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LCC-within-a-Legacy concept revisited

Air Canada and Singapore Airlines have announced plans to establish wholly-owned LCC subsidiaries for long-haul leisure-oriented markets within a year. Are such ventures worth pursuing?

Air Canada disclosed on May 5, when announcing its first-quarter results, that it is looking to set up a Canada-based LCC that would eventually operate 50 aircraft (20 widebodies and 30 narrowbodies) serving leisure markets in Europe and sun destinations in the Caribbean (see Air Canada briefing, page 14).

Singapore Airlines announced in a statement on May 25 that it intended to establish a new "no-frills, low-fare airline operating widebody aircraft on medium and long-haul routes". The wholly-owned unit would be operated independently and managed separately from SIA.

There are similarities in these airlines' situations and LCC plans. Both Air Canada and SIA focus on premium traffic, saw a sharp deterioration in their financial fortunes in 2009, are seeing significant market share losses to LCCs, and are finding their growth opportunities limited by their higher cost levels.

The LCCs are intended to be growth vehicles. Air Canada's executives noted that the markets targeted for their venture (in Europe cities such as Amsterdam, Dublin, Casablanca, Nice, Lisbon and Manchester) "present strong opportunities that we can and should access based on our franchise but that we are leaving behind because of our high cost structure".

SIA's leadership declared: "We are seeing a new market segment being created and this will provide another growth opportunity for the SIA Group". This was a reference to the rapid growth of long-haul LCC competitors such as the Singapore-based unit of Qantas' Jetstar subsidiary and AirAsiaX, the longer-haul unit of Malaysia's AirAsia Bhd.

The LCC units are also defensive moves in the sense that both airlines have lost market share, including premium traffic, to lower-cost competitors (SIA especially in the past two years and Air Canada steadily over a longer period) and therefore are keener to grab any decent growth opportunities that come their way.

Despite their premium traffic focus, both companies like to have a complete platform to cater for all customer needs. Both have already dabbled with LCCs. Air Canada experimented with low-cost units called Tango and Zip almost a decade ago. SIA has a 33% stake in Singapore-based short-haul budget carrier Tiger Airways and owns regional carrier Silk Air.

Air Canada has said that it would like to get the LCC off the ground quickly because, partly due to the 787 delivery delays, it will have many years of virtually no growth.

Both ventures can be expected to be "capital-light". They will begin operations with aircraft transferred from the parent airlines, with longer-

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term fleets to be determined later.

Air Canada has disclosed that its LCC would pay lower wages and have different work rules, therefore requiring labour concessions. The airline has presented the plans to its unions, which all happen to have open contracts and are considering the LCC as part of their current contract negotiations.

The LCC plans have not been that well received in the financial community. The response from North America-based analysts to Air Canada's plans has been quite negative, reflecting the extremely poor track record of LCC subsidiaries operated by the region's legacies (Delta's Song, United's Ted, etc.) and concerns about industry capacity. But in both North America and Asia the plans are regarded as controversial for a number of reasons.

First, a high fuel cost environment is not the best time to launch LCCs, let alone long-haul LCCs. Higher fuel prices hit low-cost carriers harder, because fuel is a larger component of their operating costs and because their low-fare models typically offer less pricing flexibility.

Second, if the planned LCCs are growth vehicles, it implies capacity addition, as opposed to focusing on capacity discipline. In Air Canada's case, there is the added worry that it might add capacity in the off-peak, contributing to excess industry capacity on the transatlantic. However, such concerns may be unfounded if most of the aircraft are transferred from the mainline. Also, Air Canada has said that its LCC would grow gradually over a number of years.

Third, LCC units are risky ventures. Setting one up and doing it right is a complex undertaking, probably not for those aspiring healthy profit margins or ROIC in the short-to-medium term. It is inconceivable that US or European legacy carriers would take such risks these days, but they also do not have LCC competition in many long-haul markets. An airline like Air Canada may feel that it needs the LCC to achieve long-term viability.

Fourth, many of the past LCC units operated by legacy employees failed because of cost creep, or because they never reached their target cost levels in the first place. Air Canada has decided that it will not go ahead unless the LCC "is and has the ability to remain truly low cost over the longer term".

Fifth, one of the biggest concerns about legacy-operated LCC units everywhere is potential cannibalisation of mainline yields. Much will obviously depend on how carefully the markets are chosen.

Still, Qantas has been using its Jetstar unit very successfully to turn around loss-making leisure-oriented routes or to launch routes that Qantas could not have operated profitably. It has apparently not cannibalised any of Qantas' domestic business. Jetstar has also remained highly disciplined on the cost side, seeing no creep over time.

Jetstar has very much been the model for Air Canada in the design of its LCC, and the same may be the case with SIA's planned LCC. Jetstar's costs are as much as 40% below Qantas', and it is the fastest growing part of the group (see *Aviation Strategy* briefing, June 2010). Ironically, however, much like Air Canada, Qantas now needs to cut costs and in recent weeks has faced continued threats of industrial action.

Ryanair – to fly or to park?

At the publication last month of Ryanair's annual results for the year to end March 2011, CEO Michael O'Leary surprised some by stating that the company may ground up to 80 aircraft (or a third of the fleet) in the coming winter season; and that this could include all 50 of the new 737-800s that he states are scheduled for delivery between September and March 2012.

One major problem for any transport system is to cope with seasonality inherent in travel patterns; whether it is the intra-day peaks and troughs of commuter mass rapid transit systems or the effects on airline demand of the timings of summer holidays, school breaks, or major sporting and cultural events. The aim for the operator is to provide capacity that will capture the optimum revenues through the peaks while having to manage efficient provision of capacity in the troughs. All airlines follow this course with a variation in levels of flying in the two main IATA traffic seasons; working their aircraft hard in their summer seasons and reducing flying in the winter when maintenance can

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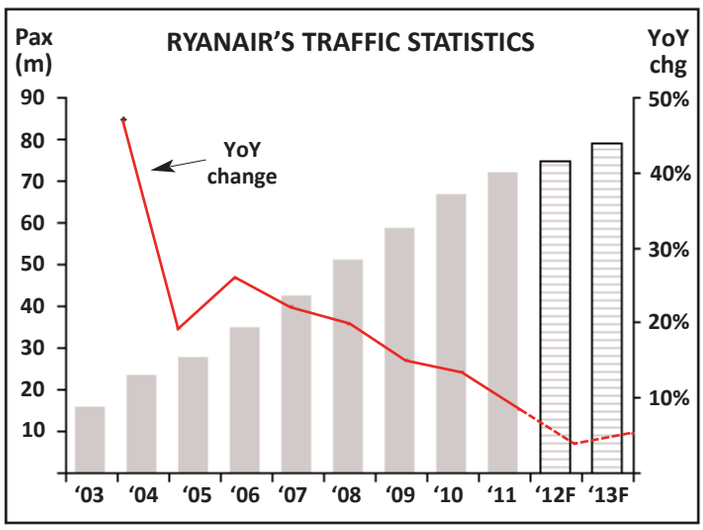
be scheduled efficiently. But there is a pervading tendency to consider that once you take delivery of an expensive aircraft you have to do something to ensure that you at least cover the cost of owning it, and in normal circumstances that means flying it. For most operators parking a new aircraft only appears attractive in extreme circumstances. The Ryanair model has turned many industry preconceptions on their heads; is this another one?

Ryanair has run a load-factor active, yield passive operation – maximising volumes by minimising price, with the aim of pushing average yield up over time. This it has done very successfully, even though it has often been accused of flying "from nowhere to nowhere". It has grown to become (according to IATA) the largest airline in the world by numbers of international passengers carried and has subsumed British Airways' former advertising claim to be the world's favourite airline (the world's favourite in international RPK terms is now Emirates). It is the largest individual carrier on intra-European services with around 12% of the market.

A second major element in its model is what the industry knows but still hates to admit - that an airline is a commodity business, at least on short/medium-hauls. Ryanair has deliberately set out to ensure that its unit cost of operation is the lowest possible (with the full understanding that in a commodity business the lowest cost producer will always win), has the most reliable service, best on-time performance and fewest misplaced bags. To help achieve this exceedingly low unit cost Ryanair benefits strongly from the exceptionally good aircraft purchase prices from its deals with Boeing at the beginning of the 2000s.

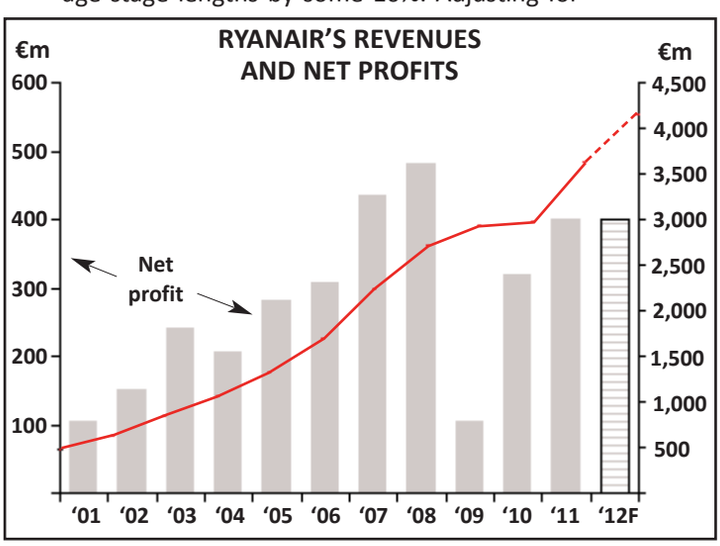
It also has an emphasis on young aircraft, with a policy to churn the older equipment as they reach eight years old, before expensive maintenance kicks in. The current average fleet age is only 3.2 years. On top of this the company emphasises the need for variable costing: among other things the cockpit and cabin crew are largely paid on an hours flown basis.

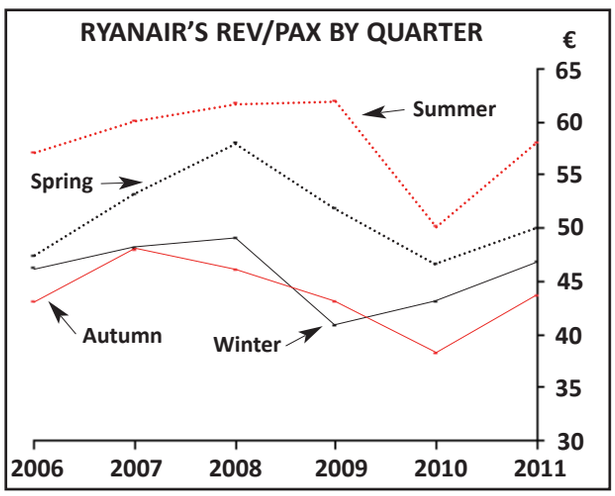
During last financial year (to March) the company acquired a net 40 new aircraft, opened eight new bases in Europe (and closed two) and initiated 328 new routes. The total numbers of passengers carried increased by 8% to 72.1m (and could possibly have been



1.5m higher except for the closure of European airspace due to the eruption of the Icelandic volcano (Ryanair at the time reported the numbers of passengers who had booked but not necessarily flown although non-flyers were not included in the annual totals). Average revenues per passenger improved by 12% year-on-year to €50.

