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Global Financial Crisis: aviation repercussions

It is sometimes very difficult to see beyond the doom and gloom in the depths of a crisis; and while the world's media and governments threaten to panic consumers into a global recession the prospects for aviation are at best opaque.

The current financial crisis generates invidious comparisons iwht the worst crises of history - notably the '29 Wall Street crash and the resulting Great Depression of the 1930s. Like all past banking cycles however there are similarities but many more differences. The prime similarity with past cycles - and particularly that of '29-'33 - is a loss of confidence in and by financial institutions, to the point where many banks have stopped lending to each other. This in turn has lead to a severe lack of liquidity in the wholesale banking markets - and the important thing about liquidity is that you do not know how important it is until you do not have it. This loss of liquidity in turn feeds a lack of confidence, and widens its scope to include the retail markets, encouraging withdrawal of savings by individuals (and retail deposits form the primary bedrock of the financial system) from institutions deemed at risk of failure.

A further similarity - common to most cycles and not just the banking cycle - is likely to be that we enter a period of consolidation, dearth of innovation as the market participants retrench resulting in the likelihood of a prolonged period of expensive debt.

In the past decade the finance industry has fled headlong into creating obscure products, which appeared to remove risk, with (seemingly) high margins - most based on the very availability of cheap debt finance and the fallacious stupidity of borrowing short to lend long. Many of these products appear to have been based on an overoptimistic assessment of the pricing of risk; and many appear not to have been understood properly by the perpetrators themselves. Overcapacity - as in any industry - eventually leads to falling returns, and in a highly cyclical industry to deep losses.

One big difference with past cycles however is the financial reporting requirements of the new improved accounting standards to mark to market tradeable investments and liabilities. This consequently exacerbates the writedowns and losses but also has a negative spiral impact on the market values of the underlying instruments. It will take time - but the finance industry will recover and will find a new upward trend in its cycle (and go through the whole process again) - the real question for us all is how long.

The aviation industry is already reeling from the impact of the

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very high fuel prices and the consequent need to raise fares and the resulting weakness in demand. If we are indeed in for a prolonged global recession, then this demand environment will weaken further - requiring even more cut-backs in capacity and tightening of belts. It will undoubtedly also lead to further failures and help to accelerate consolidation.

This last upswing in the airline cycle has not been easy - and entering the downturn there are only a handful of carriers round the world with balance sheets (and importantly cash balances) strong enough to weather the difficulties.

In Europe in particular we are seeing the network legacy carriers already accelerating consolidation: with British Airways finally coming to the altar with Iberia, Lufthansa taking out SWISS and Brussels Airlines, and eyeing Austrian (while its call option on British Midland should mature this year). Air France-KLM may in the end link up with the new improved Alitalia (unless Lufthansa's plans for Malpensa win the Northern League's favour and it manages to sneak in) while also showing interest in Austrian.

All three of the majors are trying to consolidate further the transatlantic alliances - with the prospect that 90% of transatlantic services will shortly be provided by three ATI approved joint ventures of oneworld, SkyTeam and the Star Alliance. This consolidation process should make the surviving carriers stronger and more resilient in the next upturn.

In the short haul markets in Europe, meanwhile, Ryanair and easyJet should have the finances, staying power and persistence to continue to grow into the recession and the vacuum left as others cut back or fail. Ryanair has the particular benefit of being by far the lowest cost producer in what is a commodity market and, with easyJet, has the advantage of an order book of equipment on prices arranged in the depths of the last industry recession. Smaller carriers, and ones with less robust business models, and particularly those with less cash, may well fail.

One thing appears clear - although there may become aircraft available, there is now likely to be a dearth of capital, equity or debt, to finance them and allow start-ups by the kerosene-sniffing hopefuls to fulfil their dreams of making a small fortune out of running an airline.

Leasing fallout

The greatest fallout from this crisis meanwhile is likely to be among the providers of finance to the industry, the aircraft market and particularly the aircraft leasing industry. It was inconceivable that AIG should fail - but as Charles Dodgson noted, "I can think of six impossible things before breakfast" and in the past few months those six have materialised as fact before lunch. AIG's failure, and the US government's bail out to allow the orderly winding up of its empire, will put ILFC in a precarious position.

ILFC is the world's second largest aircraft leasing company behind GE Capital, with a beneficial interest in about 950 jet aircraft (6% of the world's fleet) and manages or has subsidiary interest in a further 100 units. It also has some 160 aircraft on order, mostly weighted to Boeing. Its customer base is fairly well spread throughout the world and 90% of its fleet is placed with airlines outside the US.

It is also profitable: on revenues of $4.6bn in 2007 it generated net profits of $600m, and even in the first half of 2008 (when failed carriers ATA, Eos and Aloha in the US returned 16 aircraft) it saw revenues up by 12% to $2.5bn and net profits up by 48% to $364m. Although as a subsidiary of AIG the balance sheet probably doesn't mean much, it appears to have some $30bn of debt on balance sheet supported by $42bn of net fixed assets. AIG acquired ILFC in 1990 - just before the industry recession of the early 1990s that managed to kill off GPA (or at least that pushed it into GE's coffers) - but it has been run very effectively since then by the original founder Steven Udverhazy. As an aside it may (just) be relevant to point out that GPA, run by the late Tony Ryan, was the stable from which emerged both Ryanair's CEO Michael O'Leary and Aer Lingus' new chair-

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man Colm Barrington (who is also CEO of Babcock and Brown Air).

There will undoubtedly be some intra-group connections, although these should be relatively easy to unwind. In the short run however, ILFC could well suffer competitively from the downgrading of its parent's debt ratings - let alone a likely deterioration in lease rates. It could perhaps be offered onto the equity markets in an IPO - after all it was there before in the '80s - but equity appetite, and particularly for the intricacies of the aircraft leasing business is likely to be poor.

Interested industry buyers a few months ago would have included AWAS, BBAM, Macquarie and RBS, but each now may have their own funding problems. As it is primarily the western banks who are suffering the most from the fall out of the credit crisis, it may be more likely to find a buyer in the Middle East or Asia. A more liquid contender could be Dubai Aerospace Enterprise - who only manages 49 aircraft, but last year at the Dubai air show announced a massive $27bn aircraft order for 200 planes - while there may be a solution for capital (as some of the major investment houses have found) in the Far East.

GECAS, meanwhile, the world's largest aircraft lessor, also has its own funding problems. GE recently managed a $15bn capital raising exercise to cover underlying losses resulting from the credit crunch. At the moment it seems exceedingly unlikely that they or their leasing operation would encounter similar difficulties as seen by AIG. With 10% of the world's jet fleet under its belt the consequences of that impossible thought as well would be unthinkable.

EUROPEAN AIRLINES' EXPOSURE TO ILFC

	Leased aircraft - ILFC owned	Total Fleet	% of fleet
Air Malta	11	13	85%
Aer Lingus	18	42	43%
Vueling Airlines	9	21	43%
British Midland Airways	23	54	43%
Virgin Atlantic Airways	12	38	32%
Thomas Cook Airlines	10	44	23%
Air France-KLM	72	371	19%
Finnair	12	64	19%
SWISS	10	64	16%
Spanair	8	62	13%
Iberia	13	143	9%
Air Berlin+LTU	15	174	9%

Source: BACK Aviation/Lundqvist

It is indeed incredible that either of the two major aircraft lessors could be brought down as part of this financial crisis. In the worst case there would be some serious further repercussions for the airline industry.

The order position at Boeing and Airbus would no doubt go back into the "pool" of delivery slots allowing others constrained by the current order backlog potentially to gain equipment earlier (if they can get the funding). Some airlines may take it as an opportunity to hand back equipment to the lessors, some to reshuffle fleet mix to try to reduce ownership costs, but it would create an overhang of 16% of the world's jet fleet. The net effect could be to accelerate the downward pressure on lease rates, but also increase pressure on aircraft residual values, encourage further debt write downs at banks who lend to the industry and once again make it increasingly difficult for the majority of airlines to acquire equipment.

By James Halstead

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The break-up of BAA Limited

Faced with a critical Competition Commission (CC) report, BAA has gone for a pre-emptive sale of Gatwick.

The next couple of years could be very busy for airport transactions, what with the partial sale of AENA's airports in Spain, the sale of Prague airport and now the biggest prize of all, the sale of Gatwick. BAA announced its intentions on September 17 with a process expected to take 12 months. If that timetable is adhered to, it is likely that the sales process proper will start early in the new year, with a three month bidding process in the spring followed by three months to completion.

UK airports are uniquely attractive, with a 20-year history of private sector investment and a thriving after sales market in airports due to the use of 100% freehold sales backed by a regulatory system designed to ensure service delivery at a reasonable price.

Ironically, the proposed sale of Gatwick is due to the CC's ruling that BAA has failed to invest and has not dealt with service failings. This was precisely what regulation was supposed to prevent. The forced sale is, of course, the ultimate sanction in the regulatory process.

While the CC points the finger of blame almost entirely at BAA, other observers might suggest that at least some of the blame lies with the UK Department for Transport and the UK Civil Aviation Authority for their role in the lack of investment in new runways in the South East and the consequent decline in service, which in part can be attributed to the systematic over use of runway capacity leading to a situation where delays are endemic and terminals undersized.

So what has happened and what are the opportunities arising?

Summary of report findings

The Competition Commission has published its findings on whether or not BAA - the owner of seven UK airports including the three main London airports - should be broken up. The report is damning in its tone, even if the evidence does not necessarily point that way. To quote the chairman of the inquiry group, Christopher Clarke: "We have provisionally found that there are significant competition problems arising from BAA's common ownership of seven UK airports (Heathrow, Gatwick, Stansted and Southampton in England, and Edinburgh, Glasgow and Aberdeen in Scotland). This is evident from a large number of factors including its lack of responsiveness to the needs of its airline customers and a lack of initiative in planning capacity. This has resulted in investment that is not tailored to the requirements of airport users and lower levels and quality of service for both airlines and passengers.

We have also provisionally found that there are competition problems arising from the planning system, aspects of government policy and the system of regulation."

As for remedies, the proposals are for the forced disposal of two out of the three London airports and one of Edinburgh and Glasgow. To quote Christopher Clarke again: "We are seeking views on which two of BAA's three London airports should be sold and similarly which of Edinburgh or Glasgow airports should be sold. We do not expect to require the sale of either Southampton or Aberdeen airports. The problems at Southampton would be remedied by the sale of either Heathrow or Gatwick. At Aberdeen, we are seeking views on whether there is a need for behavioural remedies or some form of regulation. Additionally, we are seeking views on the need for additional behavioural remedies or some form of enhanced regulation at Heathrow, whether or not there is a change in ownership, to address the competition problems arising from it being the only hub airport in the South East."

Clarke then warns that regulation will also need to adjust: "Changes in ownership would

only be a first step in freeing up the market and providing greater scope for more flexible development. Changes to regulation may similarly be important and there could be benefits available from a less prescriptive government policy on airport capacity development though we recognise decisions on such policies, which are wholly for government, will be taken in a broader decision framework."

If this report were adopted largely unchanged then it would seem inevitable that BAA will be broken up. BAA has gone for a pre-emptive sale of Gatwick, but that might not be enough. The CC has set out its preferred option of disposal of three out of the seven airports. However, this is not necessarily the final outcome; the UK government - and in particular the Department for Transport - will be very conscious of the political dimension. Indeed the DfT, and its antecedents, are also identified as being part of the cause of the problem. So the favoured option is probably:

• Sale of Gatwick
• Sale of Stansted
• Sale of one of Edinburgh or Glasgow

However, it is possible that the BAA shareholders, led by Ferrovial, will take the view that with three prime assets sold, the benefit of keeping Heathrow with one of Edinburgh and Glasgow plus two smaller airports is not the most efficient solution, and may therefore prefer to own just Heathrow.

