cases appear linked to the EU's active support for Intercon consolidation.

In October, Ryanair put forward an all-cash €1.5bn ($2bn) offer to acquire Aer Lingus. Ryanair has generated the strongest returns of any European airline over the last decade, and argued that it could significantly increase returns on Aer Lingus' assets. This would be a challenging merger, given the widely divergent business models and corporate cultures, and press reports suggested that Ryanair was nowhere close to getting sufficient shares tendered to complete the acquisition. But on 21 December Ryanair was forced to withdraw the offer when the European Commission said it would need five months to determine whether the acquisition would create an irremediable violation of antitrust law. The issue here is whether antitrust law required government intervention to block the normal workings of the capital markets, and why such a review should require five months.

64% of all European airline revenue is longhaul while only 36% is for travel within Europe, or to North Africa or the Middle East. Half of this enormous long haul market is destined for smaller European airports (Tokyo-Lyon, Johannesburg-Hamburg) which cannot be served except via a European connecting hub, and where competition is strictly limited to European airlines. Most foreign airlines are not independent competitors due to restrictive bilaterals and revenue sharing alliances.

The view of the European Commission appears to be that this segment (32% of the entire European market) can be fully served by three dominant European companies, with no possibility of other competition, while another 32% of the market (traffic destined to the large hub gateway cities) can be fully served by these same three companies supplemented by open, independent competition in a few isolated cases. When Air France acquired KLM, shrinking the number of large competitors from four to three, the European Commission focused almost exclusively on the trivial number of overlapping nonstop O&Ds. This ignored both the magnitude of the longhaul connecting business, and the very concept of airlines as a network business. The Commission required less than a month to determine that an Air France-KLM merger created no serious antitrust problems, even though there is absolutely no possibility that new Intercon market entry could correct anti-competitive behavior in the future.

NORTH ATLANTIC MARKET CONCENTRATION

Market Concentration	1989	1999	2006	2009 (?)
No. of airlines with >1% share	27	20	10	6
Top two airlines' share				
Total North Atlantic	20%	24%	57%	72%
Continental Europe (72% of total N. Atlantic)		30%	65%	87%

The Irish markets served by Ryanair and Aer Lingus account for less than 1% of total European airline revenue. There are no bilateral-type entry barriers, there is a huge set of active competitors, and there is no service overlap between FR and EI at any slot constrained airport. While protections for future entry at Dublin would be appropriate, the combined FR-EI share at Dublin is no greater than Air France's share at CDG.

There is no defensible antitrust standard that would wave through KLM-Air France but raise serious red flags about Ryanair-Aer Lingus. Nor does it seem consistent that EU policy permits mergers to create a dominant national carrier in France, Britain, Italy, Spain, Sweden, Belgium and Holland, but object to the same thing in Ireland. The European Commission may discover simple remedies for whatever Irish market issues its exhaustive review may identify, but the incoherency of its overall approach raises the troubling prospect of one set of antitrust rules for "national champions" and a completely different set of rules for everybody else.

Intercon oligopoly would be impossible under

Aer Lingus-type antitrust standards. The Air France-KLM merger might have won approval, but only under conditions protecting overall levels of longhaul competition, such as reduced sanction for alliance price and schedule collusion. The EU's airpolitical negotiations are clearly serving to facilitate high levels of Intercon consolidation; antitrust administration appears to serving that policy objective as well.

The risks of Intercon consolidation

Advocates of Intercon consolidation quoted in the press have attempted to portray their efforts as a minor adjunct to a general worldwide trend towards consolidation, a trend that isn't occurring. This conflation of the economics of a handful of the largest Intercon carriers with the hundreds of non-Intercon airlines creates a variety of false impressions:

• Consolidation may be a natural trend that many industries go though (there are "too many airlines" so no problem if United merges with Continental or Lufthansa),
• Consolidation will force needed restructuring (even though mergers do nothing to fix bankrupt carriers like Alitalia or Northwest),
• Consolidation is being driven by powerful synergies or efficiencies (arguing that United or Lufthansa lack efficient scale presupposes that the ideal airline was the Aerflot of the 1980s)
• Consolidation doesn't threaten consumers because there is plenty of competition (everywhere except Intercon markets which have never had market entry/exit, and remain hugely distorted by government interference and other barriers)

Intercon consolidation advocates have falsely claimed they their objective is to do away with the 60-year old system of "national airlines". Airlines, it is argued, should be free to organise themselves anyway they want, just like any other consumer product company. Headquarters could move to Singapore, maintenance could move to China. Whatever the academic merits of such an argument, all safety, financial, consumer and workplace regulation of airlines is based on the traditional "national airline" system, these systems are highly entrenched; nobody is actually doing anything to create new regulatory schemes to replace them, and it would be a huge undertaking even if the political will existed (which it doesn't). The EU has had major problems aligning safety regulations within the EU.

The Open Aviation Area as originally proposed would have done nothing to change the traditional aeropolitical system, and the new Treaty merely replaces Dutch and Belgian nationalities with an "EU community" nationality under the traditional system, just as Norway, Denmark and Sweden established a joint nationality in the late 1940s. The major benefits of true "trans-national" airline deregulation would be in small countries, with inefficiently small airlines and markets and many illiberal restrictions, yet 100% of the recent discussion has focused on the US and the EU.

The Intercon consolidation movement does not reduce government interference with airline competition, and actually depends on maintaining it. Excessive Intercon concentration creates short-term market distortions and the risk of underming longer-term innovation.

The collapse of the Delta - USAirways merger

USAirways' proposal to merge with Delta collapsed on 31 January, when Delta's Creditors Committee formally refused to consider any reorganisation proposal other than management's 19 December standalone plan. In refusing to fully consider USAirways' offer, Delta's creditors walked away from their rights under the US bankruptcy laws to leverage the competition between competing bidders to get the highest possible overall compensation.

The USAirways' plan had the advantage of 10% deeper cuts in capacity than Delta's standalone plan; such capacity cuts have been the primary driver the industry's improved unit revenue performance. USAirways also hoped to force an additional round of Chapter 11 cost cuts (as they had prior to last years' USAirways-America West merger), and achieve significant

merger cost and network optimisation synergies. Since launching the hostile bid for Delta on 15 November, USAirways emphasised that the opportunity for additional chapter 11 restructuring and financing improvements was the key to the deal, and that the scale effects and cost synergies normally associated with "industry consolidation" were secondary factors. USAirways claimed that over half of its estimated savings potential (and thus the entire rationale for the merger) would disappear once Delta emerged from bankruptcy protection.

Merging carriers as large as Delta and USAirways (the third and seventh largest US carriers) would have been a daunting, risky undertaking, especially given the turmoil of recent years, and the still incomplete US-HP integration. Both have serious service issues (US is rated eighth out of the ten major carriers under the DOT's service quality rankings, while DL is ranked tenth) and there are major differences in management style and corporate culture.

USAirways' initially offered $8.7bn for Delta, and then increased that offer to $10 bn on 11 January, with roughly half to be paid in cash, and half in USAirways stock. Delta claimed its standalone plan would achieve a higher value, between $9.4 and $12bn, but creditors will get no cash under this plan, and Delta's valuation appears highly dubious. It is not clear why a troubled, bankrupt carrier, without any major changes to its network strategy or competitive positioning, should suddenly become worth more than Southwest Airlines, or worth more than American and Continental combined. A quarter of the value Delta imputed was based on extrapolating recent airline stock price increases (50% appreciation between August and December). USAirways' plan assumed RASM improvements linked to its capacity cuts, but Delta's valuation assumed normal supply/demand rules would not apply, and claimed RASM gains larger than USAirways had projected, even though they intend to expand capacity 3% per annum.

The battle between the USAirways and Delta plans was complicated by widely divergent interests among creditors. Current employees and aircraft and trade suppliers want more operations, even when that compromises profits and equity value. Laid off and retired employees, bondholders, and the US taxpayers (who were left with Delta's cancelled pension obligations) are totally dependent on cash payments and the value of newly issued stock. The Delta plan was clearly tailored towards the interests of the first group, the USAirways plan towards the latter. While there was no doubt that Delta's current employees would not initially welcome a plan with less flying, USAirways hoped that careful scrutiny of the two plans would focus attention on flaws in Delta's plan, and that a majority of creditors would support a plan with substantial up-front cash payments over a plan totally dependent on extremely optimistic estimates of fare increases and future stock prices.