The full year results appeared reasonably impressive. Total revenue grew by 21% and despite a 37% increase in fuel costs (to €1.2bn or 40% of total operating costs), underlying net profits jumped by 26% to €401m. Unit costs excluding fuel apparently grew by 2% year on year (mostly because of staff costs and navigation charges). But, responding to a call from the Canary Islands to provide services, Ryanair nimbly did so and partly as a result increased average stage lengths by some 10%. Adjusting for





this the company states that underlying adjusted unit costs actually fell by 7%.

The balance sheet meanwhile remains one of the healthiest in the industry. Capital expenditure in the year fell slightly to €900m and the company paid out a special dividend of €500m. At the end of March gross cash and cash equivalents on the balance sheet stood at €2.9bn (or 80% of the previous year's revenues) but on balance sheet debt had increased by €0.7bn to €3.7bn giving balance sheet net debt of €700m – or 25% of shareholders' funds.

During the year the company continued a process of concentrating capacity growth in the first half of the year – during which, even after accounting for the effects of the ash cloud, traffic grew by 12%. In the second half of the year, the company grounded some 40 aircraft and curtailed overall capacity growth.

In the fourth quarter (the three months to end March) total traffic grew by only 6% though load factors improved by a percentage point to 75.5%. Partly as a result of this but also with a higher stage length, average revenue per passenger increased by 15% year-on-year to €46.90, and despite fuel costs rising by 23% on a per seat basis, operating losses in the quarter halved to €29m, or €1.50 on a per seat basis.

This, however, emphasises the seasonality dilemma: how much can you really afford to lose in the off-season?

Taking into account Ryanair's fuel hedge positions (for 90% of its fuel requirement for the rest of the financial year to end March 2012 at around $820 a tonne of jet kerosene) and euro/dollar exchange rates, Ryanair's fuel cost per seat in the last three months of the current financial year could be around €19, up by 32% year on year, and about 50% of aircraft-related unit operating costs (and assuming no change in load factors a fuel cost per passenger of over €25 or 55% of the per passenger revenue achieved). Estimating non-fuel costs per seat to rise by a modest 2% would give total unit costs per seat of €43, which compared with an unchanged achieved passenger revenue per seat of €36 could result in an operating loss of up to €7 per seat flown. Even assuming a 12% increase in yields there could be a loss per seat for the quarter nearly double the previous year, while to break even in the quarter could require a minimum 20% increase in fares.

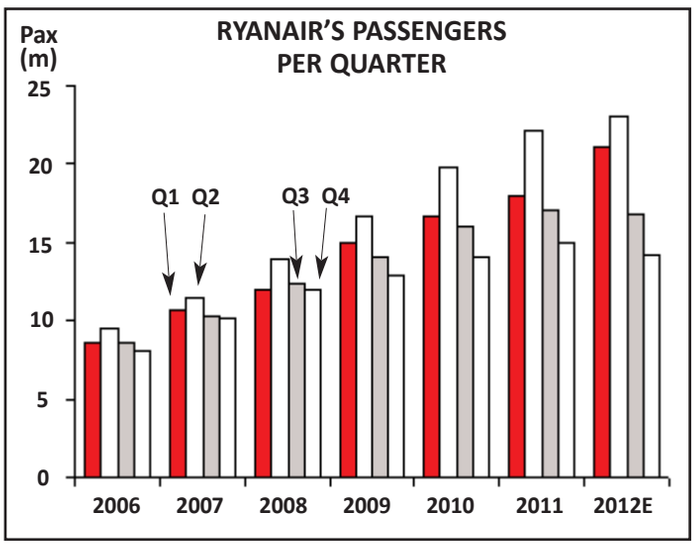
In the results' presentation the management highlighted current plans suggesting that total Ryanair traffic (and capacity) in the current financial year will rise by no more than 4% overall – accelerating the slowdown in overall growth that would naturally occur when the last of the Boeing orders are delivered in FY2013. This once again will be heavily weighted into the first half of the year with increases expected in the June and September quarters of 18% (or 9% excluding the effects of the ash cloud) and 4% respectively; while it expects traffic in the December and March 2012 quarters to decline by 2% and 5%.

Its prognosis for profitability in the current year also shows increased seasonality: higher profits in the first half because of higher volumes and yield growth; greater losses in the second half mainly due to higher fuel costs; capacity cuts in the second half to limit losses and protect full year profitability. Overall it anticipates being able to achieve profits similar to 2011's €400m on the assumption of another 12% increase in yields.

Ryanair in recent years has tended to schedule a large portion of its aircraft deliveries for the off season; using them to introduce new routes, create new bases as well as increasing density of operation at existing operational bases. This coming year is no different in that the company appears due to take 32 new 737-800s between September and March. This time, however, the company appears to have decided to keep these aircraft on the ground from delivery until the start of the next financial year as well as grounding perhaps another 50 aircraft (up from 40 last winter).

What might be the marginal operative benefit to Ryanair for not flying its new aircraft? The winter quarter for many airlines tends to be of questionable profitability at best and at current anticipated fuel prices loss making even at the operational level; so, increased flying will increase losses. For it to ground an aircraft the actual cost of doing so is likely to be little more than the effective ownership cost – it operates to enough airports where parking will be free. Assuming, as a result of the Boeing deal in the 2000s, that the company is acquiring its new aircraft at around the $37m level (compared with an estimated current new achieved price of $42m) and following its statement that it has secured funding at 4% and hedged at €1.43 to the dollar we could estimate its ownership cost including depreciation at around €2m per aircraft per year, or €0.5m a quarter, or (at its average six departures a day) €5 per seat. Were these aircraft to be leased (and just under 50 of Ryanair's 272 aircraft are on lease) at current market lease rates the cost could possibly work out 50% higher. So perhaps not to fly an aircraft for a quarter could just cost it €0.5m.

However, in doing so it is foregoing revenues (and losses). There is a naturally lower level of demand in the off season – and consequently lower unit revenues. In the past few years the premium of Ryanair's average summer season passenger fares to those in Winter has fallen from 20% to around 10% (see chart on seasonal revenues per passenger, page 4) – but then in the last two years Ryanair has taken more aggressively to objecting to airport charges at Stansted and Dublin in particular and grounded aircraft at its more expensive bases – but has still put new incoming aircraft on new bases and routes in the off seasons. New routes take time to build to reasonable maturity and even with Ryanair's model this will have had a dilutive impact on total unit revenues. We have guesstimated that a new route may suffer a 20% yield discount to the system average in its first months of operation and estimate that all other things being equal such routes would generate operating losses of €12 per passenger carried – and if the more expensive airports are included up to €17. This could imply that not flying a new aircraft on such routes might avoid operating losses of between at least €1m per aircraft for the winter quarter. Adding this to the assumption of ownership costs and speciously applying it all of the 80 aircraft the company may ground may suggest that by not flying its new aircraft Ryanair could improve profitability from what it otherwise would have been by €80m.



These plans of course are not set in stone – and the recent suggestion of the Irish Government to scrap the passenger tax and provide rebates on passenger fees should traffic exceed 2010 levels may go some way to allow Ryanair to reconsider its Dublin offering. Failing this, the reduction in winter planned capacity introduces a period of slow growth for the airline. Having failed to reach an agreement with Boeing two years ago the last of the 737-800s is due to be delivered in 2013 – by which time (after disposals) the company will have 299 737s in its fleet carrying 79m passengers a year.

Having made the massive "land-grab" in the past decade this era of lower growth may allow a gradual improvement in the "quality" of its route network and perhaps a less aggressive competitive environment. Without the annual €1bn capital expenditure the company will be generating significant amounts of cash to return to shareholders – but this time O'Leary did say that some cash would be held back for new aircraft; but although the company admitted it had been in discussions with Russian and Chinese manufacturers these are unlikely to provide viable alternatives to the Boeing solution before 2017 (and Airbus apparently doesn't even want to *talk* to Ryanair).

By James Halstead, jch@aviationeconomics.com

Emissions Trading System: One year of preparation left

The EU Emissions Trading System (ETS) is the world's first, and largest, cap-and-trade system to cover emission of CO2. It is a cornerstone of the European Union's policy to reduce greenhouse gas emissions and is a major part of the drive to meet international emissions reductions targets agreed in the 2007 Kyoto Protocol. From next year airlines will be part of the ETS, and will be bearing internally part of what were previously the external costs of pollution.

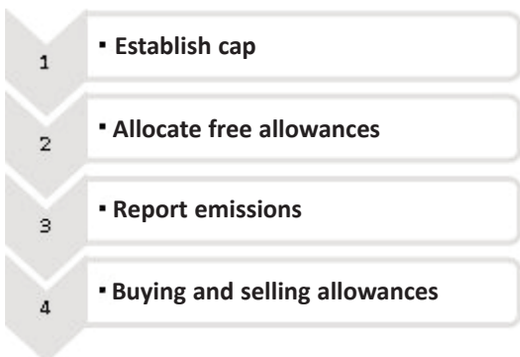
ETS works on the principle of capping the amount of permitted emissions across the sectors that are included in the scheme, and allowing the participants to trade allowances and import permits from outside the system in order to cover their emissions. In the process they create an international market for CO2 and a market mechanism whereby reducing emissions is financially rewarding.

ETS began in 2005 and has steadily expanded to include emissions from the heavy emitting industries across 30 countries. In December 2006 the European Commission (EC) developed a proposal to include emissions from the aviation sector within the ETS, which worked its way through the EU legislative process, with agreement on the basic principles reached in mid-2008. The final Directives provided for entry of aviation to the ETS in 2012, with some baseline data reporting required in 2010. On entry, aviation will be the fourth largest sector in the overall EU ETS (measured by the number of allowances allocated for free), after power and heat, metals and building materials.

Tighter caps on emissions will be introduced during the next phase, from 2013 to 2020, so the air transport industry has one year to get to grips with the trading element of ETS before entering a new era with fewer permits and, potentially, higher compliance costs.

How aviation works within ETS

Although the ETS is a multi-industry system, aviation operates within its own set of guidelines. These guidelines stipulate that all flights with origin or destination in the EU will be covered by the scheme, wherever the airline operator is registered. It extends to all airlines and operators with a narrow list of exceptions, primarily helicopters, very small aircraft, military and training flights. Other than those, airlines from around the world are included irrespective of whether they are a private business jet operator or a global carrier.



1. Establish cap The cap is based on an assessment by the Commission of baseline emissions from air transport activity averaged over the years 2004 to 2006. This figure has recently been released, following a delay of many months: 218m tonnes of CO2. In the starting year, 2012, the cap for aviation allowances has been set at 97% of this figure, or 211.5m tonnes. For the years 2013 to 2020, the cap will be 95% of the baseline, or 207m tonnes. 3% of the total allocation will be set aside for new entrants and 'fast growing' operators. After this amount is taken out, a further 15% of allowances will be withheld and auctioned in 2012.