In the well-developed UK airport market, all of the BAA's airports would be attractive in their own right as they are 100% freehold sales - an opportunity that rarely comes available in the global market for airports.

Indeed combining BAA's airports into groups (for example, Aberdeen and Glasgow) could well reduce the total sales proceeds, as bidders would prefer to concentrate on airports that fit their investment criteria without having to take on another airport that is perhaps not such a good fit.

The three South East issues

Assuming that the process of disposal is in line with the CC recommendations, then the key issues for bidders are as follows:

• What regulatory regime will be in place?
• What is likelihood of developing additional runways in the South East?
• How will the aviation market react to differing runway development options?
• What will be the regulatory regime post break-up?

To network carriers, Heathrow is generally viewed as the only airport they want to serve. Apart from services to City airport, network carriers other than BA and Virgin have only served Gatwick under sufferance and would prefer to fly from Heathrow.

Hence Heathrow is - and probably always will be - an airport with significant market power requiring regulation on fees and service delivery.

So the regulatory regime at Heathrow is likely to be an enhanced version of what is already in place:

• A price cap per passenger based on a target return on regulated assets;
• A service delivery contract with airlines with penalties for failure to delivery; and
• A specific set of investments agreed at each regulatory review.

Although Gatwick and Stansted have less market power than Heathrow, in the medium-term it seems unlikely that these airports will be subject to lower levels of regulation as there is an ever increasing shortage of capacity in the South East until one or more runways are built. Although dates as early as 2015 have been mentioned for a new runway, a more realistic date is probably 2020 given the degree of public and political opposition to any of the options and the need to go through a lengthy planning process. The likelihood of a general election in the UK during this time-frame (with the strong possibility of a change in power) also adds to the uncertainty.

However, in the medium-term, given an increase in runway capacity, it is possible to imagine a reduction in the regulatory burden, perhaps towards a high cap on price and possibly based on benchmarking against equivalent airports in Europe. Experience at Stansted has already shown that BAA has found it hard to raise its fees to the level of the cap, and its two main customers - Ryanair and easyJet - have shown themselves as highly capable negotiators prepared to cut capacity if they feel prices are too high.

If there continues to be a gap between the allowable fees cap based on return on assets, there would be an argument for removing Stansted - at least from a formal price cap to the fallback system used at UK regional airports where airports have a duty to provide pricing information to users, and users can take the airport to the regulator if they feel the fees are not cost justified or discriminate against them.

The fallback system of regulation has existed for 20 years in the UK. The result has been the development of a unique market based pricing system at UK regional airports, which enables charges to be negotiated between airline and airport with both parties comfortable that competitive pressures ensure an acceptable outcome. Significantly, under the fallback system it can be argued that pricing is probably closer to being cost related than most formal systems of regulation, as those sectors that impose the highest costs in terms of investment or throughput (charter and network carriers) end up paying higher charges than those airlines that maximise the use of existing facilities and spread their loads efficiently (low cost carriers). Significantly, although market based pricing has been subject to a handful of challenges, none have been successful.

So the outlook for regulation in the South East is a continuation of the same system, tighter in terms of obligations at Heathrow and possibly a move towards lighter regulation eventually at Gatwick and Stansted should their market power be reduced by the provision of capacity elsewhere.

The likelihood of additional runways in the South East?

Providing additional runway capacity in the crowded South East has been the stated aim of the British government since the 1960s. After examining many sites, it was decided to construct a new "Third London Airport" airport in the Thames Estuary (Maplin). However, the fuel crises brought an end to this plan on grounds of cost and environmental problems.

This left the government falling back on the development of Stansted as London's new "Third Airport" and Stansted (then a very minor airport) was chosen to be developed using the existing single runway, with outline plans for a second parallel runway. The "new" Stansted opened in the 1990s, since when development in the South East has been limited to the North Terminal at Gatwick, Terminal 5 at Heathrow and London City airport.

Opposition to the provision of additional airport capacity is intense at all locations, so no major runway has been provided (apart from the limited use London City runway) since the end of the Second World Wa,r despite a chronic shortage of runway slots in the region. So the South East market has had to struggle with five major runways (two at Heathrow and one each at Gatwick, Stansted and Luton) plus the London City runway.

The inability to construct runways is largely due to an understanding between BAA plc and the transport department (currently the Department for Transport) over planning policy. These two parties had a tacit agreement only to advance one major capacity-enhancing project at a time in the South East. This was aimed at reducing problems with Britain's time consuming and expensive public planning process.

Although the current planning process is seen as poor, only limited improvements in timing or cost are likely to be achieved for political reasons. Within this cumbersome planning process, there are three possible new runway sites:

- A third parallel runway at Heathrow, to the north of the airport which will involve the demolition of residential properties and inject further traffic into an area that is already considered to be heavily congested. This is the industry's preferred option and has a large economic benefit. However, the level of opposition cannot be overstated; it will be a brave politician who proceeds with this option. Indeed, Conservative party leader David Cameron, likely to be the next British prime minister, has already stated his opposition.
- A second parallel runway at Gatwick to the south and west of the current runway. Again, some residential properties will have to be demolished and there will be local opposition. There is also an agreement between BAA plc

and the local government authority not to start construction of a new runway until 2019. Although this agreement could be overturned by central government, that measure would run into intense political opposition in the UK parliament. The industry prefers Heathrow to be built first, but will probably support a second runway at Gatwick in the long-term.

• A second parallel runway at Stansted to the south and east of the current runway. This is the politicians' favourite option as there will be less opposition at national level (even though local opposition exists). However this option is opposed by the industry as it is in the wrong location. It is also opposed by the airlines based at Stansted (principally Ryanair and easyJet) as they are concerned about increases in landing fees that may be necessary to support such an investment.

In order of demand, the choice backed by the Treasury and airlines is straightforward:

• Heathrow;
• Gatwick; and, lastly, if ever:
• Stansted.

However, driven by environmental and local opposition the politically-preferred answer supported by the government of the day and Department for Transport is:

• Stansted;
• Heathrow; and, lastly, if ever:
• Gatwick.

A separately owned Stansted may well find the economics of developing a second runway unattractive for a very long time, in which case Gatwick becomes a more attractive option. However, the case for Heathrow will always be put forward by the airlines based there ahead of the case for Gatwick. So choosing the location of a new runway for London remains one of the trickiest decisions in the aviation industry.

Just to add to the complexity of choosing runway locations, the mayor of London - Boris Johnson - has said he favours a Thames Estuary site off the Isle of Sheppey (conveniently some distance from any of his constituents). Given the enormous cost of an offshore airport and associated transport infrastructure, this is viewed as a low probability option that has been raised and dismissed in the past on various occasions.

How will the airline industry respond to differing options?

Given the constrained nature of the current South East airport system, any new runway capacity will experience a rapid take-up of capacity. A third runway at Heathrow will experience a "land-grab" as airlines try and capture market share:

• BA will look to build a proper wave pattern of traffic, predominantly east-west in orientation. It will add secondary destinations in Europe (many currently served from Gatwick) and move the remainder of its transatlantic operations (except possibly its leisure-orientated services) out of Gatwick to Heathrow. It will also add frequencies on major routes where these are low compared with competing hubs in Europe. The increase in BA traffic will largely be transfer traffic - something that has not escaped the attentions of the environmental lobby.

• bmi and Virgin will both participate in the land grab in order to protect the value of their operations and to try and build an improved competitive position. Their role in a land grab will become stronger if they are owned or co-owned by members of global alliances. bmi already is already 30% owned by Lufthansa. Virgin Atlantic may find itself in a similar position if Singapore Airlines sells its stake, possibly to Lufthansa or a Middle East carrier.

• Many other airlines will want to add capacity at a Heathrow with a third runway; US carriers will look to move almost all their flights from Gatwick (as indeed has happened with Continental this winter). Also interested will be those airlines that sold their slots at Heathrow and moved to Gatwick.

So in the short-term there will be a rapid filling up of available capacity at Heathrow, some at the expense of Gatwick and some through reduction in average aircraft size. Given that any third runway at Heathrow will be subject to stringent noise and environmental constraints, it is likely that additional capacity will be phased in. There is also the possibility that

runway capacity will be limited to a lower level of utilisation (say 80%) compared with that currently achieved in order to reduce the number of delays that occur at Heathrow. If a limit of about 80% were introduced, that would limit movements to an increase of about 25%, not the 50% in the minds of many. There is a further constraint in that the third runway will not be a full length runway but about 2,500m, limited to short- to medium-haul flights only.

A second runway at Gatwick would also see a land-grab by airlines for slots, partly to meet pent-up demand and partly to deny slots to competitors. Whether British Airways is interested in adding flights at Gatwick largely depends on what is happening at Heathrow. The major airline to seek more slots is likely to be easyJet, looking to consolidate its role as Gatwick's largest airline. In the medium-term it is possible that Ryanair would also look to add capacity at Gatwick, seeking a greater share of the low-cost market south of the river Thames.

Based on the above analysis and long-term forecasts (in part based on the CAA's November 2007 long-term forecasts), it is possible to produce a number of scenarios for traffic in the South East.

• No additional runways

Pax (m)	2007	2010	2015	2020	2025	2030
Heathrow	68	70	75	80	85	85
Gatwick	35	35	40	40	45	45
Stansted	24	25	30	35	35	35
Luton	10	11	15	15	15	20
London City	3	4	5	5	5	5
Total	**140**	**145**	**165**	**175**	**185**	**190**
AAGR		*1.2%*	*2.6%*	*1.2%*	*1.1%*	*0.5%*

With no additional runways (but mixed mode at Heathrow, see chart above) this is the sort of scenario that would have competing hubs in Europe rubbing their hands with glee. The London system cannot sustain the sort of growth it has seen in the past. As a result, transfer traffic would spill to other hubs in Europe, air fares would rise, the number of routes would diminish and delays continue to increase, damaging the economic health of London and the UK as a whole. This scenario illustrates why the UK treasury and airlines are pushing so hard for extra capacity to be provided.

• Second runway at Stansted

Pax (m)	2007	2010	2015	2020	2025	2030
Heathrow	68	70	75	80	85	85
Gatwick	35	35	40	40	40	40
Stansted	24	25	30	40	55	65
Luton	10	11	15	15	15	20
London City	3	4	5	5	5	5
Total	**140**	**145**	**165**	**180**	**200**	**215**
AAGR		*1.2%*	*2.6%*	*1.8%*	*2.1%*	*1.5%*

This is the government's preferred option as it will be easier to pass through the planning system. Most airlines are not in favour as they prefer expansion at Heathrow and to a lesser extent Gatwick. Almost all the growth would occur on LCCs at Stansted, and Heathrow airlines would surrender some short-haul market share to make room for more long-haul traffic.

• Third runway at Heathrow

Pax (m)	2007	2010	2015	2020	2025	2030
Heathrow	68	70	75	100	120	135
Gatwick	35	35	40	40	40	40
Stansted	24	25	30	35	35	35
Luton	10	11	15	15	15	20
London City	3	4	5	5	5	5
Total	**140**	**145**	**165**	**195**	**215**	**235**
AAGR		*1.2%*	*2.6%*	*3.4%*	*2.0%*	*1.8%*

This is the preferred option of industry and the Treasury, and it is easy to see why, as it generates the most traffic with the addition of one runway. As soon as the runway opens it is possible to anticipate a rapid build up of traffic only limited by ATC limits on movements. Some of this traffic would come from Gatwick and London City; the remainder would come from a mix of increased transfer traffic (given a more efficient transfer product) and pent up demand stimulated by lower fares.