Delta management and unions ally

USAirways' bid was killed by an alliance between Delta management and its pilots union, who cleverly engineered an aggressive PR program built around the claims that a DL-US merger would be horribly anti-competitive, and then used the fear of an extensive antitrust review to railroad through a plan highly favourable to the current employees and trade creditors, without the review/negotiation process that USAirways and the bondholders had hoped for. Delta management, led by CEO Gerald Grinstein, COO Jim Whitehurst and CFO Ed Bastian appeared to view the bidding in personal terms-would they be the people to save Delta, or did the job need to get turned over to Doug Parker of USAirways because they had failed? Although the 74 year old Grinstein had long ago announced plans to step down once Delta was out of bankruptcy, Delta management stood to capture hundreds of millions of dollars worth of stock in the new company, thus had ample incentive to do everything possible to thwart Parker's bid. The pilots unions is the best organised of all creditors, thus it is not surprising that management's plan was aligned with their interests, with capacity growth, and less dramatic cuts elsewhere. The major trade creditors (Boeing and Pratt & Whitney were on Delta's Creditor Committee) have every incentive to support whatever management proposes, and no incentive to fight with the people who might be placing future aircraft orders in order to get a better deal for retirees, bondholders or taxpayers.

To get the creditors to walk away from their rights to scrutinise both plans carefully and conduct a competition between bidders, Delta management needed to convince them that actual implementation of a USAirways merger was wildly improbable, and thus management's standalone plan was the only realistic option. The creditors' decision, according to press reports, was totally driven by superficial PR claims that cannot survive serious scrutiny. Delta's PR campaign reached fruition at a 24 January Senate Commerce Committee hearing where Grinstein and Parker testified about USAirways' merger proposal. Grinstein first presented arguments that a DL-US would cause irreparable damage to consumers and competition and could not withstand antitrust scrutiny. Grinstein relied on a methodology developed when the Legacy carriers carried over 95% of US airline passengers and his overall arguments were inconsistent with the stated positions of the Department of Transportation, and the basic antitrust policies of the Bush Administration.

One cannot accept Delta's argument that DL-US clearly violates the antitrust laws without also immediately accepting that all of the potential between Legacy carriers being discussed would be equally illegal. Other Legacy mergers (such as Delta-Northwest or United-Continental) would involve larger carriers, with more network overlap, and more international routes that have much greater barriers to new competitive entry. To avoid undercutting his "mergers would be bad for consumers" arguments, Grinstein testified that Delta had never explored merger options with Northwest, although later press reports confirmed that such discussions had, in fact, taken place. Grinstein then argued that DL-US would immediately trigger mergers between United, American, Northwest and Continental, leaving DL-US as the weakest player in a highly consolidated industry. While not totally implausible, this claim ignores that the USAirways bid depends totally on chapter 11 restructuring opportunities that would not be available to any future merger, and ignores the fact that three of the four airlines (all but United) have stated that they see no financial basis for pursuing mergers.

The only basis for Grinstein's claim was the drumbeat of newspaper articles claiming "industry consolidation is inevitable", although the only "merger are inevitable" claimants quoted in these articles were the United Airlines press office and investment bankers salivating over possible deal fees. Congress has no role in merger reviews, and the Commerce Committee was not considering any aviation legislation, but Grinstein then used the subsequent press coverage, which featured several Senator's aggressive support of the Delta employees opposed to merger, to convince creditors that USAirways' "highly anticompetitive" plan would never be implemented.

Delta's bondholders and fired/retired employee creditors abandoned efforts to create a bidding war between plans on 31 January, a week after the Senate hearings, and only two days after Delta first assembled a financing plan for its standalone plan. To gain final acceptance, Delta agreed to let the Creditors Committee appoint the members of the new Delta Board of Directors, and limited management's stock award to 4% of the company (instead of the 8% given to United management, cutting their likely windfall to the $300-400m range). According to the *Wall Street Journal*, "the committee plans to install people who embrace consolidation as a strategic option and made clear to Delta in recent days that this was a condition of gaining its approval for the airline's standalone plan". Having railroaded the creditors with claims that a USAirways merger could never be implemented, Grinstein locked-in control of Delta by promising those same creditors that they could pursue a bigger, even more problematic merger.

It is quite possible that Delta's creditors would have selected a standalone plan, even after a process of careful review and negotiations. But it is difficult to believe that the events of January produced the best result for Delta or their creditors. Delta plans to emerge from chapter 11 in April, only four months after the (very sketchy) first draft of a reorganisation plan was first prepared, and creditors no longer have any leverage to demand improvements. Delta management will owe their control of the company and their multimillion dollar stock awards to the strong support provided by the pilots union, which could quickly create complicate company decision-making. The final verdict on Delta's plan should be clear by mid-2008 when it will apparent whether Delta is achieving their aggressive unit revenue forecast, and whether the value of Delta's new stock justified the decision to walk away from the USAirways offer.

US LCCs: new market realities, new strategies

In recent months LCCs in the US have announced or hinted at a host of new strategy initiatives. Florida-based LCC Spirit is going to start charging for all checked baggage and onboard beverages Ryanair-style while slashing fares by up to 40%. Low-cost pioneer Southwest, which has been very conservative with revenue management in the past, is also considering charging extra fees. AirTran and Frontier have formed a unique ticket-booking and FFP partnership, while JetBlue has agreed in principle on such a tie-up with Aer Lingus and is in negotiations with other international carriers.

These are all examples of how US LCCs are focusing on revenue generation, or trying out new revenue strategies, as their cost advantage over the legacy carriers erodes and competitive pressures mount. The interesting question is: To what extent will the business models change?

For the second year running, US LCCs no longer stood out from the crowd in terms of profitability in 2006. Although Southwest was still in the lead with a 10.7% operating margin, most other airlines were in the 2-5% range. JetBlue and US Airways, with margins of 5.4% and 5.1%, performed slightly better than AMR and Continental (4.7% and 3.8%), but AirTran only achieved a 2.2% margin and Frontier a negative 0.6%.

LCC-legacy unit cost differentials, while still significant, have lessened as a result of the network carriers' successful cost cutting and the Chapter 11 restructurings. Since LCCs are lean organisations, they have not been able to match the cost cuts. AirTran may be the only exception, in that the growing mix of the larger 737-700s in its fleet, which until 2004 included only 717s, has facilitated a strong and steady decline in ex-fuel unit costs (see AirTran briefing, page 16).

As a result, LCCs have been hit hard by the past two years' hike in fuel prices. They now have to deal with a reinvigorated legacy sector. And they did not get a chance to acquire needed additional slots, gates and assets this year, because the legacy M&A process never got started.

Add to that a host of potential negatives in 2007 - a slowing domestic economy, tougher unit revenue comparisons and a less favourable domestic capacity environment - and it is not a surprise that the LCCs have suddenly focused on revenue-generation and are ready to experiment with new strategies. That said, even the LCCs continue to find modest additional cost savings. It typically involves squeezing a little extra productivity from the workforce; for example, Southwest has continued to see a decline in employees per aircraft.

This year's revenue-boosting efforts seem focused on two areas: expanding through alliances and growing new types of ancillary revenues. In addition, JetBlue is looking at new ways to retain the highest-yield traffic, such as providing a "first class" section on aircraft.

Alliances: There appear to be two motives behind the LCCs' alliance-building: to "de-regionalise" operations (a term used by Frontier), as in the case of Frontier and AirTran, or to leverage a strong hub position to maximise revenues, as in the case of JetBlue.

AirTran and Frontier broke new ground in November 2006 by launching a referral and FFP partnership - the first of its kind between LCCs in the US. Instead of codesharing, the airlines "refer" passengers to each other via their websites and call centres, and passengers can earn and redeem frequent-flyer miles on either carrier.