2. Allocate free allowances. The amount of aviation allowances left after the auction and new entrant reserve is likely to be around 174m tonnes, which will be allocated to operators free of charge, based on the production of Revenue Tonne Kilometres (RTKs) in 2010. So if an airline flew 10% of total RTKs in 2010, it

will receive 10% of the free allowances in 2012 but for each year through to 2020.

3. Report Emissions. Airlines were mandated to report CO2 emissions in detail from 2010, and have had the option of reporting RTKs if they were interested in applying for free allowances. The CO2 reporting for 2010 and 2011 has no compliance cost, it is more of a 'dry run' for 2012 when permits will need to be surrendered for each tonne of CO2 emitted.

4. Buying and selling. In the event that an airline receives more allowances than it needs to cover its emissions, it may sell those allowances on the carbon-trading markets, of which there are six worldwide: Chicago Climate Exchange, European Climate Exchange, NASDAQ OMX Commodities Europe, PowerNext, Commodity Exchange Bratislava and the European Energy Exchange.

More likely, airlines will have insufficient permits to cover emissions and need to procure allowances to cover their emissions. There are various permit types that can be used to cover emissions, including Aviation Allowances (AAs); EU Allowances (EUAs); Certified Emission Reductions (CERs); and Emission Reduction Units (ERUs).

It is worth noting that the level of free allocation does not create an immovable cap on emissions. Rather, the industry would be able to emit 174m tonnes of CO2 in 2012 without incurring any cost. Beyond that level, emissions are still allowed, provided the relevant airlines procure credits to cover each tonne of CO2. The types of credits that can be used are defined in the Kyoto Protocol, but, because international transport is not covered by the Protocol, the allowances issued to airlines can be used for compliance by airlines only. So if an airline finds itself with a surplus of credits, these can only be used by another airline. There would be no value or compliance use for a power company to purchase AAs.

Within the mainstream EU ETS, operators may use credits from two of the Kyoto Protocol flexible mechanisms for compliance - the Joint Implementation (JI) and Clean Development Mechanisms (CDM), which issue new credits known as CERs and ERUs to projects in the developing world that reduce emissions, such as energy efficiency at a power plant. Use of these instruments for airlines is limited to 15% of the number of allowances they are required to surrender at the end of 2012, and an amount to be determined for the period 2013 to 2020. So, the CER/ERU limit for the aviation sector will be equal to 15% of an airline's actual emissions, rather than the allocation. As an airline emits more, so it may use more CERs.

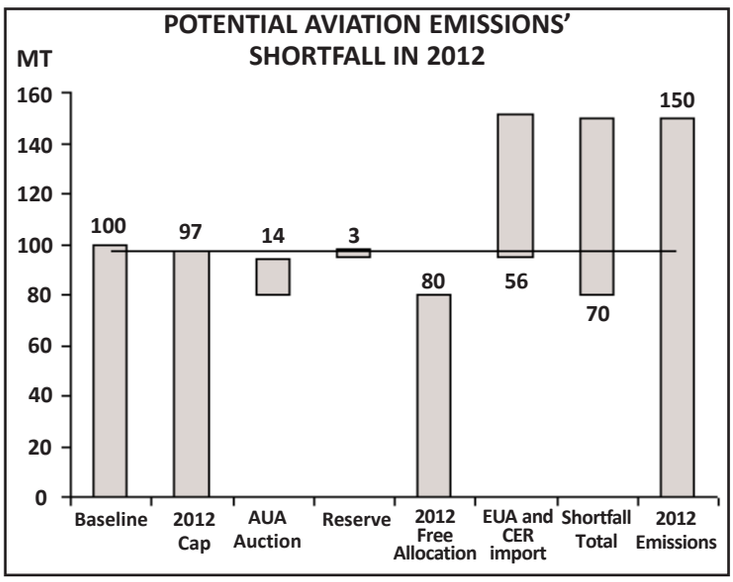
By way of illustration, if an airline is issued 100 allowances for free and in 2012 emits 200 tonnes of CO2, it will need to cover a shortfall of 100 allowances. It could buy 15 credits, comprising any combination of CERs or ERUs. The remaining 75 must therefore be EU aviation allowances (EUAAs) or mainstream EUAs, to be bought from the open market or from government auctions in any combination.

The Commission has published a list of operators to be included in the scheme which numbers almost 5,000, most of which are business and general aviation operators. Despite accounting for around 10% of operators by number, the vast majority of emissions arise from commercial airlines – estimated to produce 84% of RTKs and over 80% of CO2 emissions.

In fact, research conducted by RDC Aviation and Point Carbon suggests that the 50 largest airlines account for almost 70% of CO2 emissions, which raises the question: why have so many minor emitters been caught up in this programme? Undoubtedly for the business aviation community and small commercial operators, the proportional cost of compliance coupled with the administrative requirements far outweigh any potential environmental benefit that would be gained even if all of these carriers stopped flying all together.

Compliance, allowances and shortfall

As the carbon baseline has been retrospectively assessed on the basis of emissions between 2004 and 2006, and as only 82% of those emissions will be covered by free allowances, it comes as no surprise to



learn that the industry will be 'short' once final reporting of 2012 CO2 has been made. The chart (see page 8) approximates how the shortfall would look under a scenario whereby the industry generated 50% more emissions in 2012 than allowed for by the baseline of 100m tonnes. The free allocation of around 80m tonnes would then leave it with a total shortfall of 70m tonnes, of which 14m tonnes will be auctioned by government and 56m tonnes obtained through purchase of EUAs and CERs.

Based on carbon emissions permits on the mainstream markets trading around €17 per tonne, the combined cost to airlines that fall within the EU ETS is significant, a minimum of €1bn in 2012. Taken in isolation this is a figure that the industry can ill afford at a time when margins remain under pressure; it is twice the net profit IATA expects for European airlines in 2011. On the other hand, when compared to the cost of jet kerosene, the cost to 'offset' the emissions from a tonne of Jet A is less than 15% of the cost of the fuel (based on Jet A at about $1000/tonnes and one tonne of Jet A being equivalent to 3.15 tonnes of CO2).

Mitigation options

The additional cost to obtain emissions permits is unwelcome for airlines; nevertheless, even with projected increases in the carbon price throughout Phase 3 of the ETS, it is difficult to see how the cost of obtaining sufficient permits to cover burning a tonne of jet fuel will rise to any more than 20% of the cost of Jet A.

Plotting the cost of carbon against oil prices suggests that there is no correlation - fluctuations in the price of oil do not tend to be reflected in the carbon price. This means that airlines need to adopt a different approach to the oil and carbon markets if they are to optimise their carbon procurement strategy, and this is an area where the large emitters can engage some expertise to minimise their financial exposure. To date, whilst most carriers are only just getting to grips with their requirements, Lufthansa is already preparing to trade carbon on the European Energy Exchange (EEX); Cathay Pacific is involved in CDM projects in mainland China; and a number of the other major network carriers are claiming to be already looking at the carbon markets.

The simplest solution to the carbon cost burden is to reduce fuel burn - paradoxically for the regulators, not because of the CO2 emissions permit cost but because fuel represents the largest variable element of any airlines cost, and the biggest single component of direct operating costs. Over the past twenty years, improving fuel efficiency has been the driving force behind airframe development for new aircraft types and upgrades to existing technology. The results have been largely successful, with modern airframes 20% more efficient than they were 10 years ago, according to IATA. However as the chart (see page 9) shows, on a sector between London and Bangkok, 55% of direct operating costs are accounted for by fuel burn with an A380, and with fuel costing more than ten times the cost of the carbon it produces, it is clear that the carbon cost is a consequence of fuel burn rather than the driving force of change.

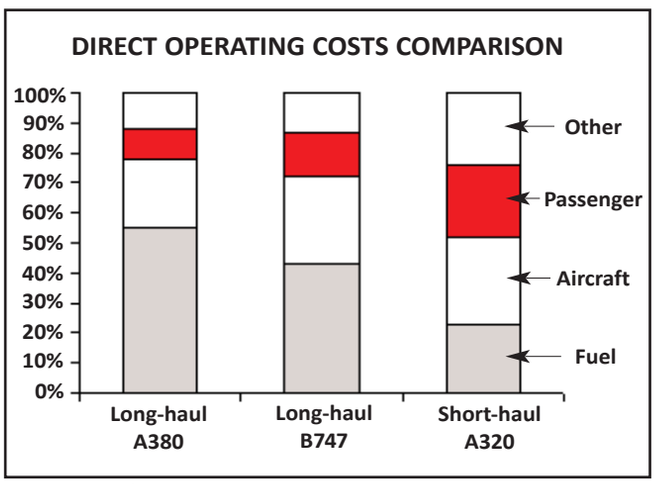
There are some relatively quick wins – improvements in airways and flight paths through the single European skies and continuous descent save fuel and therefore

emissions, but realistically these improvements are at the margins. Younger equipment is one route to emissions reductions and for any carrier about to replace an aged fleet of long-haul aircraft with more efficient types, there will be a fuel and CO2 benefit but to suggest that is cost effective to bring forward fleet replacement purely on carbon grounds is wrong. And whilst manufacturers have been keen to point out the improvements in fuel burn per available seat, often the overall fuel burn is greater with larger aircraft and so efficiencies are only seen where, for example, one A380 replaces two 747s, but in practice that is unlikely.

It would seem that the biofuels could offer that potential fix but unlike other modes of transport, the short term prospects for biofuel experimentation and integration are limited on many levels. Certification of biofuel is yet to take place although Lufthansa is beginning test flights within Germany and several operators have experimented with running engines on various mixes of biofuel. However, the barriers are steep – from the risk of failure at altitude to freeze point and density; not to mention questions over cost, sustainability and supply chain feasibility. Whether it is commercially feasible to produce biofuels on the scale required is far from certain – and in order to make them viable the cost needs to be lower than the combined cost of JetA and its associated carbon output. This seems unlikely, when estimates are that biofuel could cost upwards of US$3,000 per tonne.

Fears and challenges voiced

Aviation will be included in the EU ETS from 2012 and mitigation options are few. However, since the inclusion of air transport in the EU ETS was first announced, airlines and their representative trade bodies have argued that aviation is a special case which justifies different treatment to the other constituent industries of the ETS. This position is particularly pertinent with the proposed inclusion of long-haul flights from



outside of the EU where emissions do not occur within European air space. There is logic within this argument and the ATA has brought a test case initially against the UK, as the 'competent authority' to which most of the US majors report for ETS purposes. The basis of their argument is that including international aviation in a unilateral European scheme contravenes the Chicago Convention, which provides for emissions trading only when the two nations at either end of the air route are in agreement. It also challenges the EU's right to jurisdiction over airlines when not in European airspace. The case has subsequently moved up to the European Court of Justice and is likely to be heard at some point in 2012.