• Second runway at Gatwick

Pax (m)	2007	2010	2015	2020	2025	2030
Heathrow	68	70	75	80	85	85
Gatwick	35	35	40	40	60	70
Stansted	24	25	30	35	35	35
Luton	10	11	15	15	15	20
London City	3	4	5	5	5	5
Total	**140**	**145**	**165**	**175**	**200**	**215**
AAGR		*1.2%*	*2.6%*	*1.2%*	*2.7%*	*1.5%*

The fact that this option was not even mentioned in the CAA November 2007 forecast (due to the agreement between BAA and the local authorities not to develop a runway until after 2019) illustrates how elements in

Whitehall and BAA have sought to maintain a single planning path with no room for alternate options.

A second runway at Gatwick has a slower build up than the Stansted option due to an assumed opening date of 2022. The capacity would mainly be taken up by a mix of LCCs. One long-term possibility is the emergence of a full-scale hub operation if Heathrow was heavily constrained, either by British Airways or by another airline grouping, possibly built around Virgin Atlantic (which has expressed an interest in having its own dedicated terminal at Gatwick).

• Third runway at Heathrow and second runway at Gatwick

Pax (m)	2007	2010	2015	2020	2025	2030
Heathrow	68	70	75	100	120	135
Gatwick	35	35	40	40	50	60
Stansted	24	25	30	35	35	35
Luton	10	11	15	15	15	20
London City	3	4	5	5	5	5
Total	**140**	**145**	**165**	**195**	**225**	**255**
AAGR		*1.2%*	*2.6%*	*3.4%*	*2.9%*	*2.5%*

This maximises traffic in the system. For the first time it is possible to see growth rates in the South East that are in line with the sorts of growth rates one would expect to see if traffic was largely unconstrained. However, it still does not resolve the constraints in the early years; only a radically improved planning system can achieve that.

As the final option illustrates, London really needs not just one but two runways.

The opportunities arising from the break-up of BAA

• Heathrow

Heathrow is the airport least likely to be sold by its current owners due to its premium position in the market as London's global hub and the busiest international airport in the world.

Apart from its role as the main airport for London, Heathrow also serves as a long-haul hub dominating the transatlantic market and with a strong market presence to all long-haul markets with the exception of South America.

The main hub airline is British Airways, which operates from the new Terminal 5 and from Terminal 3 (once terminal reallocation is complete). British Airways is a founding partner of the oneworld alliance and works closely with partners including American, Qantas, Cathay Pacific, Iberia and Japan Airlines. Due to the lack of slots at Heathrow, BA's hub is not efficient in that there are no effective connecting complexes. BA also has to operate flights out of Gatwick to serve some destinations that it would prefer to serve from Heathrow. All or some of the Gatwick flights might move to Heathrow if a third runway was built.

A second hubbing operation is provided by bmi in partnership with Star alliance members. bmi has an extensive short-haul operation to UK regional destinations and major destinations in Europe, the FSU and the Middle East. However, the airline has found it difficult to sustain profitability and has recently altered its strategy by moving to medium-haul routes and purchasing BMed (another medium-haul operator formerly operating as a BA franchisee) in a bid to improve profitability.

The other Heathrow-based airline is Virgin Atlantic, operating long-haul services across the Atlantic and to other major long-haul destinations, using bmi to provide some feeder traffic.

Apart from the three based carriers, Heathrow is served by all major European and long-haul airlines. For most long-haul airlines, serving Heathrow still remains one of the most sought after routes, given the size of the London market for air travel.

The role of Heathrow as a hub has diminished with the emergence of global alliances and the shortage of runway slots. With the Open Skies agreement between the EU and the US coming into force in spring 2008, slots were changing hands for in excess of US$50m a pair (Continental paid a total of US$209 for four pairs of slots). As a result, airlines apart from the based airlines are increasingly serving Heathrow as a terminating point rather than as a hub. Star alliance airlines hub at Frankfurt and SkyTeam airlines hub as Paris CDG; both airports having effective connections and a wider range of flight destinations (if not frequencies).

A third runway would significantly enhance Heathrow's competitive position in Europe with the ability to add new frequen-

GROWTH AT HEATHROW

Heathrow	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Pax (m)	57.8	60.4	62.0	64.3	60.5	63.0	63.2	67.1	67.7	67.3	67.9
Growth YoY		*4.3%*	*2.7%*	*3.7%*	*-5.9%*	*4.3%*	*0.3%*	*6.2%*	*0.9%*	*-0.5%*	*0.8%*
Market share	61%	59%	57%	55%	53%	54%	53%	52%	51%	49%	49%

Note: Market share of all five London airports (Heathrow, Gatwick, London City, Luton and Stansted

$m	Financial Year to: Mar-04	Mar-05	Mar-06	Dec-06	Dec-07
Revenues	1,684	1,987	1,913	1,732	2,551
Operating result	680	825	794	615	877
Margin	*40%*	*42%*	*42%*	*36%*	*34%*

cies or destinations.

In the absence of a third runway, Heathrow's airlines will concentrate on long-haul and high-yielding short-haul business routes, with secondary routes moved to Gatwick (and some to London City) or dropped altogether. Overall, if there is no third runway Heathrow is likely to become increasingly a long-haul airport.

• Gatwick

Gatwick is the world's busiest single runway airport, and Gatwick's role in the London system is complex:

• The biggest scheduled operator is now easyJet, which has built its largest base at the airport serving a wide range of destinations in the UK and the rest of Europe, a position consolidated with its purchase of GB Airways, a former BA franchisee.

• British Airways operates a wide range of scheduled flights serving the local market (having about 20% of the South East market) and a wider range of leisure-dominated routes.

Up until March 2008, Gatwick also benefited from traffic distribution rules contained in the US-UK Bermuda II bilateral agreement, which meant that a large number of US routes were forced to use Gatwick rather than the preferred option of Heathrow. As a consequence, since March 2008 many US services have now moved to Heathrow and, in time, it may be expected that the US carriers will probably withdraw from Gatwick in their entirety.

The airport is also the primary charter airport for the South East, serving a wide range of destinations in the Mediterranean basin, the Caribbean and beyond, many of which are not served by scheduled airlines.

A second runway at Gatwick would lead to a land-grab similar to that at Heathrow, with the main participants being UK-based airlines led by easyJet and possibly Virgin Atlantic, British Airways and Ryanair. The announcement by Richard Branson - Virgin Atlantic's chairman - that he would be interested in being part of a consortium to bid for Gatwick does open up the possibility that Gatwick's role could evolve into one similar to Newark in the New York system, whereby Gatwick becomes the hubbing airport while Heathrow becomes the main O and D airport. Branson has suggested that he is interested in Gatwick if he can obtain a dedicated terminal. Logic suggests that in order to make this project worthwhile Branson would need to develop a feeder network, as currently the only airline offering feed at Gatwick is British Airways.

A new terminal complex would need to be constructed to handle traffic from a second runway.

Conversely, what happens if there is a third runway at Heathrow but no second runway at Gatwick? As soon as a third runway at Heathrow opens, there will be a land grab for all the available slots, led by British Airways. In theory, some 500 slots per day could become available (it might be less if the introduction was phased or capacity capped).

If short-haul took 400 slots, that would equate to 130 short-haul aircraft plus 100 long-haul aircraft being added at Heathrow. For British Airways, some of that capacity would have to come from Gatwick; say 15 long-haul aircraft plus 40 short-haul aircraft with more capacity being provided by new aircraft. That would mean BA's entire Gatwick operation being moved to Heathrow virtually overnight. Virgin Atlantic and other scheduled

GROWTH AT GATWICK

Gatwick	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Pax (m)	26.8	29.0	30.4	31.9	31.1	29.5	29.9	31.4	32.7	34.1	35.2
Growth YoY		*8.4%*	*4.7%*	*5.1%*	*-2.7%*	*-5.1%*	*1.3%*	*5.0%*	*4.1%*	*4.2%*	*3.2%*
Market share	28%	29%	28%	28%	27%	25%	25%	24%	24%	25%	25%

Note: Market share of all five London airports (Heathrow, Gatwick, London City, Luton and Stansted

$m	Financial Year to:	Mar-04	Mar-05	Mar-06	Dec-06	Dec-07
Revenues		527	572	579	533	815
Operating result		170	185	178	135	196
Margin		*32%*	*32%*	*31%*	*25%*	*24%*

airlines could also look to move their flights from Gatwick to Heathrow. However, that would leave the Gatwick market unserved by scheduled carriers, other than the LCCs - a situation which would leave BA vulnerable. So in practice, it is likely that BA might maintain some short-haul services at the airport to prevent this happening.

Meanwhile, the low-cost carriers would look to replace any short-haul routes abandoned at Gatwick, as will any long-haul low-cost carriers should they exist at the time.

• Stansted

Stansted's role is three-fold: First, it is the London base for Ryanair (the dominant airline) and easyJet (a smaller base inherited from the purchase of Go). Both airlines operate extensive low-cost services to points in the UK and other parts of Europe.

Second, Stansted plays the part of a regional airport serving the North East quadrant of the South East market with a limited network of charter services and some failed attempts to serve as an alternate long-haul airport to London. The presence of Ryanair and easyJet acts as a strong deterrent to any network carrier to operate short-haul flights at the airport; as a consequence, these carriers prefer to serve this market in a limited way from London City airport.

Third, Stansted acts as a specialist cargo airport for London, having the advantage of 24-hour operation and a 3,048 metre runway.

Currently, Stansted is the government's preferred option for a new runway for the South East. However, there is currently no pent-up demand for additional capacity at Stansted, as Ryanair and easyJet are objecting to the increases in fees necessary to construct the new runway and associated terminal and access projects while Heathrow- and Gatwick-based airlines have shown no enthusiasm for using Stansted as a third London airport (short-haul airlines prefer to use London City).

Should a third runway be provided at Heathrow or a second runway at Gatwick, there may be some moving of capacity to Gatwick, as flights from Gatwick achieve higher yields.

If no runways are provided elsewhere then the case for a second runway at Stansted improves as time goes on, simply due to lack of capacity elsewhere. So in the longer-term

GROWTH AT STANSTED

Stansted	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Pax (m)	5.4	6.8	9.4	11.9	13.7	16.0	18.7	20.9	22.0	23.7	23.8
Growth YoY		*27.3%*	*37.8%*	*26.0%*	*15.1%*	*17.5%*	*16.6%*	*11.7%*	*5.2%*	*7.7%*	*0.3%*
Market share	6%	7%	9%	10%	12%	14%	16%	16%	16%	17%	17%

Note: Market share of all five London airports (Heathrow, Gatwick, London City, Luton and Stansted

$m	Financial Year to:	Mar-04	Mar-05	Mar-06	Dec-06	Dec-07
Revenues		259	281	297	279	485
Operating result		70	76	87	79	172
Margin		*27%*	*27%*	*29%*	*28%*	*36%*

GROWTH AT SOUTHAMPTON

Southampton	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Pax (m)	0.6	0.7	0.7	0.9	0.9	0.8	1.2	1.5	1.8	1.9	2.0
Growth YoY		*17.9%*	*3.9%*	*14.0%*	*0.3%*	*-8.0%*	*54.5%*	*25.7%*	*19.9%*	*4.2%*	*2.8%*
$m						**Financial Year to:**	**Mar-04**	**Mar-05**	**Mar-06**	**Dec-06**	**Dec-07**
Revenues							29	31	37	32	48
Operating result							12	13	16	11	14
Margin							*41%*	*41%*	*43%*	*35%*	*29%*

the project may well become viable, but it will rely on a significant shortage of capacity elsewhere in the South East and a willingness of Stansted airlines to pay significantly higher fees than they do at present.