The deal links AirTran's strong East Coast network with Frontier's western US network, giving each airline access to regions where they are weak. It enables the airlines to diversify away from unusually competitive hub situations - AirTran shares its Atlanta hub with Delta and Frontier its Denver hub with United and Southwest. Frontier is one of the worst-performing US LCCs (and on the "sell" lists of many analysts, though its liquidity position remains adequate) because of its nightmarish competitive and revenue environment, with three carriers all adding significant capacity at Denver.

Frontier said recently that the AirTran alliance had met expectations and could boost its revenues by $5-6m annually. But the airline is obviously working on a number of fronts - it has set up

a new feeder subsidiary (Lynx Aviation), forged new RJ feeder contracts with regional partners and expanded to Mexico and Canada. It is also open to additional LCC alliances.

JetBlue, by contrast, is in a strong position at its JFK hub, where it accounts for over 50% of the domestic traffic. It has ample room to grow there after its new terminal opens in late 2008. The airline wants to leverage that strength to unlock new revenue sources, such as international codeshares, and has been talking to potential partners since at least mid-2006.

The first of those deals is likely to be with Aer Lingus. It was reported in February that JetBlue and Ireland's second largest carrier had "agreed in principle" to a ticket-booking alliance, to be implemented this summer. The deal would link the carriers' websites, enabling customers to book seats between Ireland and 51 US destinations in one go, but it would not include codesharing. Aer Lingus, which has left the OneWorld alliance as it pursues a low-cost strategy, operates daily flights to JFK from Dublin and Shannon and to Boston from Dublin.

Some have questioned the wisdom of sending loyal customers to an airline that comes nowhere near to matching JetBlue's service quality. But JetBlue is expected to forge similar deals with a number of international carriers, and perhaps it will find more equal partners in the larger markets, such as Virgin Atlantic on the UK-US routes (if Virgin America does not start operations). Separately, JetBlue announced a marketing partnership with Cape Air to improve feed to its Boston focus city.

In the past, LCCs shunned alliances because the idea was contrary to the low-cost model in that it tended to increase complexity, but technological developments have changed things. Southwest made that point when launching its pioneering codeshares with ATA two years ago (the motive there was to obtain gates at Chicago Midway).

The common theme for the latest LCC alliances is that they are all low-complexity, low-cost undertakings, relying on new technology. JetBlue has described the concept as "interline lite" - something that can be accomplished without significant alterations to the business model.

Ancillary revenues: Southwest pioneered the low-cost, no-frills formula for LCCs everywhere but over the years the model has evolved in different directions on the opposite sides of the Atlantic. In the US, LCCs have added frills and included services such as checked baggage, snacks and drinks, entertainment systems and advance seat assignments in the air ticket price, with the emphasis being on providing value (good service at a fair price). In Europe and elsewhere, LCCs have retained the original no-frills concept, started offering ultra-low fares and introduced extra fees for services such as checked baggage.

However, in recent years US LCCs have developed ancillary activities such as frequent-flyer programmes, co-branded credit cards and vacation packages. JetBlue, for example, has profitable partnerships with American Express, DirecTV, XM Radio and Dunkin' Donuts, as well as JetBlue Getaways. In contrast, not even large European LCCs such as Ryanair have FFPs.

These regional differences were highlighted by IdeaWorks, a Wisconsin-based brand and marketing consulting company, in an October 2006 analysis of airline ancillary revenues. Although the analysis showed that the non-US a la carte strategies produced more ancillary revenue per passenger than the US LCCs' relatively young FFPs (see chart, above), IdeaWorks felt that FFPs offered greater revenue potential, in addition to making consumers more loyal to a brand. The conclusion was that "exceptional financial results are likely to be realised by those airlines that master the magic of combining the best features of the European and US models".

The Ryanair-style "unbundling" strategy is not entirely new in the US. Allegiant Air, a Las Vegas-based niche carrier, has used the strategy very successfully for several years in leisure markets linking small cities with popular tourist destinations. The model has worked because it has been important to be able to market the lowest possible fares and because there is little direct competition (see Allegiant briefing, *Aviation Strategy* Jan/Feb 2007).

Spirit, which has hubs at Detroit and Ft. Lauderdale and serves 33 cities domestically and in Latin America and the Caribbean, is now taking a major leap towards becoming the second Ryanair-style LCC in the US. In June, the carrier will start charging $5 each for the first two checked bags (or $10 each if not booked via the website), $100 for the third bag and $1 for beverages. Currently, the first checked bag and

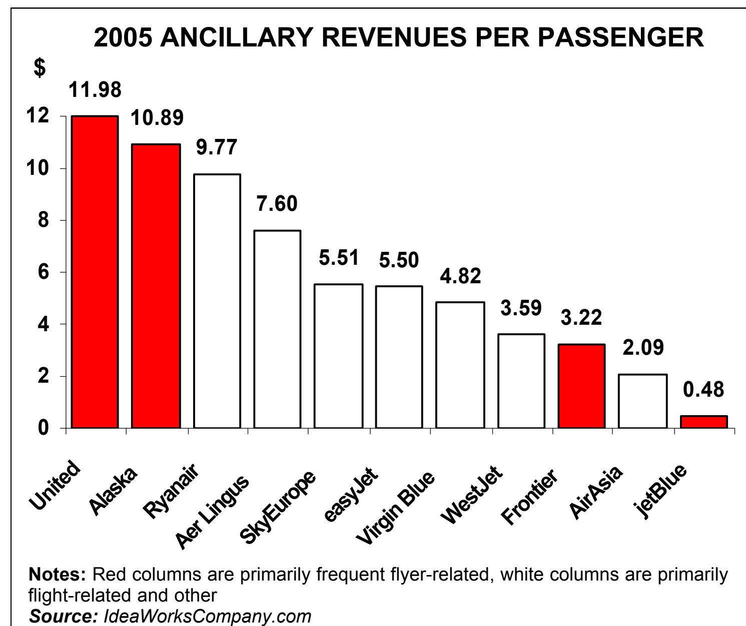
beverages are free. Spirit is also cutting fares by 10% to 40% and experimenting with Ryanair-style "one-cent, plus fees and taxes" fares in some markets in March-May. Spirit also plans to eliminate first class service but will continue to sell what will be known as "Big Front Seats" at premium prices.

That may well be a good strategy for Spirit because, like Allegiant, it is very leisure-oriented. It may lose higher-yield passengers domestically but could gain traffic in Latin America and the Caribbean, where much of its growth focuses.

But why is Southwest suddenly considering charging extra fees? The main reason is that, as a result of its weakening fuel hedges, Southwest has what one analyst called a "$300m-plus fuel hurdle" that must be overcome in 2007, for the company to have any chance of reaching its 15% earnings growth target again this year. The domestic economy may be slowing, so the airline feels that it would be "foolish to get addicted to fare increases" and that it might be best to find other ways to increase revenues.

CEO Gary Kelly also explained recently that now that it carries more domestic passengers than any other airline, Southwest is looking to leverage that strength and "could get more aggressive with revenue management, such as charging extra fees". The airline has always had extremely conservative revenue management. It has low walk-up everyday fares, no change fees, minimal codesharing, minimal ancillary revenues and modest cargo revenues. Its fare increases have always been gradual and modest. Consequently, the airline feels that there a many potential revenue opportunities.

However, Southwest is only considering a few options and is thinking about it strategically - what could be brought online this year, what in 2008 and what in 2009, while retaining a high-quality product and position as the dominant LCC. The airline noted that there are improvements in technological capability in the pipeline that will give it more flexibility to pursue new options.



Notes: Red columns are primarily frequent flyer-related, white columns are primarily flight-related and other
Source: *IdeaWorksCompany.com*

Product upgrades: JetBlue, which over the past year has put much effort into improving yield management but also expects to cut costs by $120m in 2007, has found an interesting way to woo the highest-paying customers without making anything worse for other passengers or incurring extra expenses. The airline has removed a row of seats from its A320s, reducing the seating from 156 to 150, which enables it to operate the aircraft with two (rather than three) flight attendants. This will save about $30m annually, but the loss of ticket revenue from those seats will be greater. But after the reconfiguration seats in the first 11 rows (44% of total seats) will have an industry-leading 36-inch pitch, while the remaining seats will have at least 34-inch pitch. JetBlue plans to reserve some of those front seats for last-minute or first-class type customers that would not normally fly the airline and will be "rolling out some exciting programmes" that are expected to boost revenues.