Perhaps they have a point; there will be some testing legal discussions which, if the EU wins, could pave the way for sanctions from third party countries. Certainly if the EU loses and non-European carriers are excluded, ETS becomes a millstone around the necks of EU carriers, distorts competition and ultimately it is hard to see how it can continue, for aviation at least. AEA Secretary General Ulrich Schulte-Strathaus, in a joint letter with Airbus to the EC, voiced trepidation recently saying: "We want to avoid trade conflict, which could potentially damage Europe's air links". IATA's outgoing Director General and CEO Giovanni Bisignani went further in a statement by labelling the EU's ETS scheme "illegal".

By Peter Hind, RDC Aviation
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TAP Portugal: Last of the Western European privatisations

With the Portuguese government putting TAP Portugal up for sale, rumours are swirling about potential buyers and/or merger partners - from British Airways to LATAM and Qatar Airways. What can TAP offer its new owner, whoever that may be?

Launched just after the Second World War, the Portuguese flag carrier was nationalised in the 1970s and rebranded as TAP Portugal (from TAP Air Portugal) in 2005. Today, TAP employs approximately 7,000 people and operates to more than 70 destinations over 30 countries in Europe, Africa, North America and South America.

After turning in a huge operating and net loss in 2008 (see chart, page 11), TAP has recovered well in the last couple of years, and 2010 proved to be its best ever year in terms of financial results. In 2010 TAP saw a 37.5% rise in revenue to €2.2bn, based on a 7.7% rise in passengers carried to 9.1m (above the 7% targeted rise for the year) and - impressively - a six percentage point rise in load factor to 74.5%. Operating profit rose to €101m last year, compared with €65m in 2009, while net profit reached €62.3m, 8.7% up on the 2009 result. That set of figures would have been even better were it not for that fact that TAP's fuel costs rose 45% in 2010, to €523m, while Iceland's volcanic disruption knocked €20m off the bottom line.

The improvement is continuing through 2011. In the first quarter of 2011 passengers carried rose by 6.2% compared with the same period in 2010 - with load factor up by 2.1 percentage points to 71.2% - and TAP looks well on the way to reaching its target of 9.5m passengers carried in 2011.

2010 results show that TAP is maybe starting to reap the benefits of its latest strategic plan covering the 2009-2012 period, the key parts of which include the continuation of debt reduction, to "strategically reduce capacity and seek new niches in Africa", the sale of ground handling unit Groundforce and "incisive action on all actionable costs".

Much of that cost push has been on labour, and TAP only narrowly avoided a strike by its pilots in March last year before pilot union SPAC signed a deal with management for a 1.8% pay rise, alongside an agreement on productivity improvements. However, an attempt by management this year to reduce by one the number of attendants on its flights is facing intense opposition, and in early June cabin crew announced a series of 10 one-day strikes, to be held in the latter half of June and through July. The National Union of Civil Aviation Flight Attendants says management is imposing the measure without any consultation, and unless a compromise is found then damaging strike action over the summer is a real possibility – and could put potential buyers off the airline.

Network focus

TAP's main base is Portela airport in Lisbon, which although it has space constraints is a hub operation, linking TAP's European network with flights to Africa and the Americas, and specifically Brazil in the latter. Around 70% of TAP's revenue is generated abroad and the airline operates to 49 destinations in Europe, while in the first six months of 2011 TAP launched six new European routes, between Lisbon and Athens, Vienna, Düsseldorf, Bordeaux, Manchester and Dubrovnik.

TAP's most important international market in Europe is Spain. In 2010 the airline carried 846,000 passengers between the two countries, 12% up compared with 2009, and load factor increased by five percentage points last year. The key routes are from Lisbon to Barcelona and Madrid, with more than 40 flights a week on each service. The profitability of these European routes is variable, but as a standalone airline TAP has little choice but to provide a

reasonable European network in order to provide feed into its much more profitable long-haul routes.

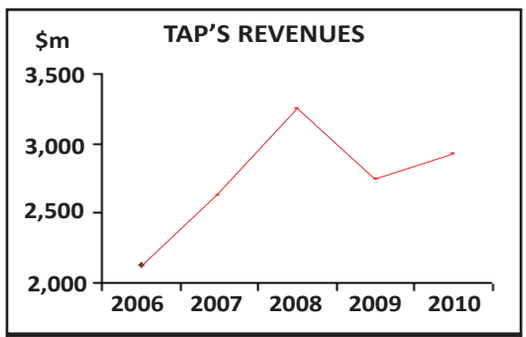
Africa and South America are the two key long-haul sectors. TAP operates more than 60 flights a week to 13 African destinations, most of which are in the former Portuguese colonies of Angola and Mozambique. The latest route was launched this June – a three-times-a-week service to Bamako, the capital of Mali – while a 14th destination will be added in July with the start of services to Sao Vicente in the Cape Verde. In 2010 TAP carried 602,000 passengers to/from Africa, 12% up on 2009, and this year it is looking for another double-digit rise.

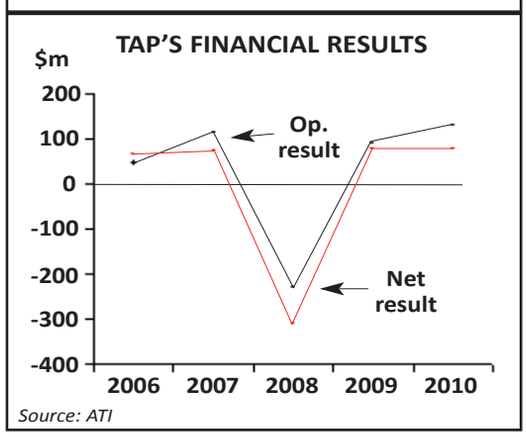
In South America TAP serves 10 destinations - all but one in Brazil - with a route to Porto Alegre launching this June. The business market is a key market for TAP on the Portugal-Brazil sector, as is the VFR Europe-bound market and Brazil-bound leisure traffic.

In these three main markets, TAP's strategy over the next year or two is consolidation of the South American route network, focused expansion in Europe (concentrating on major European capitals where possible) and continued expansion in Africa. As can be seen in the chart, opposite, TAP cautiously increased capacity last year, with the prime focus not being ASK growth but rather keeping an upwards trajectory on load factor.

Last year, although Europe still accounted for the largest single share of revenue - at 37% - Brazil was close behind with 35% of turnover. Interestingly there were 5.2m passengers on European routes in 2010 (out of a total 9.1m carried by TAP), while routes to/from Brazil accounted for 1.4m passengers. In terms of individual markets Brazil and Angola were the fastest-growing, with revenue out of those markets rising by 55% and 30% respectively in 2010.

TAP is also looking to expand routes outside of Europe, South America and Africa. A route to Miami will launch in the summer, with a non-stop service between Lisbon and Miami operating five times a week. Last year the airline carried 175,000 passengers between the US and Portugal on its sole





Source: ATI

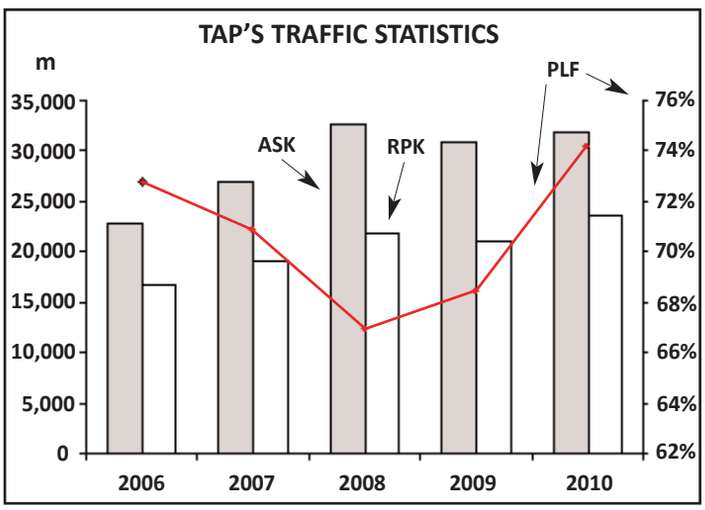
route - Lisbon to Newark - using A330-200s. That number should rise considerably in 2011, as last October TAP began codesharing with Continental on Lisbon-Newark and on domestic Continental routes from Newark. Last October TAP also began codesharing with Star partner Air China on flights between Lisbon and Oporto to Beijing and Shanghai, with connections in Spain, Germany and Italy.

However, a major constraint for TAP is long-haul-aircraft. TAP currently has 55 aircraft in its fleet, all of which are Airbus models (see chart, left), with 39 A320 family aircraft, 12 A330s and four A340s. A major overhaul of the medium-haul fleet was completed in 2009 that saw the replacement of older A320s by six new air-

TAP PORTUGAL'S FLEET

	Fleet	Orders	Options
A319	19		5
A320	17		
A321	3		
A330	12		
A340	4		
A350	-	12	3
Total	**55**	**12**	**8**

Source: *ACAS*



craft. Other than the retirement of one aircraft there was very little movement in the fleet last year. TAP also owns regional carrier PGA- Portugalia Airlines, which it bought from Grupo Espirito Santo in November 2006 for €140m. PGA has kept its brand and operates domestic and international routes from Lisbon and Porto, as well as a number of charter flights. Portugalia operates 16 aircraft, including six F100s and eight Embraer ERJ 145EPs out of Lisbon and Porto.

The only aircraft on order for TAP are 12 A350s (four -900s and eight -800 models), for delivery from 2014 onwards, so until then new long-haul opportunities can only be served through leasing in capacity. That's why senior TAP management is keen to get the airline privatised as soon as possible, so as to obtain the fresh capital needed to improve its balance sheet and – perhaps more importantly – to buy or lease more long-haul aircraft.

Up for sale

The sale of TAP, already planned in the medium-term by the Portuguese government (which owns 100% of the airline), was made a certainty in May this year when Jose Socrates, the country's caretaker prime minister, agreed a deal with the EU and IMF for €78bn of financial assistance in order to help the country out of its current economic troubles. The EU and IMF attached a number of conditions to the deal, in which the Portuguese government has to adopt a series of tax increases and cost-cutting programme in order to reduce its budget deficit. The latter includes privatisation of national assets - and TAP Portugal is at the top of that list.

Although TAP now needs to be sold by the end of the year, the privatisation process is likely to start only after the sale of its handling services subsidiary Groundforce - which has consistently been dragging down the airline's financial results - is completed. The sale of Groundforce was kicked off earlier this year although TAP has apparently only received interest in the cargo handling side of the business, and not in the passenger handling side.

But whenever the official process of selling the airline starts (and presuming that the imminent cabin staff strike is either avoided or else has relatively little impact) there will undoubtedly be many interested "trade buyers". Among those already being linked with a potential bid is International Airlines Group, with claims that informal talks have already begun between TAP and IAG. IAG will not comment on the speculation, and while its operational focus for now is undoubtedly making the synergies between BA and Iberia work, the combination of the Lisbon and Madrid hubs would give BA/Iberia a very dominant lock on traffic flows between South America and Europe – although that's surely something that regulators would be concerned about.