• Southampton

Southampton is a regional airport handling some 2m passengers at present. The site is heavily constrained as it is hemmed in by roads and rail lines limiting significant further development. The airport currently serves the catchment area in its immediate vicinity. but it is linked by rail to London Waterloo on a fast line taking about one hour, and so does have potential to capture some overflow traffic.

The runway is some 1,650 metres in length, limiting operations to turboprops and some jet aircraft flying to medium-haul destinations. The main operator is flybe, a low-cost airline flying Dash 8-Q400s and Embraer ER100s.

flybe operates to a wide range of domestic destinations and specialises in services to the Channel Islands. In addition, flybe provides services to a number of nearby European destinations as well as to some low-cost destinations, including niche French regional destinations.

Although flybe is a low-cost operator, its fleet means that its costs are slightly higher than conventional low-cost airlines, so it is subject to competition from Bournemouth and Gatwick airports.

In addition to these scheduled flights, there are a small number of charter flights that can operate from the runway to destinations in Spain.

• Scotland

BAA owns three airports in Scotland, Edinburgh Glasgow and Aberdeen.

The main competition issue concerns the two Lowlands airports, Glasgow and Edinburgh. Until recently, Glasgow was the largest airport, serving the largest city. For historic reasons Glasgow - as well as serving its local market - also acted as the preferred choice for long-haul airlines and charter flights.

However, in recent years a combination of competition from Prestwick (Glasgow's second airport) and the growth of Edinburgh in its roles as capital city, financial centre and short-break destination has meant that Edinburgh is now Scotland's busiest airport - a lead that will be further boosted by the opening of a Ryanair base (delayed until November 2008).

This active competition, led by the rapid development of low-cost flights at all three

GROWTH AT EDINBURGH

Edinburgh	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Pax (m)	4.2	4.5	5.1	5.5	6.0	6.9	7.5	8.0	8.4	8.6	9.0
Growth YoY		*9.2%*	*11.9%*	*8.0%*	*9.9%*	*14.5%*	*8.2%*	*6.9%*	*5.7%*	*1.9%*	*5.0%*
Market share	39%	39%	41%	41%	42%	43%	43%	43%	43%	43%	45%
$m						**Financial Year to:**	**Mar-04**	**Mar-05**	**Mar-06**	**Dec-06**	**Dec-07**
Revenues							117	127	133	120	174
Operating result							49	54	55	51	76
Margin							*42%*	*42%*	*41%*	*42%*	*44%*

Note: Marketshare of all three Lowlands airports (Edinburgh, Glasgow and Prestwick

GROWTH AT GLASGOW											
Glasgow	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Pax (m)	6.0	6.5	6.8	6.9	7.2	7.8	8.1	8.6	8.8	8.8	8.7
Growth YoY		*7.8%*	*4.3%*	*2.4%*	*4.7%*	*7.3%*	*4.5%*	*5.4%*	*2.6%*	*0.5%*	*-1.1%*
Market share	56%	56%	54%	52%	50%	48%	47%	46%	45%	44%	43%
Note: Marketshare of all three Lowlands airports (Edinburgh, Glasgow and Prestwick											
$m						**Financial Year to:**	**Mar-04**	**Mar-05**	**Mar-06**	**Dec-06**	**Dec-07**
Revenues							124	135	137	125	172
Operating result							43	46	48	49	58
Margin							*34%*	*34%*	*35%*	*39%*	*34%*

Lowlands airports, has a resulted in a very healthy growth of 6.5% AAGR over the last 10 years. Glasgow airport (3.8% AAGR) has lost market share as a result of competition from Prestwick (15.6% AAGR) and Edinburgh (8.1% AAGR).

Despite some evidence of competition existing, there has always been a feeling that common ownership of the Lowlands airports by BAA plc has somehow limited the development of new services, with very similar fees structures and a common marketing programme.

Therefore, the Competition Commission has recommended the sale of either Glasgow or Edinburgh, leaving two airports, one of which is Aberdeen. As has been suggested elsewhere, shareholders may decide to sell all three airports, or two airports including Aberdeen.

Historically, BAA's Scottish airports have been very centralised with legal and commercial activities provided from a Scottish airports head office based at Glasgow. For that reason alone, Edinburgh could be the easiest airport to sell off.

In view of Edinburgh's track record of faster growth and a lack of a nearby low-cost competitor, Edinburgh is also likely to be the most attractive to the market.

Aberdeen serves the North East of Scotland, with a heavy dependence on oil exploration and technology. In recent years, Inverness - the airport serving the capital of the Highlands - has had growth (6.4% AAGR) and is providing some effective competition to Aberdeen.

Because of Aberdeen's low growth rate (3.0% AAGR over the last 10 years), the growth rate of the two airports combined is just 3.6% AAGR; in part reflecting the diversion of some traffic through the Lowlands airports due to the greater availability of low-cost flights and in part due to the long-term decline in oil exploration activities based at Aberdeen.

Because of the structural decline of the oil industry, Aberdeen is likely to continue growing slowly and hence is a different proposition to both Edinburgh and Glasgow to investors. So to include Aberdeen as a bundle with one of the other BAA-owned Scottish airports is not likely to maximise the value as it does not have the usual growth story favoured by many investors.

Separate ownership of terminals?

An alternate and/or parallel option to the enhanced regulatory package above for Heathrow and possibly other London airports would be to consider separate ownership of one or more terminals.

With Heathrow terminals moving towards

GROWTH AT ABERDEEN											
Aberdeen	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Pax (m)	4.2	4.5	5.1	5.5	6.0	6.9	7.5	8.0	8.4	8.6	9.0
Growth YoY		*9.2%*	*11.9%*	*8.0%*	*9.9%*	*14.5%*	*8.2%*	*6.9%*	*5.7%*	*1.9%*	*5.0%*
$m						**Financial Year to:**	**Mar-04**	**Mar-05**	**Mar-06**	**Dec-06**	**Dec-07**
Revenues							48	54	59	120	82
Operating result							15	19	20	51	32
Margin							*32%*	*35%*	*33%*	*42%*	*39%*

a split along alliance lines, it is conceivable to consider separating out three terminals. Terminal 5 (100% BA occupied) is one obvious target for separate ownership and management as - to a lesser extent - are Terminal 4 (SkyTeam) and Terminal 1/Heathrow East (Star). That leaves Terminal 3, shared between oneworld and other mainly non-aligned airlines as a common use terminal best suited to management and operation by the airport operator. However, given that Heathrow will always be a very constrained airport, a degree of regulation and co-ordination covering access to terminal capacity would still be required even if price regulation were relaxed to allow for differential charging.

Separate terminal ownership does have four drawbacks:

• The possibility of less efficient use of scarce terminal capacity;
• Impediments to new entrants wanting to introduce services at Heathrow;
• A lack of reasonable alternatives for airlines in alliances as they can only choose between the alliance terminal and Terminal 3; and
• Increased financing costs reflecting the risk of more variable income for each terminal operator.

So even under this scenario regulation is still likely even if the fee levels between terminals could differ depending on the levels of service sought. In practice, despite some airlines arguing for separation on the grounds of increased efficiency, tariffs are more likely to go up as airlines compete for premium passengers on service rather than go down due to increased throughput and cost efficiencies.

Airline or specialist terminal management companies do provide some excellent terminals:

• Munich 2 (a 50:50 joint venture between Munich Airport and Lufthansa);
• Sydney Terminal 3, run by Qantas as its domestic terminal; and
• New York JFK Terminal 4 (run by a consortium of Schiphol, LCOR and Lehman Brothers).

So it is not beyond the realms of possibility, not just at Heathrow but also at Gatwick, where the North Terminal is a possible separation candidate - as would be any new terminals at both Gatwick and Stansted. Indeed, it may be a way of making the low-cost carriers - in particular Ryanair and easyJet - put their money where their mouths are. Both these carriers rightly point out that current terminal designs are far from the simple no-frills terminals they seek, as current designs were built to handle transfer traffic and not optimised for point-to-point traffic.

So far, the only airline that has emerged to show an interest in a dedicated terminal is Virgin Atlantic, which has expressed an interest in having a dedicated terminal at Gatwick. British Airways has remained silent, despite having 100% of Terminal 5 at Heathrow.

A busy time ahead

So it looks as though the political will exists for BAA to be broken up, and BAA itself has accepted that reality. At the very least Gatwick will come to market in 2009. More likely, if the CC achieves its aims, three attractive airports will come to market: Gatwick, Stansted and one of Edinburgh and Glasgow. The process could lead to the voluntary sale of the remaining airports, including the other of Edinburgh/Glasgow and Aberdeen and Southampton.

Depending on how the South East runway debate runs, the new owners could either end up with a business built around optimising throughput off existing runways or have the option at Gatwick to build a plausible competitor to Heathrow. At Stansted, the key consideration will be how to handle Ryanair and easyJet should a new runway be possible.

Both the major Scottish airports are attractive, especially Edinburgh. As the current sales process for Belfast City has shown, even smaller regional airports in the UK have a ready supply of buyers keen to access 100%-owned airports in stable markets.

All in all, the BAA airports should have no problems finding buyers, with the key considerations coming down to understanding the technicalities of UK regulation and also the political framework that supports and controls it. A secondary issue is dealing with the real issues of competition, price and service.

By Charles Williams

United: responding well to tough times - or cutting too deep?

United's parent UAL Corporation has in recent months been at the forefront of industry efforts to adjust to the tough fuel environment. The Chicago-based airline is contracting dramatically this autumn, as indicated by a 100-aircraft, 22% reduction in its mainline fleet and a 16% cut in domestic mainline ASMs in the fourth quarter. UAL is trimming non-fuel costs by $500m this year, is targeting $700m of incremental ancillary revenues in 2009, has raised $1.7bn of liquidity this year and recently forged a promising marketing alliance with Continental. Is all of this enough to weather the current storm and ensure longer-term survival? Or could UAL even be cutting too deep and risking its market position?

UAL emerged from a three-year Chapter 11 reorganisation in February 2006 with an improved cost structure and balance sheet but still much work left to be done on both fronts. Unlike Delta and Northwest in their respective Chapter 11 visits, United did not get its unit costs below the typical legacy carrier range. Also, despite the extensive Chapter 11-facilitated debt and lease restructuring and the shedding of pension obligations, UAL remained heavily leveraged, with an adjusted debt-to-capitalisation ratio in the high-80s and similar to AMR's.

UAL's post-Chapter 11 financial performance has been somewhat inconsistent (as one Wall Street analyst described it). In 2006 and early 2007 the company's profit margins lagged behind those of its peers. Then UAL succeeded in closing the gap, reporting operating and pre-tax profits of $1bn and $600m-plus for 2007, thanks to a solid cost performance and one of the best RASM improvements in the industry. But this year UAL has again been trailing its peers; its negative 7% pre-tax margin in the second quarter was the worst among the seven large network carriers.

Some of the inconsistency is due to fresh-start accounting associated with emergence from Chapter 11. Also, in recent quarters UAL's margins have been negatively affected by weak fuel hedging positions and the relatively large number of older, less fuel-efficient aircraft in the fleet. UAL claims that it continues to lead its peers in free cash flow (defined as cash flows from operations less capital expenditure, fuel hedge collateral received and purchase deposits paid). In the 12 months ended June 30, UAL was the only one of the top six network carriers to achieve positive free cash flow (some 0.5% of total revenue).

United's greatest strengths are its unrivalled global route network and being one of the world's best known brands. Because of those attributes, there has never really been serious doubt about its survival prospects and UAL has enjoyed much support from the financial community.