By Heini Nuutinen

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AirTran: High-quality LCC with big ambitions

AirTran Airways, which is now leading the way in alliance-building and possible consolidation among US LCCs with its recent marketing deal with Frontier and ongoing hostile takeover bid for Midwest Air Group, is one of the best-performing US carriers. It has an eight-year profit record, an innovative business model and extremely low unit costs - its stage length-adjusted non-fuel CASM has now crept below Southwest's, even though it offers a business class on all flights. But AirTran needs to diversify away from the competitive East Coast markets and reduce reliance on the Atlanta hub, which it shares with the soon-to-be revitalised Delta.

The proposed merger would be an ideal solution to the strategic challenges faced by both airlines. There would be unique network and fleet synergies and no regulatory concerns. The deal probably represents Midwest's best chance because this higher-cost, up-market airline, having miraculously avoided LCCs in the past, is extremely vulnerable to future competitive incursions into its Milwaukee hub. Most in the industry believe that this deal will ultimately get done. What are AirTran's plans for the combined carrier? And could Frontier also play a role?

AirTran is fortunate in that it was in great shape when the industry crisis began in 2001. It had just staged an impressive financial turnaround in 1999-2000, following three years of heavy losses as it rebuilt operations and restructured itself after predecessor ValuJet's 1996 crash and three-month grounding. The company had retained a low cost culture despite becoming a more up-market and conventional type of operation. It had also raised its unit revenues by 52% between 1997 and 2000, introduced the 717 to its fleet in 1999, obtained lease financing on highly favourable terms for the first three years' deliveries and completed a major debt refinancing in early 2001. With all of those issues resolved, AirTran was ready to start growing (see *Aviation Strategy*, March 2001).

As a result, AirTran went against the industry trend by accelerating growth and fleet renewal in the wake of the post-September 2001 crisis. ASM growth was stepped up from 7% in 2000 and 12% in 2001 to 26% in 2002, and growth remained in the 20-30% range in each of the past four years. Last year's capacity growth was 23.7%, making AirTran probably the fastest-growing of the US non-regional carriers.

The main benefit has been significant cost savings from fleet renewal. AirTran's ex-fuel unit costs have declined by 14% in the past five years. Also, the strategy enabled AirTran to quickly take advantage of the old US Airways' downsizing, while continuing to successfully fend off Delta at Atlanta.

AirTran has tripled its annual revenues in the past six years, from $624m in 2000 to $1.9bn in 2006. It has transformed itself from a struggling LCC into the tenth largest US carrier, only slightly smaller than JetBlue. Although AirTran did not achieve the spectacular high-teens operating margins posted by JetBlue and Southwest before fuel prices started rising a couple of years ago, it has posted operating and pre-tax profits for eight consecutive years - a feat accomplished by only two US non-regional carriers (the other is Southwest). AirTran's operating margins declined from 11-13% in 1999-2000 to the 4-9% range in 2001-2003 and, because of fuel, further to the 2-3% level in the past three years. For 2006 the airline reported operating and net profits of $42.1m and $15.5m respectively, representing 2.2% and 0.8% of revenues.

AirTran's profits in the past two years have suffered also due to industry capacity addition on the East Coast, its own rapid expansion and a decline in short-haul demand in the aftermath of the August

2006 London terrorist scare. The airline was the industry's worst unit-revenue performer in the fourth quarter of 2006, seeing its PRASM fall by 7.1%, which contrasted with the industry (ATA) domestic PRASM gain of 5.5%. Also, AirTran saw its 4Q operating profit halve to $2.5m and it reported a $3.3m net loss for the latest period, compared to breakeven a year earlier.

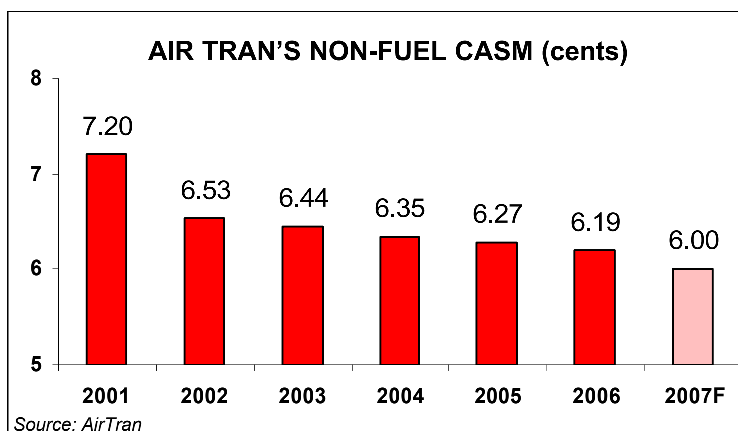
The fourth quarter loss was incurred despite impressive unit cost performance. AirTran's CASM was down by 5.6%, helped by a 7.7% reduction in fuel prices (the average stage length was flat). Ex-fuel CASM fell by 4.1% to 5.94 cents - a record low for the airline.

AirTran's quarterly results have fluctuated considerably in the past two years as a result of Delta's erratic behaviour before and during its bankruptcy. The airline is vulnerable to Delta's actions because 66% of its capacity is in the Atlanta markets. After filing for Chapter 11 in September 2005, Delta initially cut back sharply, reducing its seats in AirTran's Atlanta markets from 80,000 in May 2005 to less than 60,000 by January 2006. But in September Delta began adding back capacity, increasing the seats to 70,000 by November. Although the latest developments are again positive - Delta is removing about 12% of the November capacity this spring - it all basically underlines AirTran's need to diversify its route network.

Attaining cost leadership

AirTran's ex-fuel unit costs have declined for five consecutive years - from 7.20 cents per ASM in 2001 to 6.19 cents in 2006 - and a further 3% reduction, to about six cents, is anticipated in 2007. This trend is driven by the increasing mix of the larger 737s in the fleet, as well as continued improvement in overall efficiency and reductions in distribution costs.

Even though AirTran is primarily a hub-and-spoke carrier, it has always operated the Atlanta hub using the more efficient free-flow system that the legacy carriers have been switching to in recent years.



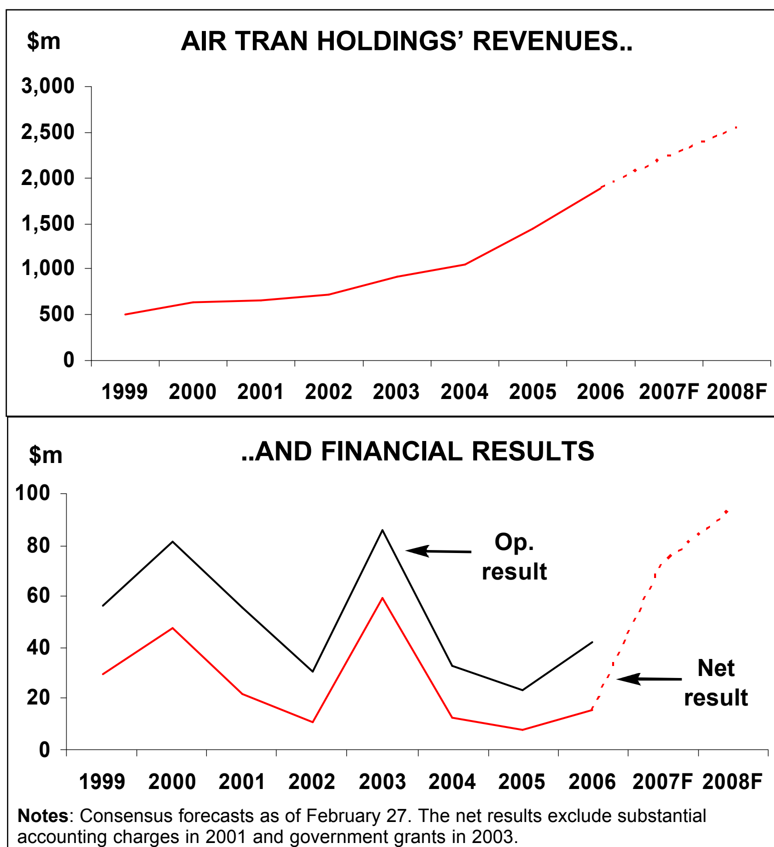
Source: AirTran

This explains why it has relatively high average aircraft utilisation for a short haul carrier (11 hours daily in 2006). Notably, AirTran has industry-leading employee efficiency; its 60.4 FTEs (full-time equivalent employees) per aircraft in the fourth quarter was slightly below Southwest's and significantly below JetBlue's.