A deal with Qatar Airways looks far-fetched, even given the very deep pockets of the Qataris and the recent major investment in Cargolux. The Portuguese prime minister visited Qatar in January this year and reports out of Portugal claim he specifically presented the government's plan for the privatisation of TAP to the Qataris. In the same month Fernando Pinto, the CEO of TAP, said that Qatar Airways wanted to start routes between Doha and Portugal, although TAP has implied that routes of its own to Qatar were not a priority, and that if Qatar started a service "it's one more volume of passengers that we can distribute to other locations".

SOUTH AMERICA - EUROPE 2010 TOTAL SEATS (m)	
Iberia	2.7
TAP Portugal	1.9
Air France	1.8
TAM Linhas Aereas	1.5
Lufthansa	0.8
KLM	0.8
Avianca	0.7
Alitalia	0.6
LAN Airlines	0.6
Aerolineas Argentinas	0.5
Air Europa	0.4
British Airways	0.3
Santa Barbara Airlines	0.2
SWISS	0.2
Others	0.7
Grand Total	**13.6**
ALLIANCE SHARES	
TAP (Star)	14%
Other Star	18%
oneworld	26%
SkyTeam	23%

Source: *CAPSTATS*

Arguably the most sensible speculation has been over a bid by LATAM Airlines, the imminent merger of Brazil's TAM and Chile's LAN Airlines (once regulators have approved the creation of the largest airline in Latin America). A merger between LATAM and TAP would be the most comfortable fit in terms of culture and language, and TAP's management would prefer this deal too, with Fernando Pinto famously saying last year that a merger between the two would be "a good idea". Pinto was born in Brazil and headed up Varig before moving to TAP in 2000.

There remains a suspicion that this may be TAP's preferred option because its management may then see itself as being the more "senior" in a combined airline - a situation that certainly wouldn't be the case if someone like IAG took over TAP.

A bigger problem for the LATAM bid is whether it could actually afford the cost of the deal without substantial financial help from governments in South America.

Air France/KLM interest has been mooted, but it already has a strong network to Brazil, with 1m seats recorded last year (see chart, below). AF/KL, like Lufthansa, remains reticent and wary of too much disclosure to the Portuguese government.

TAP joined the Star alliance in 2005, which implies that Lufthansa would be a possible investor. TAP has codeshare deals with almost 30 airlines, most of which are Star members – although in February the European Commission said it was investigating the codeshare relationship between TAP and Brussels Airlines (as well as between fellow Star members Lufthansa and Turkish Airlines, although the two cases are independent). The TAP investigation relates to the Lisbon-Brussels route and the Commission says that, airlines "should, in principle, be competing with each other … this form of free-flow, parallel, hub-to-hub codeshare agreement may distort competition leading to higher prices and less service quality for customers." It's unknown as to how the investigation is progressing, and when the EC will announce a decision.

Lufthansa would like to counteract oneworld's Madrid gateway into South America by locking in the Lisbon hub through an acquisition of TAP – or, put another way, it can't afford for TAP and Lisbon to be picked off by a rival at oneworld or SkyTeam. Lufthansa is ominously silent on the issue, so when the Portuguese government officially starts the sale process it will be no surprise if TAP's senior Star partner is one of those that makes a bid.

BRAZIL - EUROPE 2010 TOTAL SEATS (m)	
TAP Portugal	1.7
TAM Linhas Aereas	1.5
Air France	0.8
Iberia	0.6
Lufthansa	0.4
British Airways	0.3
KLM	0.2
Alitalia	0.2
SWISS	0.2
Others	0.3
Grand Total	**6.2**
ALLIANCE SHARES	
TAP (Star)	28%
Other Star	33%
oneworld	10%
SkyTeam	20%

Source: *CAPSTATS*

Air Canada: Continued labour and financial challenges

Since its close brush with extinction in the summer of 2009, when it had to be bailed out by its unions and the government, Air Canada has rebuilt its cash position, achieved impressive cost cuts and even turned modestly profitable on an operating basis (in 2010). It is well positioned to benefit from the recovery of global business travel. However, Air Canada continues to underperform other global carriers in terms of profit margins and unit revenues. Renewed labour challenges and escalating low-cost competition in key markets raise into question its longer-term survival.

Air Canada's most important challenge is to clinch new contracts with its labour unions that facilitate crucial pension reforms and additional cost cutting, without which the airline will not be viable in the long run. The contracts of all of the four major unions have become amendable in recent months. The workers are opposed to further giveaways, especially on the pension front.

The strength of labour opposition to the pension proposals was illustrated by the three-day mid-June strike of Air Canada's customer service and sales employees. Agreement on a tentative four-year contract was only reached after the Canadian government followed through on a threat and submitted legislation that would have forced an end to the strike. The deal provides for wage increases (reportedly 9% over four years) and "slight" changes to existing employees' pension plans. However, the tough issue of whether new hires will be eligible for a defined-benefit pension plan will go to binding arbitration.

While there is currently no threat of labour action from the other three groups, Air Canada faces a summer (or longer) of difficult labour dealings. Its pilots recently rejected a tentative agreement reached in March but are expected to get back to the negotiating table. The flight attendants and the mechanics have remained firm on the pension reform issues, and the flight attendants have asked for federal mediation.

Additional cost cuts are critical because Air Canada faces growing competition in all of its key markets. Within North America, it faces a revitalised US legacy sector and an LCC sector that is capturing market share and increasingly also targeting business traffic. In long-haul international markets, there is new competition in all shapes and sizes, including Middle Eastern carriers such as Emirates and Etihad; the Canada-UAE trade dispute over air services is illustrative of the new pressures that Air Canada is under.

It is a point of concern that, despite the 2009 bailout, Air Canada has continued to financially underperform its key competitors. In 2010 - its best year in a decade, and one in which many US legacies achieved 10%-plus operating margins - Air Canada had only a 3.3% operating margin. And there is no clear indication that it could catch up: the best that most analysts foresee for the next few years are low-single digit operating margins.

However, Air Canada enjoys many inherent advantages. First, it has a great global route franchise. Second, it still has leading market shares in the Canadian domestic, US-Canada transborder and long-haul international markets. Third, it offers a superior product and service quality (at least compared to the US legacies), making it well-positioned to retain and attract premium traffic. Fourth, it belongs to what is arguably the strongest of the three global alliances (Star) and will increasingly benefit from robust joint ventures.

So Air Canada is pressing on with efforts to achieve "sustained profitability" in the longer-term (there is no talk of margin or ROIC goals, as at the US legacies). The key strategies include continued cost transformation, making the corporate culture more "customer-centric and entrepreneurial", building on the Air Canada brand and global network, and deleveraging the company.

Air Canada's international growth efforts include the very interesting strategy of trying

to capture incremental sixth freedom premium traffic between the US and Asia/Europe through Toronto and other Canadian hubs. Is that strategy paying off?

But the growth efforts also include the risky proposal to establish a separate LCC subsidiary to tackle more leisure-oriented international markets. While labour may well pose an obstacle to such a venture, why would Air Canada even want to consider it, given the poor track record of LCC units operated by legacy employees?

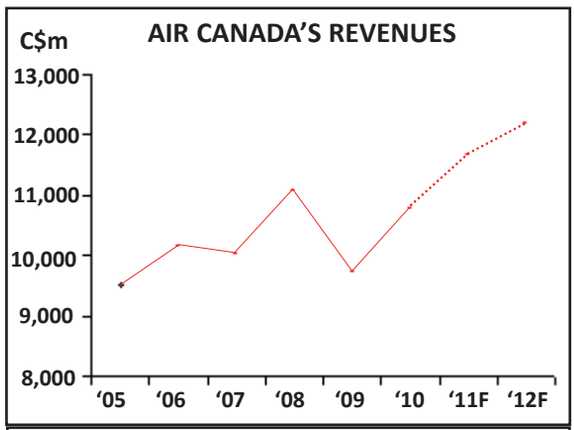
Even though there is probably little chance of Air Canada ever disappearing – its formidable global franchise and dominant role in the Canadian aviation market probably ensure that partners, banks or the government would always step in to provide assistance or more funds – the airline needs to stop what seems like a slow but steady decline into oblivion. Will the current and planned strategies do the trick?

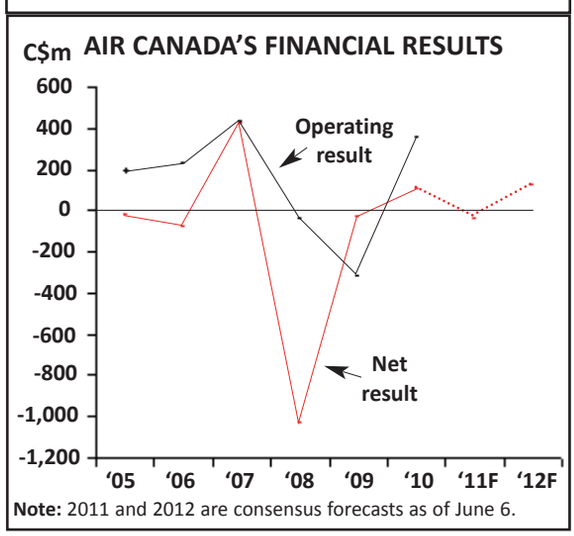
Mediocre results despite bailouts

Few global carriers have received as much help as Air Canada in terms of bailouts, restructurings (in and out of bankruptcy), labour concessions and pension relief in order to get their houses in order. To start with, Air Canada completed an 18-month bankruptcy reorganisation in September 2004, which reduced its net debt and capitalised leases from C$12bn to C$5bn and gave it a relatively healthy cash position of C$1.9bn (C$1=US$1.02). But the cost cutting programme initiated in bankruptcy fell far short of giving the airline a competitive cost structure (see *Aviation Strategy* briefing, November 2004).

Air Canada was never able to consolidate the promising early turnaround seen in late 2004 (in the wake of three and a half years of losses totalling C$1.7bn). It achieved only marginal operating profits in 2005-2007 (2-4% of revenues) and plunged back into losses in 2008-2009. It had an annual net profit only once in the last decade (in 2007).

The airline's finances deteriorated rapidly in early 2009 as the global recession began to bite. By May 2009 Air Canada was in a crisis, with cash reserves amounting to only C$1bn or 10% of annual revenues, which would not have covered the debt and pension obligations in the subsequent 12 months. New CEO Calin Rovinescu, who had taken over in April 2009 after Montie Brewer's resignation, set about to find creative solutions to avert bankruptcy (*Aviation Strategy* briefing, July/August 2009).





Note: 2011 and 2012 are consensus forecasts as of June 6.