Labour strain

But United's labour relations continue to be strained. The airline has a history of labour strife - something that has raised questions about its corporate culture, though much of the current anger stems from the Chapter 11 sacrifices and the deep cuts implemented this autumn. It has been painful to watch the management and pilots at total loggerheads, fighting one another in court, in the middle of an industry crisis. The pilots staged work slowdowns in July, in opposition to UAL's downsizing plans and to pressure the management to reopen a contract that becomes amendable in early 2010, which must have contributed to UAL's losses.

UAL's financial prospects, like those of its peers, have improved materially in the past couple of months, in the first place because of the significant decline in fuel prices. After peaking at around $147 per barrel in early July, crude oil has returned to the $100-$110 level last seen in April, even briefly dipping to the low-90s in the wake of the Wall Street crisis in mid-September. Second, the profit out-

look is better because US airlines are moving ahead with a massive 11%-plus aggregate domestic capacity reduction in the fourth quarter, which should give them pricing power. Third, demand has held up well so far.

But many concerns remain. Oil prices continue to be high and extremely volatile. Demand is likely to weaken as the economic picture worsens and fares continue to rise. One of the biggest concerns is that business travel demand will weaken, both domestically and globally, as a result of the credit crisis and a potential full-blown recession. Therefore the significant capacity cuts, which began in earnest in September, and other survival measures will have to be maintained. What exactly has UAL done to ensure its survival?

Focus on liquidity

In recent months the main focus at UAL, as at other US carriers, been on maintaining and boosting liquidity. "With changing market conditions and volatile fuel prices, as we all know, cash is king", noted UAL's CFO-elect Kathryn Mikells at a late-September conference, adding that the Wall Street crisis has made an appropriate level of liquidity even more critical.

UAL is well positioned on this front. First, its current liquidity position is adequate. The company expected to end the September quarter with total cash of $3.5bn, about 17% of this year's revenues.

Second, UAL enjoys positive free cash flow and has modest calls on its cash, including no plans for new aircraft, a modest $450m non-aircraft spending budget in 2008 (recently reduced from $650m) and limited debt maturities.

Third, even after significant capital-raising in recent months (some of which was used to reduce debt), UAL has better flexibility than many of its peers to further improve liquidity. While any plans to sell assets such as the FFP and the aircraft maintenance business have obviously been shelved, the airline has $3bn in high-quality unencumbered hard assets that can be sold or used as collateral in financing transactions. About $2bn of those assets are aircraft, with spare parts and engines accounting for another $840m.

The recent moves included raising $550m in cash through a combination of asset sales, secured aircraft financings and the release of restricted cash. Subsequently, UAL also renegotiated agreements with its affinity card provider and credit card processor that in aggregate will boost liquidity by $1.2bn. Those deals included a $600m forward-sale of frequent-flyer miles to Chase (which is expected to generate an additional $200m in cash over the next few of years) and a reduction in the credit card holdback from $385m to $25m (the reduction was dramatic because the $385m holdback dated from the Chapter 11 exit agreement). Significantly, these transactions enabled UAL to raise a lot of cash without touching its hard unencumbered assets.

The 116-strong, $2bn pool of unencumbered aircraft is diverse; it includes all of United's mainline types. As of September 18, the company had already sold three of the 737s that are retired as part of the capacity reduction plan and felt good about the prospect of monetising the other unencumbered aircraft despite a tighter market.

A late-July JPMorgan report noted that UAL's airport slots are also quite valuable and that Heathrow alone could be worth $500m. The MRO business has $280m in annual revenues, but divesting it could only take place with labour's approval.

Aggressive capacity cuts

UAL has been leading the US airline industry in necessary downsizing this autumn. The airline is slashing mainline domestic capacity by as much as 15.5-16.5% in the fourth quarter, while regional affiliate capacity will fall by 2.5-2.5%. Unlike its peers, United is also pulling back significantly in international markets, where ASMs are slated to decline by 7-8% in the current quarter.

Next year will see a further capacity reduction. The current plan envisages a two-year contraction rate (2009 over 2007) of 19.5-20.5% in mainline domestic ASMs, 6-7% in international ASMs and 12-13% in consolidated system ASMs.

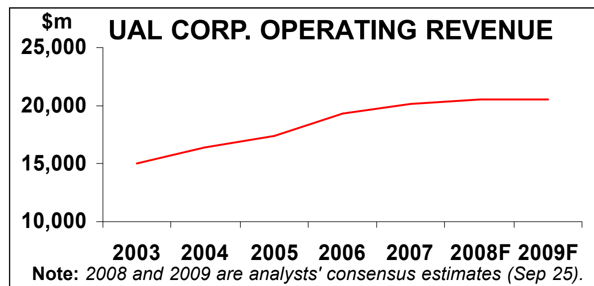
The cuts are being facilitated by the retirement of 100 mainline aircraft (22% of the total), including all of United's 737s and six of its 30 747s. About three quarters of the 100 aircraft will be retired this year, with the remainder going in 2009. In conjunction, the airline is reducing its workforce by 7,000 by the end of 2009.

UAL is also eliminating Ted - the last remaining airline-within-an-airline in the US, though it was only created in February 2004 while UAL was in Chapter 11. The Denver-based unit was nothing more than a separate leisure-oriented brand; it never got its unit costs much below United's. Its fleet of 56 A320s will be reconfigured to include United's first class seats between next spring and year-end 2009.

The capacity cuts will be mainly through frequency reductions or aircraft downgauging in underperforming markets, rather than eliminating service to many cities, so as not to degrade the overall ("world's best") route system. While closing some seven stations this year, UAL retains a commitment to all five of its US hubs and feels that the planned cuts will not unduly damage any of them. Los Angeles is seeing a massive 20% capacity reduction in the fourth quarter, with Denver being cut by 16%, Chicago 12%, San Francisco 11% and Washington/Dulles 3%.

Like its peers, United is finding it easier to cut domestic capacity now that LCCs generally are in the same boat. The airline has only seen competitive inroads from Southwest (in Denver), with the other LCCs essentially being in a contraction mode.

Internationally, UAL is eliminating routes that are not performing well, including all service to Nagoya, Los Angeles-Hong Kong, Los Angeles-Frankfurt and Denver-Heathrow, and reducing service to Mexico City. The airline also postponed its planned San Francisco-Guangzhou service by a year to June 2009 and is delaying the launch of Dulles-Moscow by six months to March 2009. Those routes are either too expensive or risky to develop at present (China and Russia), their economics do not make sense at $100-plus oil prices, or their yields and profitability have suffered as a result of significant capacity addition. United's management expects the capacity cuts to lead to significantly better revenue performance and reduced losses in international operations.



Note: *2008 and 2009 are analysts' consensus estimates (Sep 25).*

UAL first outlined its steeper capacity and fleet reductions on June 4, a week after terminating its merger talks with US Airways and a couple of weeks before announcing a marketing alliance with Continental, and has since then slightly added to the cuts. The overall aim is to "resize the business appropriately for the environment" in order to restore profitability. Specifically, the current cuts resize UAL to a fuel environment where oil averages $125 per barrel. This is probably still a reasonable assumption in light of all the uncertainty - or, if it turns out to be an overestimate, an earlier return to profitability would not be such a bad outcome.

As UAL downsizes, the management is determined to remove all the corresponding costs out of the system. One key component is the elimination of 1,500 or 20% of the total salaried and management positions this year. UAL is also reducing frontline positions by at least 5,500 or 12% by the end of 2009, hopefully mostly through voluntary programmes.

Otherwise, removing costs is made somewhat easier by the older fleet and the fact that variable costs (such as fuel) now form a larger proportion of total operating costs. The A320, which will be deployed in many markets previously covered by 737s, has a 16% lower fuel burn per seat than the 737-300/500s. The retirement of the 93 737s is expected to lead to a 2.5% improvement in the mainline fleet's fuel efficiency. Including also the 747s, the 100 aircraft retirements will lower the average age of United's fleet from 13 to 11.8 years.

United expects to sell the owned 737s (46 out of the 93 total) to operators outside the US, where demand apparently continues

UNITED'S MAINLINE FLEET

	Fleet	Average age (years)
A319-100	55	8
A320-200	97	10
737-300	64	19
737-500	27	16
757-200	97	16
747-400	30	12
767-300	35	13
777-200	52	9
Total	**457**	**13**

Note: *As at June 30 2008.* **Source:** *UAL.*

to be strong and where the returns are likely to be higher. Also, as UAL executives expressed it on September 18, "the capital markets will also logically support that the aircraft will be deployed outside the US". In other words, that capacity is likely to be permanently removed from the US market. United has retained AAR to help remarket the 737s, which, according to a September 16 press release, were available immediately. Many of the 47 leased 737s will come off lease this year or in 2009, so the retirement schedule looks feasible.

Despite the significant ASM reduction, United expects its mainline ex-fuel CASM to increase by only 1.5-2.5% in 2008, which is essentially the same as the guidance given in January when the airline expected its mainline capacity to be merely flat this year. This is a result of the expanded cost-reduction programme, which now anticipates $500m cost savings in 2008. Future targets will include maintenance costs, catering costs, salaries and wages (particularly in overhead functions), feeder service, efficiency improvements with partners and distribution and sales costs.

Reports from different US airlines indicate that product unbundling and ancillary activities are turning out to be a surprisingly lucrative revenue source. UAL has been at the forefront of pursuing the so-called "other" revenues. The management calls such activities a "very large opportunity", capable of producing over $1bn in annual revenue.

United's efforts have focused on three areas. First, like its peers, it has been increasing existing ticketing, change and excess baggage fees. Second, United is creating new revenue streams by charging for a la carte service, such as checked bags, within North America. United led the industry with a $25 second-bag charge in the spring; all the legacy carriers followed. In June United followed American in adding a $15 charge for the first checked bag. In mid-September United doubled the second-bag fee to $50. The bag fees alone represent $300m of additional revenue in 2009.

Third, United has introduced what it calls "travel enhancement products". These include the "Economy Plus" and premium cabin up-sell programmes, which are expected to generate $275m of revenue in 2009, and new products like "Award Accelerator", which are expected to generate $100m of revenue next year. Award Accelerator, the most recent addition, enables customers to spend a little extra to double or triple their frequent-flyer miles; the first month brought in 20,000 sales or $1.5m of revenue.

All in all, United is expecting more than $1bn in merchandising, up-sell and fee revenue in 2009, which would represent a $700m increase over the 2007 total.

Alliance plans

UAL's post-Chapter 11 strategy has focused on finding a merger partner. But all of those efforts have failed, most recently the promising-sounding talks with US Airways that UAL abruptly terminated at the end of May. Instead, in late June UAL settled on a close marketing alliance with Continental, with whom it had explored a merger in April before Continental opted not to merge with anyone.

But UAL may yet have the last laugh, particularly if it manages to take the UA/CO alliance beyond a traditional partnership or, of course, if Delta and Northwest run into serious integration problems. Mergers are full of potential pitfalls and the bulk of the benefits can probably be achieved through an alliance.

The UA/CO alliance will include broad domestic and international bilateral codesharing, linkage of FFPs, Continental joining the Star alliance, establishing a four-carrier immu-

nised transatlantic joint venture that would also include Lufthansa and Air Canada (along the lines of the SkyTeam JV) and "developing plans for cost and other synergies that are not dependent on antirust immunity".

On the negative side, this alliance will be a long time coming. It will not kick in until late 2009, at the earliest, because of complex contractual issues. First the Delta/Northwest merger has to close, so that Northwest loses its veto powers over transactions involving Continental. Continental then has to extract itself from its current alliance contracts with Delta, Northwest and SkyTeam - the principal contractual restriction will apparently not terminate until nine months after the closure of DL/NW. UAL and Continental will need to get antitrust immunity and government approvals for their alliance. And Continental has (wisely) indicated that it intends to transition out of SkyTeam and into Star "in a customer friendly manner".