AirTran is now the lowest-cost carrier in the US on a non-fuel, stage length-adjusted basis, having overtaken Southwest in 2006. On a total CASM basis (including fuel costs), AirTran estimates that its stage length-adjusted unit costs were 11% higher than Southwest's in 2006 but that the differential will reduce to 3% in 2007 as Southwest's fuel costs continue to rise due to its weakening hedges.

But what matters more is how the unit costs compare with Delta's. AirTran claims that its cost advantage over Delta has widened from what it was five years ago, despite Delta's Chapter 11 restructuring. In AirTran's estimates, its stage length-adjusted non-fuel CASM in the second quarter of 2006 was 39% below Delta's, compared to a 30% differential five years earlier.

AirTran has always stressed that the key to coping with Delta is keeping costs low. Explaining the management philosophy at a recent conference, president/COO Bob Fornaro noted that "it's really the only way we can manage the business". From time to time, Delta will add capacity and AirTran's margin declines. Then Delta will take out capacity and AirTran's margin improves. "But they cannot impact on our costs."



Notes: Consensus forecasts as of February 27. The net results exclude substantial accounting charges in 2001 and government grants in 2003.

Successful product strategy

Aside from the RASM and yield challenges resulting from capacity addition, AirTran has a highly successful product and revenue strategy. The airline caters for all passenger segments, but its model is more specifically designed to meet the needs of business travellers than the Southwest and JetBlue models are. It offers "key attributes of major airlines at affordable prices". This includes a separate business class cabin, featuring two-by-two oversized seating and more legroom, for $40-$80 extra per segment; assigned seating, XM satellite radio (AirTran was its launch customer in 2004) and a range a booking channels (including travel agencies).

In contrast with JetBlue, which realised only last year that it needed to use sophisticated yield management, AirTran has always had such systems in place to maximise revenues. It offers a simple fare structure, with prices varying according to how early bookings are made (fourteen, seven or three days in advance, or walk-up). The airline participates in all the major GDSs.

These strategies have been instrumental in pulling in business traffic. AirTran has an enhanced quality image and has consistently ranked high in customer satisfaction surveys. However, like the other US LCCs, AirTran now faces more efficient and aggressive legacy carriers and needs to make extra efforts to improve revenue generation.

One of the hottest new trends among US LCCs is growing ancillary revenues - something that even Southwest is now focusing on. AirTran's "other" revenues surged by 50% to $73m last year. However, AirTran has not mentioned any new ancillary revenue initiatives; rather, all of its current efforts seem focused on developing new geographic sources of revenue - meaning route expansion, alliances and mergers.

Fleet and route expansion

AirTran's fleet development has had two distinct phases. First, the airline replaced its original DC-9 fleet with the 717-200s in 1999-2003. The last DC-9s were retired in January 2004. Following an order for ten additional 717s in 2003, the final two 717s were delivered in 2006 - the year when Boeing stopped 717 production. The type is ideally suited to AirTran's typical short-haul operations (its average stage length was 652 miles at year-end).

Second, AirTran added a second aircraft type, the 737-700, to its fleet in 2004, after placing an order for up to 100 737-700/800s in 2003. The type has facilitated growth, as well as longer-haul operations, including flights from Atlanta and other points in the East to the West Coast. The airline noted recently that the 737 offers opportunity to expand also to Canada, Mexico, Central America and the Caribbean, "should we choose to do so".

Both the 717 and the 737 fleets have been obtained at bargain prices. The initial

717 order was originally ValuJet's $1bn 50-aircraft order for the MD-95 in 1995, benefiting from launch customer pricing. The 737-700/800 order, in turn, was perfectly timed in the wake of the post-2001 industry crisis, securing massive discounts because no other US airline was ordering aircraft.

AirTran now has one of the youngest fleets in the industry, with an average age of about three years. The fleet included 127 aircraft at year-end - 40 737s and 87 717s - plus 60 737s on firm order for delivery in 2007-2011. In September the airline pushed back some deliveries to 2009-2011 and since then has also agreed to sell two 737s due this April (to a non-US airline), in order to reduce near-term capacity growth. After receiving 22 new aircraft in 2006, AirTran is taking ten 737s this year, followed by 15 in 2008. This year's ASM growth is expected to be 19% - still much faster than the growth rates planned by other US LCCs - though the 12% increase currently envisaged for 2008 is more conservative.

Since 2000 AirTran's network has evolved basically in three ways. First, there are now coast-to-coast flights and generally more east-west flying. Second, non-Atlanta flying has increased from 10% in 2001 to 34% in January 2007. Third, with several years of rapid growth, the airline has significantly strengthened the East Coast network by adding destinations, developing focus cities, connecting the dots and boosting frequencies.

Therefore, despite the obvious weaknesses (Atlanta's dominance and the huge blank spaces in the western half of the country), AirTran has gained competitive market mass. As many as 16 of its cities (compared to only two five years ago) have service to at least five destinations; the top five are Atlanta (52 destinations), Orlando (24), Baltimore/Washington (13), Tampa (11) and Chicago (10). Furthermore, even though AirTran lacks the power typically wielded by a dominant operator at a hub, its Atlanta operation, with 215 daily departures in January, is among the nation's largest mainline hub operations, similar in size to Southwest's Las Vegas, US Airways' Charlotte and Continental's Newark hubs.

AirTran typically aims to add 4-5 new cities per year, plus numerous new connections between existing cities. Last year saw two new destinations - Seattle (Washington) and White Plains (New York) - and over 20 new non-stop routes. As of March 1, the airline had launched or announced six new cities in the first half of 2007, including Newburgh (New York), Phoenix (Arizona), St. Louis (Missouri) and Charleston (South Carolina), as well as seasonal service to Daytona Beach (Florida) and San Diego (California), and 20-plus new non-stop routes. Many of the new services will be operated from Atlanta, using new gates acquired last summer, but the airline has also announced expansion from Baltimore and Orlando.

The new east-west services to Seattle, Phoenix and San Diego make much sense strategically and will help reduce seasonality. Newburgh may sound like a less obvious choice, particularly since JetBlue also started Florida service from there in January, but the airport, just 55 miles north of New York City, is poised to become another major gateway to the metropolitan region and is even building an international passenger terminal. AirTran believes that it is well positioned to compete with JetBlue there because its costs are lower, because it also serves the business-oriented Atlanta market from Newburgh and because it has a better schedule.

Alliance and merger plans

AirTran announced a marketing alliance with Frontier, a Denver-based LCC, in mid-November. This "online and call centre" referral and FFP partnership is the first of its kind between US LCCs. It means that both airlines include an integrated route map and a full list of destinations on their web sites and refer customers to each other. Customers can earn and redeem frequent-flyer miles on either carrier.

The alliance, which AirTran describes as "low-complexity" (a concept that is particularly important to LCCs), is significant in

that it links AirTran's East Coast network with Frontier's western US network, doubling the destinations available to customers and providing a platform for possible codeshares in the future. It could work well because Frontier's situation is broadly similar to AirTran's - a hub-and-spoke LCC having to share its DIA hub with United - though Frontier faces much worse challenges, because it is smaller than AirTran, with a much weaker network, and because Southwest has been building service out of DIA since January 2006.