Air Canada regained financial stability after successfully addressing its key issues in the summer and autumn of 2009. First, it secured agreements with its unions on two-year contract extensions on a "cost neutral" basis and a 21-month pension-funding moratorium, with payments capped for a further three years. Second, the labour deals enabled Air Canada to raise C$1.4bn in new liquidity, to bring its unrestricted cash to 15% of annual revenues (one of its key financial targets). Third, Air Canada renegotiated contracts with suppliers, vendors and credit card providers, including its capacity purchase

agreement with regional carrier Jazz. Importantly, in mid-2009 Air Canada also launched a three-year "Cost Transformation Programme" (CTP), aimed at generating C$530m of annualised cost savings and revenue gains by the end of 2011.

Since then Air Canada has made further significant progress on many of these fronts. A C$1.1bn debt offering in 2010 helped bring year-end cash reserves to C$2.2bn or 20% of annual revenues – the highest in the airline's history. Air Canada is also exceeding the CTP plan targets, having achieved C$440m or 83% of the total targeted annual benefits by early May. Ex-fuel CASM declined by an impressive 4.5% in 2010 and by another 5.3% in this year's first quarter.

As a result of the cost cutting, economic recovery and favourable currency developments, Air Canada achieved a modest financial turnaround in 2010, recording operating and net profits of C$361m and C$107m, respectively, on revenues of C$10.8bn. The March quarter saw continuation of the recovery trend, with operating losses narrowing to C$66m from the year-earlier C$136m, despite the significant fuel price hike.

But Air Canada's operating margins continue to lag those of its peers. In the first quarter, Air Canada had the second-worst operating margin (negative 2.4%) among the top 11 North American carriers. Only AMR's margin was weaker (negative 4.2%), but AMR has special reasons for underperforming, including never having been in bankruptcy.

While Air Canada's main problem continues to be a significant CASM disadvantage over both LCCs and the US legacies, this year it has also underperformed on the unit revenue front, despite the business travel recovery trend. According to BofA Merrill Lynch, its first-quarter currency-adjusted 2.4% RASM increase was nearly six points below US airlines' and ten points below WestJet's. (Air Canada did see a healthy 13% increase in premium-cabin revenues but it was mainly volume-driven.)

Long-haul markets were largely to blame. Air Canada has been adding much capacity to Europe and Asia, though industry capacity too was up significantly in the transatlantic market in the traditionally weak first quarter. According to BofA Merrill Lynch, on the European routes Air Canada's currency-adjusted RASM fell by 2.4% in the first quarter, compared to a 0.8% decline for US carriers. On the Asian routes, Air Canada's currency-adjusted 2.9% RASM decline contrasted with an 11% gain recorded by the US carriers.

Despite fuel, most global airlines, including all the US legacies except AMR, are likely to remain profitable in 2011, thanks to a combination of fare increases, fuel surcharges, capacity discipline and continued recovery of business travel. However, Air Canada is expected to plunge back into losses in 2011. The current consensus estimate for 2012 is a modest profit of around C$130m.

Air Canada is pursuing all the possible remedies. On the capacity front, it has followed the US legacies lead and trimmed this year's growth plans by two points since February. After last year's 7% growth, system ASMs are currently slated to increase by 3.5-4.5% in 2011, with domestic capacity decreasing slightly. The growth will be mainly driven by new US and long-haul international services added in 2010 and will be accomplished through increased aircraft utilisation.

Building on the brand and global network

When faced with the crisis two years ago, Air Canada's management firmly rejected the inevitable "shrink to profitability" calls from analysts. Instead, the airline proposed to operate "in a better, smarter, more effective way, with a benchmarked matrix for 'best of class' while not conceding market share". An overriding consideration was to safeguard the brand. Also, Air Canada wanted to expand its international presence by leveraging its array of route authorities, the geographical advantages of its main hubs and partnerships through the Star alliance.

It was an understandable (and reasonable) strategy for a carrier that enjoys so many inherent advantages. In 2010, Air Canada still accounted for 56% of the total domestic ASMs (WestJet's share was 36%),

35% of the US-Canada capacity (compared to WestJet's 15%) and 39% of Canada's long-haul international capacity. It has well-situated hubs (Toronto, Montreal and Vancouver), a new fleet and one of the world's best customer loyalty programmes.

Focusing on the brand and international growth made sense also in light of Air Canada's superior product, service quality and reputation. Air Canada reconfigured its long-haul fleet many years before the US legacies, installing lie-flat seats in its Executive First cabins and seat-back entertainment systems at every seat. Its offerings include a concierge programme and the famed Maple Leaf lounges. Air Canada felt that it had product advantage.

So while cutting capacity in the weakest markets, Air Canada has undertaken a surprising amount of new international expansion since late 2009. Last year saw the addition of five new European gateways - Geneva, Barcelona, Brussels, Copenhagen and Athens; to supplement the carrier's "European flagship" routes of London, Paris and Frankfurt – and new service to some 15 US cities. The airline also grew significantly on the Pacific, adding flights to China, Korea and Japan.

The new services have supported the post-2009 strategy of trying to attract more global connecting traffic via Canada, which Air Canada only recently began marketing aggressively to US business customers. The selling points are the superior on-board amenities, new airport premium products and the ease of making connections at Canada's less congested gateways. All of Air Canada's operations at its Toronto Pearson hub are centralised in a single terminal with streamlined customs procedures, making it potentially very convenient for travel to and from the US. Cities close to the border, such as Seattle, San Francisco, Boston and Pittsburgh, are the most obvious markets. Air Canada is seeing "encouraging" results from the efforts to capture flow traffic, especially between the Northeast US and Asia-Pacific, and to a lesser extent between the US West Coast and Europe.

As a result of these strategies, Air Canada's long-haul international revenues have now surpassed its domestic revenues (41% and 40%, respectively, of passenger revenues in 2010; the remaining 19% came from transborder operations).

But in the short term the increased flow traffic may have contributed to the RASM underperformance. While Air Canada may not have had to price too aggressively because of its product advantage, it has had to offer competitive fares to stimulate demand through the Canadian hubs at a time when there is excess industry capacity in the Atlantic and Pacific markets.

This summer Air Canada has continued to add much capacity internationally, particularly from Toronto, where it is boosting frequencies to many European cities. However, in the autumn, Air Canada may well trim capacity plans for the winter.

Like its peers, Air Canada will be able to increasingly rely on alliances for growth. There have been two important strategic developments: the transatlantic joint venture with Lufthansa and United Continental, which was finalised in December 2010, and the proposed revenue-sharing transborder joint venture with United Continental, which is awaiting regulatory approvals. The Atlantic JV is already yielding positive results in terms of incremental traffic. The transborder JV has been delayed due to the Canadian regulators' decision to carry out a full competitive review, but the airlines still hope to implement it this year.

Alliances will be all the more important because Air Canada will remain fleet-constrained until its 787 deliveries commence in late 2013. The airline is due to receive the first two of 37 ordered 787s in 4Q13, and the type will both provide for growth and replace 767s.

Air Canada continues to try to defend its position in the increasingly competitive Canadian domestic market, where WestJet, Porter Airlines and others are aggressively trying to capture business traffic. Armed with weapons such as pre-reserved seating and an FFP, WestJet has greatly expanded in the "Eastern Triangle" business markets. Porter has built up a sizable operation from City Airport in downtown Toronto and has siphoned off business traffic from Toronto

AIR CANADA'S FLEET

Model	In Active Service	On Order	Options
A319-100	39		
A320-200	37		
A321-200	10		
A330-300	8		
767-300ER	31		
777-200LR	6		
777-300ER	12		18
787-8		37	13
E-175 LR	15		15
E-190 LR/AR	45		45
Total	**203**	37	**91**

Source: *ACAS*

Pearson in key markets such Toronto-Montreal. Air Canada's recent moves have included rebranding its regional service (including its subsidiary Jazz) as Air Canada Express and using it to resume service at the City Airport in May.

LCC subsidiary plans

As part of its growth strategy, Air Canada has tentative plans to set up a separate low-cost subsidiary "within the next year" to target leisure-oriented international markets. However, these plans will require the cooperation of labour, which may or may not be forthcoming.

The management discussed the idea in some detail in the 1Q call in early May. They noted the dismal success rate of the many LCC units launched by legacy carriers a decade ago (including Tango and Zip by Air Canada), but said that they had learned from the experience. In their assessment, the past LCC units had three problems: cost creep, insufficient scale (such as Zip) and yield cannibalisation.

One of the rare success stories Air Canada is using as a benchmark is Qantas' low-cost unit Jetstar. The management noted that Jetstar has remained extremely disciplined over time on the cost side and did not cannibalise any of the domestic business. The Australian and Canadian markets are fairly similar in nature.

Air Canada will only go ahead with the LCC if it "is and has the ability to remain truly low cost over the longer term. It needs to be able to avoid the type of cost creep that has plagued legacy carriers over the years." The unit would pay lower wages and have different work rules, as well as probably lower distribution costs.

The LCC unit would be specifically targeted to two types of long-haul markets: high-volume leisure-oriented routes to Europe (such as Amsterdam, Dublin, Casablanca, Nice, Lisbon and Manchester) and sun destinations in the Caribbean. It would be a growth vehicle, entering many new markets that Air Canada has not been able to serve because of its high legacy cost structure.

The venture would have sufficient scale: eventually a 50-strong fleet of two types, including 20 widebody and 30 narrowbody aircraft. The widebodies would be mostly incremental and the narrowbodies would be mostly transferred from Air Canada. However, the LCC would start with something like six A319s and four 767s and grow gradually over a number of years.

One reason Air Canada would like to launch the LCC early is that, because of the 787 delivery delays, it will have many years of virtually no growth. It would not be able to bring aircraft into the fleet unless it had a "compelling business case to do that". Yet the LCC would require only minimal capex. It would help Air Canada create a more seasonally balanced network, reduce costs and eventually help improve ROIC.

However, the financial community is not totally on board with the LCC idea, which they view as risky (in light of the poor track record of such ventures in North America and Air Canada's lagging financial performance) and possibly adding to overcapacity in long haul international markets.

Debt, pension and cost challenges

With the completion of its fleet-wide cabin refurbishment programme and the 777 deliveries, Air Canada has very modest capital spending requirements until 2014, when the 787 deliveries start in earnest. So

it is likely to generate positive free cash flow in 2011-2013, just like it did last year (C$746m).

The good news is that Air Canada is determined to take advantage of that window and deleverage its balance sheet a little. However, the disappointing news is that it is only looking to make its scheduled repayments, which amount to C$500m this year and C$400m in 2012, rather than pay down debt early. It remains extremely highly leveraged, with adjusted net debt of C$4.6bn as of March 31.

Of course, pension liabilities are another problem area. As a 75-year-old formerly government-owned airline, Air Canada has about C$13bn of liabilities under its defined-benefit pension plans. At the beginning of 2011, based on preliminary estimates, the pension deficit stood at C$2.1bn, which was C$600m lower than a year earlier as a result of strong fund performance. Although the mid-2009 moratorium on pension contributions expired at the end of 2010, Air Canada's funding obligations will be capped in 2011-2013 (amounting to only C$150m this year, for example). However, the payments will soar in 2014, so new solutions are needed.