On the positive side, the prospects for DL/NW closing and UA/CO gaining antitrust immunity and regulatory approvals appear good, given recent precedents. Continental's and United's networks are highly complementary, with little overlap, so they add value to each other and to customers. And the potential is there to create an absolutely powerful global alliance. Continental's inclusion will make Star bigger than SkyTeam on transatlantic, accounting for almost one third of the US-EU market.

The airlines have said that their earlier merger discussions enabled them to identify efficiency opportunities that go well beyond those typical in a traditional alliance. In particular, there is enthusiasm about potential opportunities in IT, procurement, airport facilities and joint purchasing. Also, JVs similar to the one outlined for the transatlantic are planned for the Latin America and Asia/Pacific regions.

Prospects

Like the other US legacies, UAL is headed for a significant financial loss in 2008. The current consensus estimate (September 25) is a net loss before special items of $10.92 per share or around $1.37bn. However, a substantial improvement is anticipated next year, thanks to lower fuel prices and the impact of the capacity cuts and other measures implemented this autumn. The current consensus estimate for 2009 is a loss of $2.06 per share or $260m, though the range of individual analysts' forecasts is rather wide: from a profit of $4.48 per share to a loss of $9.58 per share. It all depends on fuel and economic trends, both of which are shrouded in uncertainty.

In addition to restoring profitability, United has another near-term imperative: turning around its operational performance, which has lagged seriously and is critical for retaining business passengers. In the 12 months to May 31 United ranked fifth among the six major network carriers in the DOT's on-time rankings. The airline is now tackling the problem through measures such as adding ground and gate rest time at hubs and increasing spare aircraft from 2.5% to 5% of the scheduled fleet.

UAL's current strategy is to target capital investments and resources on "projects that drive margins and improve customer experience". This means spending on the product rather than ordering aircraft. Much of the focus is on the new premium product being introduced on the 777s and 747s over the next two years; so far, 11 aircraft have been reconfigured to include the new "United First Suite" and full lie-flat seats in business class, and the product was brought to the Pacific market in August.

Orders for new long-range aircraft such as the 787 or the A350 are obviously long overdue, but UAL will not place them until it is making money - remarkable discipline that it shares with AMR and some other US carriers. But nor has UAL taken up its right (under a deal dating back from Chapter 11) to cancel any of its $2.2bn of A319 and A320 orders, despite stating in a July SEC filing that it was "highly unlikely" to take future delivery of those aircraft. Perhaps those orders could be converted for the A350?

Longer-term challenges include potential for labour disputes. Labour-management relations at UAL appear acrimonious enough to potentially inflict serious financial damage and, among other things, reduce flexibility to seek mergers in the future.

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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
Air France/ KLM Group YE 31/03	**Year 2006/07**	**30,773**	**29,129**	**1,644**	**1183**	**5.3%**	**3.8%**	**245,066**	**199,510**	**81.4%**	**73,484**
	Apr-Jun 07	8,011	7,486	724	566	9.0%	7.1%	63,376	51,567	81.4%	19,325
	Jul-Sep 07	9,183	7,855	1,328	1041	14.5%	11.3%	67,375	57,009	84.6%	20,448
	Oct-Dec 07	8,678	8,202	476	207	5.5%	2.4%	62,615	49,591	79.2%	17,868
	Jan-Mar 08	8,543	8,612	-69	-810	-0.8%	-9.5%	62,948	49,060	77.9%	17,154
	Year 2007/08	**34,173**	**32,182**	**1,991**	**1,087**	**5.8%**	**3.2%**	**256,314**	**207,227**	**80.8%**	**74,795**
	Apr-Jun 08	9,830	9,464	366	266	3.7%	2.7%	66,610	53,472	80.3%	19,744
BA YE 31/03	Jul-Sep 06	4,331	4,080	251	315	5.8%	7.3%	38,727	30,872	79.7%	9,935
	Oct-Dec 06	4,051	3,798	253	210	6.2%	5.2%	36,563	27,073	74.0%	7,878
	Jan-Mar 07	3,792	3,731	61	-140	1.6%	-3.7%	36,405	26,003	71.4%	7,269
	Year 2006/07	**16,149**	**15,004**	**1,145**	**578**	**7.1%**	**3.6%**	**148,321**	**112,851**	**76.1%**	**33,068**
	Apr-Jun 07	4,395	3,868	527	539	12.0%	12.3%	37,514	28,836	76.9%	8,648
	Jul-Sep 07	4,729	4,118	611	458	12.9%	9.7%	38,191	30,500	79.9%	9,206
	Oct-Dec 07	4,142	3,774	368	247	8.9%	6.0%	37,122	27,531	74.2%	7,913
	Jan-Mar 08	4,049	3,824	225	133	5.6%	3.3%	36,745	26,149	71.2%	7,394
	Year 2007/08	**17,315**	**15,584**	**1,731**	**1,377**	**10.0%**	**8.0%**	**149,572**	**113,016**	**75.6%**	**33,161**
	Apr-Jun 08	4,455	4,386	69	53	1.5%	1.2%	37,815	27,757	73.4%	8,327
Iberia YE 31/12	Jul-Sep 06	1,825	1,700	125	96	6.8%	5.3%	16,846	14,065	83.5%	7,354
	Oct-Dec 06	1,811	1,750	61	-12	3.4%	-0.7%	16,458	13,132	79.8%	6,682
	Year 2006	**6,545**	**6,391**	**154**	**72**	**2.4%**	**1.1%**	**65,802**	**52,493**	**79.8%**	**27,799**
	Jan-Mar 07	1,745	1,734	16	16	0.9%	0.9%	16,104	12,798	79.5%	6,318
	Apr-Jun 07	1,829	1,752	75	83	4.1%	4.5%	16,458	13,307	80.9%	6,863
	Jul-Sep 07	2,080	1,882	198	211	9.5%	10.1%	17,119	14,653	85.6%	7,216
	Oct-Dec 07	1,963	1,681	279	140	14.2%	7.1%	16,773	13,471	80.3%	6,463
	Year 2007	**7,617**	**7,049**	**568**	**450**	**7.5%**	**5.9%**	**66,454**	**54,229**	**81.6%**	**26,860**
	Jan-Mar 08	1,948	1,990	-42	-661	-2.2%	-33.9%	16,360	12,990	79.4%	
	Apr-Jun 08	2,142	2,148	-6	33	-0.3%	1.5%	16,771	13,372	79.7%	
Lufthansa YE 31/12	Jul-Sep 06	6,765	6,188	577	461	8.5%	6.8%	39,225	30,627	78.1%	14,781
	Oct-Dec 06	6,316	6,062	254	529	4.0%	8.4%	36,204	27,056	74.7%	13,103
	Year 2006	**24,979**	**23,913**	**1,066**	**1,014**	**4.3%**	**4.1%**	**146,720**	**110,330**	**75.2%**	**53,432**
	Jan-Mar 07	6,258	6,184	74	593	1.2%	9.5%	35,028	26,109	74.5%	12,329
	Apr-Jun 07	7,267	6,506	761	663	10.5%	9.1%	39,573	30,544	77.2%	14,629
	Jul-Sep 07 *	8,960	8,004	956	843	10.7%	9.4%	48,662	39,112	80.4%	18,836
	Oct-Dec 07*	8,197	8,103	94	165	1.1%	2.0%	45,845	35,128	76.6%	17,106
	Year 2007	**30,682**	**28,797**	**1,885**	**2,264**	**6.1%**	**7.4%**	**169,108**	**130,893**	**77.4%**	**62,900**
	Jan-Mar 08*	8,368	8,086	282	85	3.4%	1.0%	45,131	34,828	77.2%	15,992
	Apr-Jun 08*	10,113	9,285	829	541	8.2%	5.3%	50,738	40,258	79.3%	18,488
SAS YE 31/12	Jul-Sep 06	2,476	2,318	158	83	6.4%	3.4%	14,468	11,059	76.4%	10,319
	Oct-Dec 06	2,215	2,121	94	679	4.2%	30.7%	13,672	9,343	68.3%	9,705
	Year 2006	**5,270**	**5,010**	**260**	**169**	**4.9%**	**3.2%**	**54,907**	**39,247**	**71.5%**	**39,059**
	Jan-Mar 07	1,978	2,025	-47	-7	-2.4%	-0.4%	12,844	8,543	66.5%	9,088
	Apr-Jun 07	2,383	2,247	136	89	5.7%	3.7%	15,091	10,915	72.3%	11,045
	Jul-Sep 07	2,612	2,518	94	109	3.6%	4.2%	15,352	11,890	77.4%	11,031
	Oct-Dec 07	2,041	2,039	2	-96	0.1%	-4.7%	14,263	9,701	68.0%	9,923
	Year 2007	**5,969**	**5,676**	**293**	**259**	**4.9%**	**4.3%**	**57,551**	**41,048**	**71.3%**	**41,087**
	Jan-Mar 08	2,046	2,185	-139	-181	-6.8%	-8.8%	10,669	7,235	67.8%	7,277
	Apr-Jun 08	2,959	2,968	-9	-69	-0.3%	-2.3%	16,465	11,851	72.0%	11,622
Ryanair YE 31/03	Jul-Sep 06	864	553	313	268	36.2%	31.0%				11,481
	Oct-Dec 06	651	575	76	63	11.7%	9.7%			82.0%	10,300
	Jan-Mar 07	661	611	48	41	7.3%	6.2%				10,019
	Year 2006/07	**2,887**	**2,278**	**609**	**518**	**21.1%**	**17.9%**	**48,924**	**40,118**	**82.0%**	**42,500**
	Apr-Jun 07	934	722	212	187	22.7%	20.0%			82.0%	12,600
	Jul-Sep 07	1,229	795	434	384	35.3%	31.2%			86.0%	13,952
	Oct-Dec 07	824	760	64	68	7.7%	8.3%				
	Jan-Mar 08	859	808	51	-85	6.0%	-9.9%				
	Year 2007/08	**3,846**	**3,085**	**761**	**554**	**19.8%**	**14.4%**			**82.0%**	**50,900**
	Apr-Jun 08	1,215	1,202	13	-141	1.0%	-11.6%			81.0%	15,000
easyJet YE 30/09	Year 2004/05	2,478	2,356	122	109	4.9%	4.4%	32,141	27,448	85.2%	29,600
	Oct 05-Mar 06	1,095	1,177	-82	-50	-7.5%	-4.6%	16,672	13,642	81.8%	14,900
	Year 2005/06	**2,917**	**2,705**	**212**	**170**	**7.3%**	**5.8%**	**37,088**	**31,621**	**84.8%**	**33,000**
	Oct 06-Mar 07	1,411	1,333	-47	-25	-3.3%	-1.8%	19,108	15,790	81.2%	16,400
	Year 2006/07	**3,679**	**3,069**	**610**	**311**	**16.6%**	**8.5%**	**43,501**	**36,976**	**83.7%**	**37,200**
	Oct 07-Mar 08	1,795	1,772	22	-87	1.2%	-4.8%	23,442	19,300	82.3%	18,900

Note: *Lufthansa group including SWISS. Annual figures may not add up to sum of interim results due to adjustments and consolidation.