Subsequently, in mid-December AirTran went public with an unsolicited $290m offer to acquire Midwest Air Group, the parent of Midwest Airlines and regional carrier Skyway Airlines, in a cash and stock transaction. This was not a new idea; AirTran had evaluated Midwest for almost two years, and Midwest had turned down its first offer in the summer of 2005.

Since the rejection of the mid-December offer, AirTran has taken its case directly to the Midwest shareholders by launching a tender offer for the company, increased the price by 18% (valuing the offer at $345m) and extended the tender offer deadline twice (currently April 11). AirTran has also nominated three directors for election to the Midwest board at the company's annual shareholders' meeting this spring. Midwest has continued to urge its shareholders not to tender their shares and is trying to pitch its own standalone strategic plan.

While the outcome is obviously uncertain, and the existence of Midwest's poison pill poses a potential hurdle, many analysts believe that AirTran will ultimately succeed. This is because AirTran is an extremely determined bidder - in the 4Q earnings call, the management stated that the intention was to "do whatever it takes to complete the transaction" - and because the alternative scenario for Midwest is to face LCC competition from AirTran, Southwest and others in its key markets possibly even in the near-term. The Justice Department closed its mandatory review of the merger proposal without challenging it in February.

The merger is potentially attractive because the two have complementary route networks, strong fleet commonality (the largest and second-largest 717 operators), comparable corporate cultures and commitments to quality service. AirTran would be able to upgrade Midwest's MD-80s with its new 737s, resulting in CASM reductions. The airline anticipates $60m in annual synergies from the merger, arising from improved fleet and capacity utilisation, MD-80 replacement and increased efficiency in maintenance and other areas.

The merger would create a new nationwide LCC, especially if Frontier is included as a marketing partner. It would have about $3bn in combined revenues in 2007 (AirTran's estimated $2.3bn plus Midwest's $700m), making it about the same size as JetBlue but only about 30% of Southwest's size and a quarter of US Airways' size.

AirTran's growth plan for the combination would be to, first, expand Midwest's Milwaukee hub; second, develop Kansas City into a focus city; and third, continue to expand from Atlanta. AirTran regards Milwaukee as an underserved market; other US cities with similar populations, such as Charlotte and Cincinnati, have at least two or three times the daily flights and seats. This obviously makes Milwaukee a very attractive target for future LCC expansion. In a late-February presentation to Milwaukee community leaders and Midwest shareholders, AirTran promised that it would double seat capacity, add 29 new destinations and boost daily departures by 50% (to 215) at Milwaukee by the summer of 2009. The new long-haul destinations from Milwaukee would include Seattle, Vancouver, San Francisco, San Jose, San Diego, San Antonio, Houston, New Orleans, Cancun (Mexico), San Juan (Puerto Rico), Montreal (Canada) and several Florida cities.

Importantly, the merger would result in instant diversification, making the network much better balanced than what either airline has today. AirTran currently has 66% of its capacity at Atlanta, while Midwest is even more highly concentrated at Milwaukee (83%). Combining the companies would reduce Atlanta's share to 46% and Milwaukee's to 24%, while Kansas City,

Orlando and Baltimore would be focus cities, with 7%, 7% and 5% shares, respectively.

There is understandably sadness and concern in Milwaukee and among Midwest customers about the potential loss of the luxurious product and service provided by Midwest, known as "the best care in the air", which includes wide leather seats with footrests and baked-onboard chocolate chip cookies. In its standalone plan, Midwest states that it would continue to provide a "truly differentiated travel experience at a time when other airlines have commoditised flying". AirTran has responded that the Midwest product is not consistent throughout its network because of its RJs and that there is more nostalgia than reality to the carrier's image. However, AirTran would retain key amenities such as baked-onboard cookies and sees prospects for an enhanced product that would combine the best of each airline's service.

Midwest's standalone plan envisages 10% annual ASM growth in the next three years, addition of two MD-80s and numerous 30-seat and 50-seat RJs and improving profitability (the airline reported a small profit for 2006, its first since 2000). Critics have made the point that RJs are not well-suited to low-cost competition. AirTran has argued that that plan is "heavily dependent on a benign competitive environment, maintaining significant fare premiums and favourable fuel costs".

In AirTran's estimates, the merger would be accretive to earnings at the end of the first full year and "significantly accretive" thereafter. The cash portion of the purchase price would be funded by a new five-year secured credit facility. According to S&P, the acquisition would increase AirTran's lease-adjusted debt by 25% (primarily through the addition of Midwest's substantial operating lease commitments), but because of the $60m annual synergies, there would be no material impact on credit ratios.

Financial outlook

Delta's planned capacity cuts this spring and AirTran's continued CASM reductions mean that AirTran's financial outlook is highly favourable. The current consensus forecast is a profit before special items of 79 cents per share in 2007 (compared to 14 cents last year), to be followed by a profit of $1.04 in 2008. These estimates do not include any impact from the possible Midwest merger.

There is nothing on the horizon that could reverse the favourable CASM trend. AirTran is unionised but benefits from generally good labour relations. However, it should be noted that the pilots are currently in mediation over a contract that became amendable in 2005.

Competing capacity is the "key wildcard in any earnings scenario for AirTran", as Raymond James analysts put it in a recent report. Delta's emergence from bankruptcy, expected this spring or summer, should at least initially be good news for AirTran, because Delta will have to focus on profitability and behave responsibly. In the longer-term, however, there is the risk that a stronger Delta could resume aggressive capacity addition in AirTran's markets.

AirTran's balance sheet is much weaker than Southwest's and somewhat weaker than JetBlue's. The company is highly leveraged due to substantial operating lease commitments; the adjusted debt-to-capital ratio is around 90%. Debt and capital lease obligations surged to $811.1m at the end of 2006, from $472.6m a year earlier, due to 737 acquisitions. However, AirTran's liquidity position is satisfactory; cash amounted to $335m at year-end, representing 18% of 2006 revenues.

Contractual obligations are running at around $1bn annually over the next three years, around half of which are aircraft purchase commitments. But funding the orders should not be a problem. AirTran has secured debt financing for all of this year's and five of next year's 737 deliveries. After leasing virtually all of its 717 fleet from Boeing Capital, the company has bought almost half of its 737s. Total assets have increased from $473m in 2002 to $1.6bn at the end of last year.