In the current contract negotiations, the management has proposed to the unions essentially two things: reducing existing employees' future pension benefits by up to 40%, and switching new hires to defined-contribution pension plans, which do not provide a guaranteed level of payout upon retirement.

Union opposition to these changes is not surprising, given Air Canada's improved financial position and the lucrative compensation packages earned by its top executives last year. The switch to defined-contribution plans should really have been done in bankruptcy (as at the US legacies). Then again, the proposals are in line with what many companies in North America have implemented in the past decade, and given also the new conservative political climate in Canada, Air Canada's workers will have to accept the new reality. It is not clear if the threat of strike-busting legislation will help or hinder the labour situation at the airline.

But Air Canada's most important task is to achieve the planned "radical cost transformation". It is on track to realise the C$530m CTP target by year-end, but that plan has not really helped reduce the cost disadvantage against WestJet, other LCCs and the US legacies. According to a CAPA analysis, in domestic-only comparisons WestJet's CASM is about half of Air Canada's. BofA ML calculated that the differential is about a penny per ASM wider than that between US legacies and LCCs.

Air Canada is working to make cost containment and reduction a permanent part of its culture (following US legacies' example here). Also, over medium term there are cost reduction opportunities with airport fees, maintenance and aircraft ownership costs - three areas that apparently account for the majority of the ex-fuel CASM difference between Air Canada and the average US legacy. The airline hopes to cut maintenance costs when its current heavy maintenance agreement expires in 2013, and it expects to reduce ownership costs by purchasing more future aircraft.

In the past two years Air Canada has worked hard to try to improve its corporate culture – something that the CEO calls "perhaps the most important priority". The aim is to foster a culture where "leadership, entrepreneurship and ownership are valued and rewarded". Those efforts have included building a more transparent relationship with the unions and paying C$64m in 2010 performance rewards to employees (including C$13m in special one-time share awards to high-performing individuals).

Achieving a good culture has to be one of the toughest challenges for airlines, but Air Canada's management has claimed that there has already been a positive shift, as indicated by improved customer satisfaction ratings and surveys showing a 20% improvement in "employee engagement". Of course, the pension reform proposals may have at least temporarily derailed that process.

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Jet and freighter values and lease rates

The following tables reflect the current values (not "fair market") and lease rates for narrowbodies, widebodies and freighters. Figures are provided by The Aircraft Value Analysis Company (contact details below) and are not based exclusively on recent market transactions but more reflect AVAC's opinion of the worth of the aircraft. These figures are not solely based on market averages. In assessing current values, AVAC bases its calculations on many factors such as number of type in service, number on order and backlog, projected life span, build standard, specification etc. Lease rates are calculated independently of values and are all market based.The values and lease rates are as assessed at end-April 2011 and mid-range values are shown for all types.

NARROWBODY VALUES (US$m)

	NEW	5 years old	10 years old	20 years old		NEW	5 years old	10 years old	20 years old
A318	26.4	18.3			**717-200**		10.0	7.6	
A319 (IGW)	32.1	26.0	20.0		**737-300 (LGW A)**				3.5
A320-200 (IGW)	39.4	31.3	24.2	10.0	**737-400 (LGW A)**				3.5
A321-200 (LGW)	45.7	35.3	26.3		**737-500 (LGW A)**				2.9
					737-600 (LGW)		18.1	12.2	
					737-700 (LGW)	33.2	26.3	20.6	
					737-800 (LGW)	42.4	33.6	25.6	
					737-900ER	45.7			
					757-200 (RB 211)			15.5	9.5
					757-200ER (PW)			15.3	9.4
					757-300 (LGW)			17.5	

WIDEBODY VALUES (US$m)

	NEW	5 years old	10 years old	20 years old		NEW	5 years old	10 years old	20 years old
A300B4-600				4.1	**747-400 (PW)**			42.6	19.3
A300B4-600R				8.0	**767-200 (CF6)**				3.7
A310-300 (IGW)				4.7	**767-300 (CF6)**				8.4
A330-200			52.2		**767-300ER (LGW)**			26.8	14.2
A330-300 (IGW)			42.4		**777-200 (PW)**			37.7	
A340-300 (LGW)			33.5		**777-200ER**	109.2	87.4	65.3	
A340-300			38.2		**777-300**		72.7	50.7	
A340-300ER			40.5		**787-8**	103.6			
A340-500 (IGW)		68.8							
A340-600 IGW)		70.3			**MD-11P**				14.5
A380-800	203.0								

NARROWBODY LEASE RATES (US$000s per month)

	NEW	5 years old	10 years old	20 years old		NEW	5 years old	10 years old	20 years old
A318	240	179			**717-200**		142	114	
A319 (IGW)	298	252	204		**737-300 (LGW A)**				78
A320-200 (IGW)	314	279	244	140	**737-400 (LGW A)**				70
A321-200 (LGW)	386	314	255		**737-500 (LGW A)**				61
					737-600 (LGW)		152	116	
					737-700 (LGW)	318	260	212	
					737-800 (LGW)	366	300	253	
					737-900ER	397			
					757-200 (RB 211)			164	140
					757-200ER (PW)			163	140
					757-300 (LGW)			176	

WIDEBODY LEASE RATES (US$000s per month)

	NEW	5 years old	10 years old	20 years old		NEW	5 years old	10 years old	20 years old
A300B4-600				120	**747-400 (PW)**			423	283
A300B4-600R				107	**767-200 (CF6)**				102
A310-300 (IGW)				100	**767-300 (CF6)**				123
A330-200			549		**767-300ER (LGW)**			322	242
A330-300 (IGW)			467		**777-200 (PW)**			404	
A340-300 (LGW)			439		**777-200ER**	934	796	656	
A340-300 (HGW)			474		**777-300**		719	570	
A340-300ER			486		**787-8**	807			
A340-500 (IGW)		741							
A340-600 IGW)		735			**MD-11P**				180
A380-800	1,832								

FREIGHTER VALUES (US$m)

	New	5 years old	10 years old	20 years old
A300-F4-600R		45.4	34.9	
A330-200F	101.1			
737-300QC				6.9
747-400M			51.1	26.7
747-400F (CF6)		91.3	75.4	
747-400ERF		93.7		
757-200PF				14.9
767-300F	61.2	50.9	40.7	
777-200LRF	156.8			
MD-11C				20.7 (1992 build)
MD-11F			34.5 (2000 build)	

FREIGHTER LEASE RATES (US$000s per month)

	New	5 years old	10 years old	20 years old
A300-F4-600R		369	319	
A330-200F	867			
737-300QC				122
747-400M			492	379
747-400F (CF6)		894	771	
747-400ERF		928		
757-200PF				184
767-300F	469	438	392	
777-200LRF	1,325			
MD-11C				279 (1992 build)
MD-11F			428 (2000 build)	