		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	Jan-Mar 07	759	778	-18	-10	-2.4%	-1.3%	10,652	7,552	71.0%	5,471	13,236
	Apr-Jun 07	904	827	78	46	8.6%	5.1%	10,448	8,196	78.5%	5,329	9,748
	Jul-Sep 07	995	852	143	86	14.4%	8.6%	10,225	8,154	79.7%	4,878	9,753
	Oct-Dec 07	747	730	17	7	2.3%	0.9%	9,688	7,239	74.7%	4,191	9,672
	Year 2007	**3,506**	**3,294**	**212**	**125**	**6.0%**	**3.6%**	**45,359**	**34,389**	**75.8%**	**25,110**	**13,485**
	Jan-Mar 08*	840	889	-50	-36	-5.9%	-4.3%	9,791	7,284	74.4%	4,080	9,881
	Apr-Jun 08*	931	824	107	63	11.4%	6.8%	10,039	7,841	78.1%	4,425	9,880
American	Jan-Mar 07	5,427	5,179	248	81	4.6%	1.5%	72,362	56,063	77.5%	23,299	85,100
	Apr-Jun 07	5,879	5,412	467	317	7.9%	5.4%	68,632	57,402	83.6%	25,301	85,500
	Jul-Sep 07	5,946	5,627	319	175	5.4%	2.9%	69,636	58,401	83.9%	25,448	85,800
	Oct-Dec 07	5,683	5,752	-69	-69	-1.2%	-1.2%	73,408	58,416	79.5%	24,080	85,800
	Year 2007	**22,935**	**21,970**	**965**	**504**	**4.2%**	**2.2%**	**273,307**	**222,719**	**81.5%**	**98,160**	**85,800**
	Jan-Mar 08	5,697	5,884	-187	-328	-3.3%	-5.8%	66,065	52,283	79.1%	23,048	85,500
	Apr-Jun 08	6,179	7,469	-1,290	-1,448	-20.9%	-23.4%	67,137	55,358	82.5%	24,278	85,700
Continental	Jan-Mar 07	3,179	3,115	64	22	2.0%	0.7%	43,853	34,519	78.7%	16,176	
	Apr-Jun 07	3,710	3,447	263	228	7.1%	6.1%	47,622	39,626	83.2%	18,120	45,000
	Jul-Sep 07	3,820	3,540	280	241	7.3%	6.3%	48,836	40,912	83.8%	17,901	
	Oct-Dec 07	3,523	3,443	80	71	2.3%	2.0%	45,947	36,483	79.4%	16,732	
	Year 2007	**14,232**	**13,545**	**687**	**459**	**4.8%**	**3.2%**	**165,951**	**135,655**	**81.7%**	**50,960**	**45,000**
	Jan-Mar 08	3,570	3,636	-66	-80	-1.8%	-2.2%	45,665	35,855	78.5%	16,440	
	Apr-Jun 08	4,044	4,115	-71	-3	-1.8%	-0.1%	48,895	39,824	81.4%	17,962	46,000
Delta	Jan-Mar 07	4,144	3,989	155	-130	3.7%	-3.1%	56,774	43,794	77.1%	25,325	52,260
	Apr-Jun 07	5,003	4,513	490	1,592	nm	nm	61,358	50,818	82.8%	28,305	55,542
	Jul-Sep 07	5,227	4,774	453	220	8.7%	4.2%	65,889	54,774	83.1%	28,987	55,022
	Oct-Dec 07	4,683	4,685	-2	-70	0.0%	-1.5%	60,210	47,052	78.1%	26,499	55,044
	Year 2007* **	**19,154**	**18,058**	**1,096**	**1,612**	**5.7%**	**8.4%**	**244,187**	**196,403**	**80.4%**	**109,180**	**54,467**
	Jan-Mar 08	4,766	11,027	-6,261	-6,390	-131.4%	-134.1%	58,083	45,390	78.1%	25,586	55,382
	Apr-Jun 08	5,499	6,586	-1,087	-1,044	-19.8%	-19.0%	62,338	51,931	83.3%	27,459	55,397
Northwest	Jan-Mar 07	2,873	2,672	201	-292	7.0%	-10.2%	36,845	29,964	81.3%	15,600	30,008
	Apr-Jun 07**	3,181	2,824	357	2,149	nm	nm	38,070	32,495	85.9%	17,400	29,589
	Jul-Sep 07	3,378	2,919	459	244	13.6%	7.2%	38,445	33,222	86.4%	17,300	29,579
	Oct-Dec 07	3,096	3,009	87	-8	2.8%	-0.3%	36,836	30,361	82.4%	16,100	30,306
	Year 2007****	**12,528**	**11,424**	**1104**	**2,093**	**8.8%**	**16.7%**	**138,603**	**117,335**	**84.7%**	**53,680**	**29,871**
	Jan-Mar 08	3,127	7,180	-4,053	-4,139	-129.6%	-132.4%	37,592	30,921	82.3%	15,874	30,053
	Apr-Jun 08	3,576	3,876	-300	-377	-8.4%	-10.5%	39,458	33,557	85.0%	17,500	29,295
Southwest	Jan-Mar 07	2,198	2,114	84	93	3.8%	4.2%	38,105	25,924	68.0%	19,960	33,195
	Apr-Jun 07	2,583	2,255	328	278	12.7%	10.8%	40,204	30,606	76.1%	23,442	33,261
	Jul-Sep 07	2,588	2,337	251	162	9.7%	6.3%	41,385	31,680	76.5%	23,533	33,787
	Oct-Dec 07	2,492	2,366	126	111	5.1%	4.5%	40,649	28,171	69.3%	24,876	34,378
	Year 2007	**9,861**	**9,070**	**791**	**645**	**8.0%**	**6.5%**	**160,314**	**116,361**	**72.6%**	**88,710**	**33,655**
	Jan-Mar 08	2,530	2,442	88	34	3.5%	1.3%	40,454	28,311	69.8%	21,505	33,895
	Apr-Jun 08	2,869	2,664	205	321	7.1%	11.2%	42,381	31,882	75.2%	23,993	34,027
United	Jan-Mar 07	4,373	4,465	-92	-152	-2.1%	-3.5%	61,900	49,415	79.8%	16,350	51,500
	Apr-Jun 07	5,213	4,676	537	274	10.3%	5.3%	64,451	55,049	85.4%	18,190	51,400
	Jul-Sep 07	5,527	4,871	656	334	11.9%	6.0%	65,547	55,089	84.0%	17,804	51,800
	Oct-Dec 07	5,030	5,094	-64	-53	-1.3%	-1.1%	62,679	49,732	79.3%	16,042	51,700
	Year 2007	**20,143**	**19,106**	**1,037**	**403**	**5.1%**	**2.0%**	**228,200**	**188,857**	**82.8%**	**68,630**	**55,000**
	Jan-Mar 08	4,711	5,152	-441	-537	**-9.4%**	-11.4%	61,812	47,854	77.4%	15,250	52,500
	Apr-Jun 08	5,371	8,065	-2,694	-2,729	-50.2%	-50.8%	63,600	52,433	82.4%	16,994	51,100
US Airways Grp.	Jan-Mar 07	2,732	2,616	116	66	4.2%	2.4%	35,411	27,039	76.4%	19,935	36,000
	Apr-Jun 07	3,155	2,866	289	263	9.2%	8.3%	37,144	30,631	82.5%	22,232	35,485
	Jul-Sep 07	3,036	2,834	202	177	6.7%	5.8%	31,653	26,385	83.4%	14,965	34,321
	Oct-Dec 07	2,776	2,850	-74	-79	-2.7%	-2.8%	34,859	26,812	76.9%	19,828	
	Year 2007	**11,700**	**11,167**	**533**	**427**	**4.6%**	**3.6%**	**127,344**	**102,248**	**80.3%**	**66,060**	
	Jan-Mar 08	2,840	3,036	-196	-236	-6.9%	-8.3%	35,298	27,316	77.4%	19,731	34,684
	Apr-Jun 08	3,257	3,793	-536	-567	-16.5%	-17.4%	37,465	30,736	82.0%	21,481	34,359
JetBlue	Jan-Mar 07	608	621	-13	-22	-2.1%	-3.6%	11,861	9,562	80.6%	5,091	9,260
	Apr-Jun 07	730	657	73	21	10.0%	2.9%	12,981	10,840	83.5%	5,587	9,421
	Jul-Sep 07	765	686	79	23	10.3%	3.0%	13,446	11,020	82.0%	5,528	9,301
	Oct-Dec 07	739	709	30	-4	4.1%	-0.5%	13,056	9,995	76.6%	5,181	9,909
	Year 2007	**2,842**	**2,673**	**169**	**18**	**5.9%**	**0.6%**	**51,334**	**41,411**	**80.7%**	**21,390**	**9,473**
	Jan-Mar 08	816	799	17	-8	2.1%	-1.0%	13,510	10,562	78.2%	5,518	10,165
	Apr-Jun 08	859	838	21	-7	2.4%	-0.8%	13,491	10,872	80.6%	5,637	9,547

Notes: 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. *Mainline stats for ASKs, RPKs, pax. and employees. ** = April to May Predecessor Company, June Successor Company; ***= Net result includes net reorganisation items of $1,215m. **** = Unaudited results Successor Company. Net result includes net reorganisation items of $1,551m.