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		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group emp.
Alaska	Jul-Sep 05	689	609	80	82	11.6%	11.9%	9,369	7,399	79.0%	4,632	8,961
	Year 2005	**2,975**	**2,983**	**-8**	**-6**	**-0.3%**	**-0.2%**	**35,875**	**27,221**	**75.9%**	**16,759**	**9,065**
	Jan-Mar 06	735	861	126	-80	17.1%	-10.9%	8,914	6,566	73.7%	3,905	8,988
	Apr-Jun 06	710	639	71	49	10.0%	6.9%	9,389	7,440	79.2%	4,443	9,347
	Jul-Sep 06	760	789	-29	-20	-3.8%	-2.6%	9,895	7,842	79.3%	4,710	9,467
American	Apr-Jun 05	5,309	5,080	229	58	4.3%	1.1%	72,447	57,605	79.5%		88,500
	Jul-Sep 05	5,485	5,446	39	-153	0.7%	-2.8%	73,405	59,584	81.2%		88,500
	Year 2005	**20,657**	**21,008**	**-351**	**-892**	**-1.7%**	**-4.3%**	**283,417**	**222,685**	**78.6%**	**98,040**	**87,200**
	Jan-Mar 06	5,344	5,229	115	-92	2.2%	-1.7%	68,801	53,131	77.2%	23,642	86,600
	Apr-Jun 06	5,975	5,499	476	291	8.0%	4.9%	71,774	59,314	82.6%	25,879	86,500
	Jul-Sep 06	5,830	5,610	220	1	3.8%	0.0%	71,641	58,526	81.7%	24,977	86,400
	Oct-Dec 06	5,397	5,212	185	17	3.4%	0.3%	67,813	53,430	78.8%		85,200
America West	**Year 2005**	**3,254**	**3,374**	**-120**	**-195**	**-3.7%**	**-6.0%**	**49,088**	**39,042**	**79.5%**	**22,130**	**12,100**
	Jan-Mar 06	859	776	83	58	9.7%	6.8%	13,463	10,472	77.8%	6,730	12,828
	Apr-Jun 06	981	920	61	68	6.2%	6.9%	14,144	11,589	81.9%	7,377	12,766
	Jul-Sep 06	922	1,028	-106	-100	-11.5%	-10.8%	12,177	9,722	79.8%	5,463	12,365
Continental	Apr-Jun 05	2,857	2,738	119	100	4.2%	3.5%	36,138	29,041	80.4%	11,465	
	Jul-Sep 05	3,001	2,892	109	61	3.6%	2.0%	37,450	31,185	81.7%	11,642	
	Year 2005	**11,208**	**11,247**	**-39**	**-68**	**-0.3%**	**-0.6%**	**163,537**	**129,064**	**78.9%**	**61,015**	**42,200**
	Jan-Mar 06	2,947	2,936	11	-66	0.4%	-2.2%	37,070	28,996	78.2%	11,486	42,600
	Apr-Jun 06	3,507	3,263	244	198	7.0%	5.6%	45,477	37,605	82.7%	17,596	43,450
	Jul-Sep 06	3,518	3,326	192	237	5.5%	6.7%	47,091	38,691	82.2%	17,328	41,500
	Oct-Dec 06	3,157	3,137	20	-26	0.6%	-0.8%	43,903	35,036	79.8%	16,603	
Delta	Apr-Jun 05	4,185	4,314	-120	-382	-2.9%	-9.1%	65,136	50,957	78.2%	31,582	65,300
	Jul-Sep 05	4,216	4,456	-240	-1,130	-5.7%	-26.8%	66,054	52,323	79.2%	30,870	58,000
	Year 2005	**16,191**	**18,192**	**-2,001**	**-3,818**	**-12.4%**	**-23.6%**	**252,327**	**193,042**	**76.5%**	**118,853**	
	Jan-Mar 06	3,719	4,204	-485	-2,069	-13.0%	-55.6%	55,685	42,460	76.3%	25,531	53,735
	Apr-Jun 06	4,655	4,286	369	-2,205	7.9%	-47.4%	60,699	48,364	79.7%	27,221	51,700
	Jul-Sep 06	4,659	4,491	168	52	3.6%	1.1%	63,797	51,150	80.2%	27,556	51,000
Northwest	Apr-Jun 05	3,195	3,375	-180	-217	-5.6%	-6.8%	38,256	32,218	84.2%	15,145	38,348
	Jul-Sep 05	3,378	3,545	-167	-469	-4.9%	-13.9%	38,881	32,889	84.6%	14,984	33,755
	Year 2005	**12,286**	**13,205**	**-919**	**-2,533**	**-7.5%**	**-20.6%**	**147,694**	**122,017**	**82.6%**	**56,470**	**32,460**
	Jan-Mar 06	2,890	2,905	-15	-1,104	-0.5%	-38.2%	35,757	29,432	82.3%	15,700	31,318
	Apr-Jun 06	3,291	2,996	295	-285	9.0%	-8.7%	37,743	32,593	86.4%	14,300	31,267
	Jul-Sep 06	3,407	3,041	366	-1,179	10.7%	-34.6%	38,741	33,024	85.2%	17,600	32,760
Southwest	Apr-Jun 05	1,944	1,667	277	159	14.2%	8.2%	34,341	24,912	72.5%	20,098	31,366
	Jul-Sep 05	1,989	1,716	273	227	13.7%	11.4%	35,170	26,336	74.9%	20,638	31,382
	Year 2005	**7,584**	**6,764**	**820**	**548**	**10.8%**	**7.2%**	**137,069**	**96,917**	**70.7%**	**77,693**	**31,729**
	Jan-Mar 06	2,019	1,921	98	61	4.9%	3.0%	35,532	24,591	69.2%	19,199	31,396
	Apr-Jun 06	2,449	2,047	402	333	16.4%	13.6%	36,827	28,716	78.0%	21,999	31,734
	Jul-Sep 06	2,342	2,081	261	48	11.1%	2.0%	38,276	28,592	74.7%	21,559	32,144
	Oct-Dec 06	2,276	2,102	174	57	7.6%	2.5%	38,486	27,036	70.2%	21,057	32,664
United	Apr-Jun 05	4,423	4,375	48	-1,430	1.1%	-32.3%	56,538	47,156	83.4%	17,150	55,600
	Jul-Sep 05	4,655	4,490	165	-1,172	3.5%	-25.2%	58,123	48,771	83.9%	17,448	54,600
	Year 2005	**17,379**	**17,598**	**-219**	**-21,176**	**-1.3%**	**-121.8%**	**225,785**	**183,898**	**81.4%**	**67,000**	
	Jan-Mar 06***	4,465	4,636	-171	22,628	-3.8%	506.8%	61,511	48,739	79.2%	16,267	53,600
	Apr-Jun 06	5,113	4,853	260	119	5.1%	2.3%	64,499	54,541	84.6%	18,228	53,500
	Jul-Sep 06	5,176	4,841	335	190	6.5%	3.7%	66,377	55,165	83.1%	18,099	
	Oct-Dec 06	4,586	4,563	23	-61	0.5%	-1.3%	63,226	50,324	79.6%	16,704	51,700
US Airways	**Year 2005****	**7,212**	**7,425**	**-213**	**160**	**-3.0%**	**2.2%**	**82,908**	**62,594**	**75.5%**	**39,977**	**21,486**
	Jan-Mar 06	2,648	2,523	125	65	4.7%	2.5%	17,748	13,350	75.2%	13,591	19,255
	Apr-Jun 06	3,191	2,849	342	305	10.7%	9.6%	19,396	15,944	82.2%	9,626	19,222
	Jul-Sep 06	2,968	2,952	16	-78	0.5%	-2.6%	20,255	15,943	78.7%	8,962	19,180
US Airways Group	**Year 2006**	**11,557**	**10,999**	**558**	**304**	**4.8%**	**2.6%**	**123,889**	**97,667**	**78.8%**	**57,345**	**32,459**
JetBlue	Apr-Jun 05	430	390	39	12	9.1%	2.8%	9,408	8,247	87.7%	3,695	7,284
	Jul-Sep 05	453	439	14	3	3.1%	0.7%	10,190	8,825	86.6%	3,782	7,452
	Year 2005	**1,701**	**1,653**	**48**	**-20**	**2.8%**	**-1.2%**	**38,145**	**32,508**	**85.2%**	**14,729**	**8,326**
	Jan-Mar 06	490	515	-25	-32	-5.1%	-6.5%	10,584	8,909	84.2%	4,335	9,039
	Apr-Jun 06	612	565	47	14	7.7%	2.3%	11,590	9,533	82.2%	4,525	9,377
	Jul-Sep 06	628	587	41	-0.5	6.5%	-0.1%	12,129	9,756	80.4%	4,773	9,223
	Oct-Dec 06	633	569	64	17	10.1%	2.7%	11,712	9,331	79.7%	4,932	9,265

** = Predecessor company, 9 months to 30/09/05; Successor company, 3 months to 31/12/05

*** = Including reorganisation items - net loss of $311m without

Note: Annual figures may not add up to sum of interim results due to adjustments and consolidation. 1 ASM = 1.6093 ASK. All US airline Financial Year Ends are 31/12.