		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
ANA	**Year 2003/04**	**11,529**	**11,204**	**325**	**234**	**2.8%**	**2.0%**	**87,772**	**55,807**	**63.6%**
YE 31/03	**Year 2004/05**	**12,024**	**11,301**	**723**	**251**	**6.0%**	**2.1%**	**85,838**	**55,807**	**65.0%**
	Year 2005/06	**12,040**	**11,259**	**781**	**235**	**6.5%**	**2.0%**	**86,933**	**58,949**	**67.8%**
	Year 2006/07	**12,763**	**11,973**	**790**	**280**	**6.2%**	**2.2%**	**85,728**	**58,456**	**68.2%**
	Year 2007/08	**13,063**	**12,322**	**740**	**563**	**5.7%**	**4.3%**	**90,936**	**61,219**	**67.3%**
Cathay Pacific	**Year 2004**	**5,024**	**4,350**	**674**	**581**	**13.4%**	**11.6%**	**74,062**	**57,283**	**77.3%**
YE 31/12	Jan-Jun 05	3,074	2,799	275	225	8.9%	7.3%	39,535	30,877	78.1%
	Year 2005	**6,548**	**6,015**	**533**	**424**	**8.1%**	**6.5%**	**82,766**	**65,110**	**78.7%**
	Jan-Jun 06	3,473	3,201	272	225	7.8%	6.5%	43,814	34,657	79.1%
	Year 2006	**7,824**	**7,274**	**550**	**526**	**7.0%**	**6.7%**	**89,117**	**71,171**	**79.9%**
	Jan-Jun 07	4,440	4,031	409	341	9.2%	7.7%	49,836	38,938	79.6%
	Year 2007	**9,661**	**8,670**	**991**	**900**	**10.3%**	**9.3%**	**102,462**	**81,101**	**79.8%**
	Jan-Jun 08	5,443	5,461	-18	-71	-0.3%	-1.3%	56,949	45,559	80.0%
JAL	**Year 2003/04**	**18,398**	**19,042**	**-644**	**-844**	**-3.5%**	**-4.6%**	**145,900**	**93,847**	**64.3%**
YE 31/03	**Year 2004/05**	**19,905**	**19,381**	**524**	**281**	**2.6%**	**1.4%**	**151,902**	**102,354**	**67.4%**
	Year 2005/06	**19,346**	**19,582**	**-236**	**-416**	**-1.2%**	**-2.2%**	**148,591**	**100,345**	**67.5%**
	Year 2006/07	**19,723**	**19,527**	**196**	**-139**	**1.0%**	**-0.7%**	**139,851**	**95,786**	**68.5%**
	Year 2007/08	**19,583**	**18,793**	**790**	**148**	**4.0%**	**0.8%**	**134,214**	**92,173**	**68.7%**
Korean Air	**Year 2003**	**5,172**	**4,911**	**261**	**-202**	**5.0%**	**-3.9%**	**59,074**	**40,507**	**68.6%**
YE 31/12	**Year 2004**	**6,332**	**5,994**	**338**	**414**	**5.3%**	**6.5%**	**64,533**	**45,879**	**71.1%**
	Year 2005	**7,439**	**7,016**	**423**	**198**	**5.7%**	**2.7%**	**66,658**	**49,046**	**71.4%**
	Year 2006	**8,498**	**7,975**	**523**	**363**	**6.2%**	**4.3%**	**71,895**	**52,178**	**72.6%**
	Year 2007	**9,496**	**8,809**	**687**	**12**	**7.2%**	**0.1%**	**76,181**	**55,354**	**72.7%**
Malaysian	**Year 2003/04**	**3,061**	**3,012**	**49**	**86**	**1.6%**	**2.8%**	**55,692**	**37,659**	**67.6%**
YE 31/03	**Year 2004/05**	**3,141**	**3,555**	**-414**	**-421**	**-13.2%**	**-13.4%**	**64,115**	**44,226**	**69.0%**
Apr-Dec 05	2005	2,428	2,760	-332	-331	-13.7%	-13.6%	49,786	35,597	71.5%
YE 31/12	**2006**	**3,696**	**3,751**	**-55**	**-37**	**-1.5%**	**-1.0%**	**58,924**	**41,129**	**69.8%**
YE 31/12	**2007**	**4,464**	**4,208**	**256**	**248**	**5.7%**	**5.6%**	**56,104**	**40,096**	**71.5%**
Qantas	Jul-Dec 04	5,017	4,493	524	358	10.4%	7.1%	57,402	43,907	76.5%
YE 30/06	**Year 2004/05**	**9,524**	**8,679**	**845**	**575**	**8.9%**	**6.0%**	**114,003**	**86,986**	**76.3%**
	Jul-Dec 05	4,999	4,626	373	258	7.5%	5.2%	59,074	45,794	77.5%
	Year 2005/06	**10,186**	**8,711**	**1,475**	**542**	**14.5%**	**5.3%**	**118,070**	**90,899**	**77.0%**
	Jul-Dec 06	6,099	5,588	511	283	8.4%	4.6%	61,272	49,160	80.2%
	Year 2006/07	**11,975**	**11,106**	**869**	**568**	**7.3%**	**4.7%**	**122,119**	**97,622**	**79.9%**
	Jul-Dec 07	7,061	6,323	738	537	10.5%	7.6%	63,627	52,261	82.1%
	Year 2007/08	**14,515**	**13,283**	**1,232**	**869**	**8.5%**	**6.0%**	**127,019**	**102,466**	**80.7%**
Singapore	**Year 2003/04**	**5,732**	**5,332**	**400**	**525**	**7.0%**	**9.2%**	**88,253**	**64,685**	**73.3%**
YE 31/03	**Year 2004/05**	**7,276**	**6,455**	**821**	**841**	**11.3%**	**11.6%**	**104,662**	**77,594**	**74.1%**
	Year 2005/06	**6,201**	**5,809**	**392**	**449**	**6.3%**	**7.2%**	**109,484**	**82,742**	**75.6%**
	Year 2006/07	**9,555**	**8,688**	**866**	**1,403**	**9.1%**	**14.7%**	**112,544**	**89,149**	**79.2%**
	Year 2007/08	**10,831**	**9,390**	**1,441**	**1,449**	**13.3%**	**13.4%**	**113,919**	**91,485**	**80.3%**
Air China	**Year 2004**	**4,050**	**3,508**	**542**	**288**	**13.4%**	**7.1%**	**64,894**	**46,644**	**71.9%**
YE 31/12	**Year 2005**	**4,681**	**4,232**	**449**	**294**	**9.6%**	**6.3%**	**70,670**	**52,453**	**74.2%**
	Year 2006	**5,647**	**5,331**	**316**	**338**	**5.6%**	**6.0%**	**79,383**	**60,276**	**75.9%**
	Year 2007	**6,770**	**6,264**	**506**	**558**	**7.5%**	**8.2%**	**85,257**	**66,986**	**78.6%**
China Southern	**Year 2004**	**2,897**	**2,787**	**110**	**19**	**3.8%**	**0.7%**	**53,769**	**37,196**	**69.2%**
YE 31/12	**Year 2005**	**4,682**	**4,842**	**-160**	**-226**	**-3.4%**	**-4.8%**	**88,361**	**61,923**	**70.1%**
	Year 2006	**5,808**	**5,769**	**39**	**26**	**0.7%**	**0.4%**	**97,044**	**69,575**	**71.7%**
	Year 2007	**7,188**	**6,974**	**214**	**272**	**3.0%**	**3.8%**	**109,733**	**81,172**	**74.0%**
China Eastern	**Year 2004**	**2,584**	**2,524**	**60**	**39**	**2.3%**	**1.5%**	**41,599**	**27,581**	**66.3%**
YE 31/12	**Year 2005**	**3,356**	**3,372**	**-16**	**-57**	**-0.5%**	**-1.7%**	**52,428**	**36,381**	**69.4%**
	Year 2006	**3,825**	**4,201**	**-376**	**-416**	**-9.8%**	**-10.9%**	**70,428**	**50,243**	**71.3%**
	Year 2007	**5,608**	**5,603**	**5**	**32**	**0.1%**	**0.6%**	**77,713**	**57,180**	**73.6%**
Air Asia	**Year 2004/05**	**152**	**122**	**30**	**25**	**19.7%**	**16.4%**	**6,525**	**4,881**	**74.8%**
YE 30/06	**Year 2005/06**	**230**	**172**	**57**	**34**	**25.0%**	**14.8%**	**8,646**	**6,702**	**77.5%**
	Year 2006/07	**453**	**325**	**128**	**141**	**28.3%**	**31.1%**	**12,391**	**9,863**	**79.6%**
	Jul-Sep 07	134	91	42	52	31.6%	39.0%	3,645	2,707	74.3%
	Oct-Dec 07	189	122	67	73	35.4%	38.9%	4,274	3,223	75.4%
	Jan-Mar 08	166	126	40	50	24.1%	30.1%	4,364	2,970	68.1%
	Apr-Jun 08	190	142	48	3	25.3%	1.5%	4,514	3,286	72.8%

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

EUROPEAN SCHEDULED TRAFFIC

	Intra-Europe			North Atlantic			Europe-Far East			Total long-haul			Total Int'l	
	ASK	RPK	LF	ASK	RPK	LF	ASK	RPK	LF	ASK	RPK	LF	ASK	RPK
	bn	bn	%	bn	bn	%	bn	bn	%	bn	bn	%	bn	bn
2000	208.2	132.8	63.8	229.9	179.4	78.1	137.8	108.0	78.3	508.9	396.5	77.9	755.0	555.2
2001	212.9	133.4	62.7	217.6	161.3	74.1	131.7	100.9	76.6	492.2	372.6	75.7	743.3	530.5
2002	197.2	129.3	65.6	181.0	144.4	79.8	129.1	104.4	80.9	447.8	355.1	79.3	679.2	507.7
2003	210.7	136.7	64.9	215.0	171.3	79.7	131.7	101.2	76.8	497.2	390.8	78.6	742.6	551.3
2004	220.6	144.2	65.4	224.0	182.9	81.6	153.6	119.9	78.0	535.2	428.7	80.1	795.7	600.7
2005	309.3	207.7	67.2	225.9	186.6	82.6	168.6	134.4	79.7	562.6	456.4	81.1	830.8	639.3
2006	329.9	226.6	68.7	230.5	188.0	81.5	182.7	147.5	80.7	588.2	478.4	81.3	874.6	677.3
2007	346.6	239.9	69.2	241.4	196.1	81.2	184.2	152.1	82.6	610.6	500.4	81.9	915.2	713.9
Jul-08	32.3	23.9	73.9	23.9	20.1	84.2	16.6	13.5	81.5	57.2	47.8	83.5	86.5	69.8
Ann. change	1.2%	-1.2%	-1.9	1.8%	0.0%	-1.5	4.5%	1.1%	-2.8	4.5%	2.0%	-2.0	4.2%	2.0%
Jan-Jul 08	209.0	141.6	67.8	142.9	113.9	79.7	111.2	88.7	79.7	369.8	294.8	79.7	557.4	423.9
Ann. change	3.7%	2.8%	-0.6	2.9%	1.1%	-1.5	3.9%	1.5%	-1.9	5.1%	2.6%	-1.9	5.4%	3.5%

Source: AEA

EIGHT LARGEST US PASSENGER AIRLINES' SCHEDULED TRAFFIC

	Domestic			Atlantic			Pacific			Latin America			Total Int'l		
	ASK	RPK	LF	ASK	RPK	LF	ASK	RPK	LF	ASK	RPK	LF	ASK	RPK	LF
	bn	bn	%	bn	bn	%	bn	bn	%	bn	bn	%	bn	bn	%
2005	**225.1**	**172.2**	**77.8**	**41.9**	**33.2**	**82.1**	**27.4**	**22.3**	**82.7**	**24.2**	**17.2**	**72.7**	**93.5**	**72.7**	**79.8**
2006 Q1	219.2	169.3	77.2	39.6	29.7	75.0	26.1	21.7	83.2	28.2	21.1	74.8	93.9	72.5	77.2
Q2	228.1	188.3	82.6	49.7	42.1	84.7	28.2	23.9	84.7	26.3	20.4	77.6	104.2	86.4	82.9
Q3	232.2	187.9	80.9	54.0	45.3	83.9	28.7	24.4	85.0	26.3	20.4	77.6	109.0	90.1	82.7
Q4	223.2	174.3	78.1	46.0	36.1	78.5	27.8	22.8	81.9	25.8	19.2	74.2	99.6	78.1	78.4
2006	**902.7**	**719.7**	**79.7**	**189.2**	**153.2**	**81.0**	**110.8**	**92.8**	**83.7**	**106.6**	**81.1**	**75.7**	**406.7**	**327.1**	**80.4**
2007 Q1	217.4	169.6	77.5	42.9	32.5	75.5	27.0	22.5	83.4	29.5	22.7	76.8	99.4	77.7	78.2
Q2	226.6	189.9	83.8	53.7	44.9	83.6	28.1	23.5	83.8	27.1	20.8	76.8	108.9	89.2	81.9
Q3	229.9	191.8	83.4	59.6	49.9	83.8	28.9	24.7	85.2	26.2	21.1	80.8	114.7	95.7	83.4
Q4	221.3	172.8	78.1	51.3	40.9	79.7	28.3	22.8	80.7	26.1	20.2	77.4	105.7	83.9	79.4
2007	**896.9**	**724.2**	**80.7**	**207.6**	**168.2**	**81.0**	**112.3**	**93.5**	**83.3**	**109.0**	**84.9**	**77.9**	**428.7**	**346.5**	**80.8**

Note: *Legacy airlines plus Alaska and Southwest.*

JET ORDERS

	Date	Buyer	Order	Delivery/other information
Boeing				
	4 Sept	Saga A/L	2 x 737-800	plus 2 purchase rights
	29 Aug	SAS	1 x 737-800	
	29 Aug	Saga Airlines	2 x 737-800s	
	18 Aug	Egyptair	2 x 777-300ERs	
	8 Aug	American	26 x 737-800s	
	6 Aug	British Airways	2 x 777-300ERs	
	4 Aug	Azerbaijan Airlines	2 x 737-900ERs, 2 x 767-300ERs	
Airbus				
	30 Sept	Arik Air	3 x A340-500	
	4 Sept	CIT Aerospace	10 x A320 family	

Note: *Only firm orders from identifiable airlines/lessors are included.* **Source:** *Manufacturers.*

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