		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
Air France/	Oct-Dec 04	6,628	5,745	883	83	13.3%	1.3%	54,144	42,042	77.6%	15,934	
KLM Group	**Year 2004/05**	**24,641**	**21,744**	**641**	**453**	**2.6%**	**1.8%**	**214,606**	**168,998**	**78.7%**	**64,075**	**102,077**
YE 31/03	Apr-Jun 05	6,257	5,982	275	135	4.4%	2.2%	57,936	46,041	79.5%	17,948	101,886
	Jul-Sep 05	6,790	6,154	636	864	9.4%	12.7%	60,472	50,961	84.2%	18,705	
	Oct-Dec 05	6,430	6,205	225	91	3.5%	1.4%	58,266	46,644	80.0%	17,120	102,291
	Year 2005/06	**25,901**	**24,771**	**1,136**	**1108**	**4.4%**	**4.3%**	**234,669**	**189,253**	**80.6%**	**70,020**	**102,422**
	Apr-Jun 06	7,282	6,766	516	306	7.1%	4.2%	60,839	49,596	81.5%	19,049	
	Jul-Sep 06	7,779	7,058	721	475	9.3%	6.1%	63,616	53,611	84.2%	19,600	
BA	**Year 2004/05**	**14,681**	**13,666**	**1,015**	**472**	**6.9%**	**3.2%**	**144,189**	**107,892**	**74.8%**	**35,717**	**46,065**
YE 31/03	Apr-Jun 05	3,716	3,398	318	162	8.6%	4.4%	36,706	27,768	75.6%	9,177	46,079
	Jul-Sep 05	3,887	3,427	460	301	11.8%	7.7%	37,452	29,812	79.6%	9,767	46,144
	Oct-Dec 05	3,664	3,362	301	212	8.2%	5.8%	37,119	27,499	74.1%	8,530	45,624
	Jan-Mar 06	3,692	3,530	162	144	4.4%	3.9%	36,657	26,780	73.1%	8,160	45,171
	Year 2005/06	**14,813**	**13,588**	**1,227**	**812**	**8.3%**	**5.5%**	**147,934**	**111,859**	**75.6%**	**35,634**	**47,012**
	Apr-Jun 06	4,208	3,825	383	280	9.1%	6.7%	38,222	29,909	78.3%	9,569	45,100
	Jul-Sep 06	4,331	4,080	251	315	5.8%	7.3%	38,727	30,872	79.7%	9,935	45,058
	Oct-Dec 06	4,051	3,798	253	210	6.2%	5.2%	36,563	27,073	74.0%	7,878	42,197
Iberia	**Year 2004**	**5,895**	**5,663**	**232**	**230**	**3.9%**	**3.9%**	**61,058**	**45,924**	**75.2%**	**26,692**	**24,993**
YE 31/12	Jan-Mar 05	1,531	1,571	-40	-21	-2.6%	-1.4%	15,261	11,421	74.8%	6,181	24,044
	Apr-Jun 05	1,466	1,392	74	54	5.0%	3.7%	15,843	11,939	75.4%	7,242	24,435
	Jul-Sep 05	1,439	1,368	71	53	4.9%	3.7%	16,659	13,619	81.8%	7,656	25,069
	Oct-Dec 05	1,451	1,504	-53	-7	-3.7%	-0.5%	15,864	12,082	76.2%	6,596	23,845
	Year 2005	**5,808**	**5,712**	**96**	**608**	**1.7%**	**10.5%**	**63,628**	**49,060**	**77.1%**	**27,675**	**24,160**
	Jan-Mar 06	1,457	1,536	-79	-54	-5.4%	-3.7%	15,689	11,876	75.7%	6,300	23,772
	Apr-Jun 06	1,816	1,753	63	44	3.5%	2.4%	16,809	13,420	79.8%	7,461	24,109
	Jul-Sep 06	1,825	1,700	125	96	6.8%	5.3%	16,846	14,065	83.5%	7,354	22,721
	Oct-Dec 06	1,811	1,750	61	-12	3.4%	-0.7%	16,458	13,132	79.8%	6,682	
Lufthansa	Jul-Sep 04	5,511	5,164	347	154	6.3%	2.8%	38,115	28,883	75.8%	14,053	
YE 31/12	**Year 2004**	**25,655**	**24,285**	**1370**	**551**	**5.3%**	**2.1%**	**140,648**	**104,064**	**74.0%**	**50,300**	**34,700**
	Jan-Mar 05	5,041	5,079	-38	-150	-0.8%	-3.0%	32,477	23,793	73.3%	11,190	
	Apr-Jun 05	5,487	5,138	349	140	6.4%	2.6%	37,700	28,178	74.7%	13,583	
	Jul-Sep 05	5,798	5,411	387	501	6.7%	8.6%	38,967	30,466	78.2%	14,203	
	Year 2005	**21,397**	**20,545**	**852**	**725**	**4.0%**	**3.4%**	**144,182**	**108,185**	**75.0%**	**51,260**	**37,042**
	Jan-Mar 06	5,369	5,460	-91	-118	-1.7%	-2.2%	33,494	24,044	71.8%	11,442	
	Apr-Jun 06	6,529	6,203	326	142	5.0%	2.2%	37,797	28,603	75.7%	14,106	
	Jul-Sep 06	6,765	6,188	577	461	8.5%	6.8%	39,225	30,627	78.1%	14,781	
SAS	**Year 2004**	**8,830**	**8,967**	**-137**	**-283**	**-1.6%**	**-3.2%**	**43,077**	**28,576**	**64.0%**	**32,354**	**32,481**
YE 31/12	Jan-Mar 05	1,842	1,990	-148	-137	-8.0%	-7.4%	12,465	7,342	58.9%	7,299	31,797
	Apr-Jun 05	2,046	1,925	121	64	5.9%	3.1%	13,810	9,259	67.0%	9,357	32,285
	Jul-Sep 05	2,140	2,036	104	68	4.9%	3.2%	13,599	9,838	72.3%	9,325	
	Oct-Dec 05	2,050	1,966	84	25	4.1%	1.2%	12,880	8,646	67.1%	8,945	
	Year 2005	**7,789**	**7,717**	**173**	**32**	**2.2%**	**0.4%**	**38,454**	**26,487**	**68.9%**	**23,799**	**32,363**
	Jan-Mar 06	1,078	1,064	-150	-137	-13.9%	-12.7%	12,275	8,179	66.6%	8,532	31,528
	Apr-Jun 06	2,439	2,319	120	75	4.9%	3.1%	14,005	10,325	74.0%	10,325	32,622
	Jul-Sep 06	2,476	2,318	158	83	6.4%	3.4%	14,086	10,745	76.3%	10,141	32,772
	Oct-Dec 06	2,215	2,121	94	679	4.2%	30.7%	13,405	9,162	68.4%	9,611	25,534
Ryanair	**Year 2004/05**	**1,727**	**1,301**	**426**	**345**	**24.7%**	**20.0%**	**36,611**	**31,205**	**84.0%**	**27,593**	
YE 31/03	Apr-Jun 05	488	392	96	84	19.7%	17.2%			83.4%	8,500	2,764
	Jul-Sep 05	652	409	244	208	37.4%	31.9%				9,500	2,987
	Oct-Dec 05	439	381	58	44	13.2%	10.0%			83.0%	8,600	2,963
	Year 2005/06	**2,045**	**1,598**	**447**	**371**	**21.9%**	**18.1%**			**83.0%**	**34,768**	**3,063**
	Apr-Jun 06	711	539	172	146	24.2%	20.5%				10,700	
	Jul-Sep 06	864	553	313	268	36.2%	31.0%				11,481	3,881
	Oct-Dec 06	651	575	76	63	11.7%	9.7%			82.0%	10,300	4,209
easyJet	**Year 2003/04**	**1,963**	**1,871**	**92**	**74**	**4.7%**	**3.8%**	**25,448**	**21,566**	**84.5%**	**24,300**	**3,727**
YE 31/03	Oct-Mar 05	1,039	1,116	-77	-41	-7.4%	-3.9%	14,526	12,150	83.8%	13,500	
	Year 2004/05	**2,364**	**2,278**	**86**	**76**	**3.6%**	**3.2%**	**32,141**	**27,448**	**85.2%**	**29,600**	**4,152**
	Oct-Mar 06	1,095	1,177	-82	-50	-7.5%	-4.6%	16,672	13,642	81.8%	14,900	
	Year 2005/06	**3,034**	**2,813**	**221**	**176**	**7.3%**	**5.8%**	**37,088**	**31,621**	**84.8%**	**33,000**	**4,859**

Note: Annual figures may not add up to sum of interim results due to adjustments and consolidation.

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