		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.
Air France/	**Year 2008/09**	**34,152**	**34,335**	**-184**	**-1,160**	**-0.5%**	**-3.4%**	**262,359**	**209,060**	**79.7%**	**73,844**	**106,933**
KLM Group	Apr-Jun 09	7,042	7,717	-676	-580	-9.6%	-8.2%	63,578	50,467	79.4%	18,703	106,800
YE 31/03	Jul-Sep 09	8,015	8,082	-67	-210	-0.8%	-2.6%	66,862	56,141	84.0%	19,668	105,444
	Oct-Dec 09	7,679	8,041	-362	-436	-4.7%	-5.7%	61,407	49,220	80.2%	17,264	105,925
	Year 2009/10	**29,096**	**31,357**	**-2,261**	**-2,162**	**-7.8%**	**-7.4%**	**251,012**	**202,453**	**80.7%**	**71,394**	**104,721**
	Apr-Jun 10	7,301	7,469	-168	939	-2.3%	12.9%	60,345	49,283	81.7%	17,623	102,918
	Jul-Sep 10	8,579	7,835	743	374	8.7%	4.4%	66,558	56,457	84.8%	19,704	
	Oct-Dec 10	7,956	7,847	109	-62	1.4%	-0.8%	62,379	50,753	81.4%	17,551	101,946
British Airways	**Year 2008/09**	**15,481**	**15,860**	**-379**	**-616**	**-2.4%**	**-4.0%**	**148,504**	**114,346**	**77.0%**	**33,117**	**41,473**
YE 31/03	Apr-Jun 09	3,070	3,216	-146	-164	-4.7%	-5.3%	36,645	28,446	77.6%	8,446	
	Jul-Sep 09	3,479	3,507	-28	-167	-0.8%	-4.8%	37,767	31,552	83.5%	9,297	38,704
	Oct-Dec 09	3,328	3,287	41	-60	1.2%	-1.8%	34,248	26,667	77.9%	7,502	
	Year 2009/10	**12,761**	**13,130**	**-369**	**-678**	**-2.9%**	**-5.3%**	**141,178**	**110,851**	**78.5%**	**31,825**	**37,595**
	Apr-Jun 10	3,092	3,207	-115	-195	-3.7%	-6.3%	32,496	24,192	74.4%	7,013	
	Jul-Sep 10	3,908	3,332	576	365	14.7%	9.3%	37,163	31,066	83.6%	9,339	
IAG Group	Oct-Dec 10	5,124	5,116	8	121	0.2%	2.4%	50,417	39,305	78.0%		56,243
	Jan-Mar 11	4,969	5,109	-139	45	-2.8%	0.9%	51,118	37,768	73.9%		56,159
Iberia	**Year 2008**	**8,019**	**8,135**	**-116**	**47**	**-1.4%**	**0.6%**	**66,098**	**52,885**	**80.0%**		**21,578**
YE 31/12	Jan-Mar 09	1,436	1,629	-193	-121	-13.4%	-8.4%	15,369	11,752	76.5%		20,715
	Apr-Jun 09	1,455	1,632	-177	-99	-12.1%	-6.8%	15,668	12,733	81.3%		20,760
	Jul-Sep 09	1,667	1,744	-77	-23	-4.6%	-1.4%	16,275	13,369	82.1%		21,113
	Oct-Dec 09	1,589	1,784	-195	-134	-12.3%	-8.5%	14,846	11,759	79.2%		20,096
	Year 2009	**6,149**	**6,796**	**-647**	**-381**	**-10.5%**	**-6.2%**	**62,158**	**49,612**	**79.8%**		**20,671**
	Jan-Mar 10	1,453	1,552	-98	-72	-6.8%	-5.0%	14,360	11,605	80.8%		19,643
	Apr-Jun 10	1,502	1,498	27	40	1.8%	2.6%	15,324	12,648	82.5%		20,045
	Jul-Sep 10	1,730	1,637	93	95	5.4%	5.5%	16,834	14,404	85.6%		20,668
Lufthansa	**Year 2008**	**36,551**	**34,625**	**1,926**	**812**	**5.3%**	**2.2%**	**195,431**	**154,155**	**78.9%**	**70,543**	**108,123**
YE 31/12	Jan-Mar 09	6,560	6,617	-58	-335	-0.9%	-5.1%	44,179	32,681	74.0%	15,033	106,840
	Apr-Jun 09	7,098	7,027	71	54	1.0%	0.8%	49,939	38,076	76.2%	18,142	105,499
	Jul-Sep 09	8,484	8,061	423	272	5.0%	3.2%	56,756	46,780	82.4%	22,164	118,945
	Year 2009	**31,077**	**30,699**	**378**	**-139**	**1.2%**	**-0.4%**	**206,269**	**160,647**	**77.9%**	**76,543**	**112,320**
	Jan-Mar 10	7,978	8,435	-457	-413	-5.7%	-5.2%	52,292	39,181	74.9%	19,031	117,732
	Apr-Jun 10	8,763	8,560	203	248	2.3%	2.8%	57,565	45,788	79.5%	22,713	116,844
	Jul-Sep 10	9,764	8,754	1,010	810	10.3%	8.3%	63,883	53,355	83.5%	26,089	116,838
	Year 2010	**36,057**	**34,420**	**1,636**	**1,492**	**4.5%**	**4.1%**	**235,837**	**187,700**	**79.3%**	**91,157**	**117,019**
SAS	**Year 2008**	**8,120**	**8,277**	**-107**	**-977**	**-1.3%**	**-12.0%**	**41,993**	**29,916**	**71.2%**	**29,000**	**24,635**
YE 31/12	Jan-Mar 09	1,352	1,469	-118	-90	-8.7%	-6.6%	8,870	5,541	62.5%	5,748	22,133
	Apr-Jun 09	1,546	1,665	-119	-132	-7.7%	-8.6%	9,584	7,055	73.6%	6,850	18,676
	Jul-Sep 09	1,522	1,486	36	21	2.3%	1.4%	8,958	6,868	76.7%	6,245	17,825
	Oct-Dec 09	1,474	1,676	-202	-186	-13.7%	-12.6%	8,160	5,764	70.6%	6,055	16,510
	Year 2009	**5,914**	**6,320**	**-406**	**-388**	**-6.9%**	**-6.6%**	**35,571**	**25,228**	**70.9%**	**24,898**	**18,786**
	Jan-Mar 10	1,322	1,428	-106	-99	-8.0%	-7.5%	7,951	5,471	68.8%	5,735	15,835
	Apr-Jun 10	1,321	1,367	-46	-66	-3.5%	-5.0%	8,769	6,612	75.4%	6,282	15,709
	Jul-Sep 10	1,471	1,538	-67	-145	-4.6%	-9.8%	9,180	7,239	78.9%	6,655	15,570
	Oct-Dec 10	1,556	1,606	-51	7	-3.2%	0.4%	8,761	6,389	72.9%	6,557	15,123
	Year 2010	**5,660**	**5,930**	**-270**	**-308**	**-4.8%**	**-5.4%**	**34,660**	**25,711**	**74.2%**	**25,228**	**15,559**
Ryanair	**Year 2008/09**	**4,191**	**3,986**	**205**	**-241**	**4.9%**	**-5.7%**			**81.0%**	**58,559**	
YE 31/03	Apr-Jun 09	1,055	844	211	168	20.0%	15.9%			83.0%	16,600	
	Jul-Sep 09	1,418	992	426	358	30.0%	25.2%			88.0%	19,800	
	Oct-Dec 09	904	902	2	-16	0.2%	-1.8%			82.0%	16,021	
	Year 2009/10	**4,244**	**3,656**	**568**	**431**	**13.5%**	**10.2%**			**82.0%**	**66,500**	
	Apr-Jun 10	1,145	992	152	120	13.3%	10.5%			83.0%	18,000	7,828
	Jul-Sep 10	1,658	1,150	508	426	30.7%	25.7%			85.0%	22,000	8,100
	Oct-Dec 10	1,015	1,016	-1	-14	-0.1%	-1.3%			85.0%	17,060	8,045
easyJet	Apr-Sep 08	2,867	2,710	157	251	5.5%	8.7%	32,245	28,390	88.0%	24,800	
YE 30/09	**Year 2007/08**	**4,662**	**4,483**	**180**	**164**	**3.9%**	**3.5%**	**55,687**	**47,690**	**85.6%**	**43,700**	**6,107**
	Oct 08-Mar 09	1,557	1,731	-174	-130	-11.2%	-8.3%	24,754	21,017	84.9%	19,400	
	Year 2008/09	**4,138**	**3,789**	**93**	**110**	**2.3%**	**2.7%**	**58,165**	**50,566**	**86.9%**	**45,200**	
	Oct 09 - Mar10	1,871	1,995	-106	-94	-5.6%	-5.0%	27,077	23,633	87.3%	21,500	
	Year 2009/10	**4,635**	**4,364**	**271**	**240**	**5.9%**	**5.2%**	**62,945**	**56,128**	**87.0%**	**48,800**	
	Oct 10 - Mar 11	1,950	2,243	-229	-181	-11.7%	-9.3%	29,988	26,085	87.0%	23,900	

Note: 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	Oct - Dec 09	846	793	53	24	6.3%	2.8%	9,133	7,322	80.2%	3,765	8,701
	Year 2009	**3,399**	**3,132**	**267**	**122**	**7.9%**	**3.6%**	**37,246**	**29,550**	**79.3%**	**15,561**	**8,915**
	Jan - Mar 10	830	804	26	5	3.1%	0.6%	8,917	7,197	80.7%	3,641	8,537
	Apr -Jun 10	976	866	110	59	11.3%	6.0%	9,836	8,162	83.0%	4,170	8,621
	Jul - Sep 10	1,068	851	216	122	20.2%	11.4%	10,531	8,980	85.3%	4,562	8,737
	Oct - Dec 10	959	839	119	65	12.4%	6.8%	10,037	8,410	83.8%	4,141	8,711
	Year 2010	**3,832**	**3,361**	**472**	**251**	**12.3%**	**6.6%**	**39,322**	**32,749**	**83.3%**	**16,514**	**8,651**
	Jan - Mar 11	965	831	134	74	13.9%	7.7%	11,445	9,419	82.3%	5,752	11,884
American	Oct - Dec 09	5,063	5,453	-390	-344	-7.7%	-6.8%	59,356	48,131	81.1%	20,893	78,000
	Year 2009	**19,917**	**20,921**	**-1,004**	**-1,468**	**-5.0%**	**-7.4%**	**244,250**	**197,007**	**80.7%**	**85,719**	**78,900**
	Jan - Mar 10	5,068	5,366	-298	-505	-5.9%	-10.0%	59,296	46,187	77.9%	20,168	77,800
	Apr -J un 10	5,674	5478	196	-11	3.5%	-0.2%	61,788	51,821	83.9%	22,166	78,300
	Jul - Sep 10	5,842	5,500	342	143	5.9%	2.4%	64,277	53,985	84.0%	22,468	78,600
	Oct - Dec 10	5,586	5,518	68	-97	1.2%	-1.7%	61,219	49,927	81.6%	21,299	78,300
	Year 2010	**22,170**	**21,862**	**308**	**-471**	**1.4%**	**-2.1%**	**246,611**	**201,945**	**81.9%**	**86,130**	**78,250**
	Jan - Mar 11	5,533	5,765	-232	-436	-4.2%	-7.9%	60,912	46,935	77.1%	20,102	79,000
Continental	Oct - Dec 09	3,182	3,181	1	85	0.0%	2.7%	42,308	34,700	82.0%	15,258	41,000
	Year 2009	**12,586**	**12,732**	**-146**	**-282**	**-1.2%**	**-2.2%**	**176,305**	**143,447**	**81.4%**	**62,809**	**41,000**
	Jan - Mar 10	3,169	3,220	-51	-146	-1.6%	-4.6%	42,350	33,665	79.5%	14,535	39,365
	Apr - Jun 10	3,708	3,380	328	233	8.8%	6.3%	39,893	33,910	85.0%	16,300	38,800
	Jul - Sep 10	3,953	3,512	441	354	11.2%	9.0%	46,844	40,257	85.9%	16,587	38,900
Delta	Oct - Dec 09	6,805	6,851	-46	-25	-0.7%	-0.4%	85,814	70,099	81.7%	37,947	81,106
	Year 2009	**28,063**	**28,387**	**-324**	**-1,237**	**-1.2%**	**-4.4%**	**370,672**	**304,066**	**82.0%**	**161,049**	**81,106**
	Jan - Mar 10	6,848	6,780	68	-256	1.0%	-3.7%	85,777	68,181	79.5%	36,553	81,096
	Apr - Jun 10	8,168	7,316	852	467	10.4%	5.7%	94,463	80,294	85.0%	42,207	81,916
	Jul - Sep 10	8,950	7,947	1,003	363	11.2%	4.1%	102,445	87,644	85.6%	44,165	79,005
	Oct - Dec 10	7,789	7,495	294	19	3.8%	0.2%	91,774	74,403	81.1%	39,695	79,684
	Year 2010	**31,755**	**29,538**	**2,217**	**593**	**7.0%**	**1.9%**	**374,458**	**310,867**	**83.0%**	**162,620**	**79,684**
	Jan - Mar 11	7,747	7,839	-92	-318	-1.2%	-4.1%	90,473	69,086	76.4%	36,764	81,563
Southwest	Oct - Dec 09	2,712	2,545	167	116	6.2%	4.3%	37,828	29,249	77.3%	25,386	34,726
	Year 2009	**10,350**	**10,088**	**262**	**99**	**2.5%**	**1.0%**	**157,714**	**119,823**	**76.0%**	**86,310**	**34,726**
	Jan - Mar 10	2,630	2,576	54	11	2.1%	0.4%	36,401	27,618	75.9%	23,694	34,637
	Apr - Jun 10	3,168	2,805	363	112	11.5%	3.5%	40,992	32,517	79.3%	22,883	34,636
	Jul - Sep 10	3,192	2,837	355	205	11.1%	6.4%	41,130	33,269	80.9%	22,879	34,836
	Oct - Dec 10	3,114	2,898	216	131	6.9%	4.2%	38,891	32,196	80.7%	22,452	34,901
	Year 2010	**12,104**	**11,116**	**988**	**459**	**8.2%**	**3.8%**	**158,415**	**125,601**	**79.3%**	**88,191**	**34,901**
	Jan - Mar 11	3,103	2,989	114	5	3.7%	0.2%	39,438	30,892	78.3%	25,599	35,452
United	Oct - Dec 09	4,193	4,267	-74	-240	-1.8%	-5.7%	54,121	44,273	81.8%	19,618	42,700
	Year 2009	**16,335**	**16,496**	**-161**	**-651**	**-1.0%**	**-4.0%**	**226,454**	**183,854**	**81.2%**	**81,246**	**43,600**
	Jan - Mar 10	4,241	4,172	69	-82	1.6%	-1.9%	53,023	42,614	80.4%	18,818	42,800
	Apr - Jun 10	5,161	4,727	434	273	8.4%	5.3%	58,522	49,319	84.3%	21,234	42,600
	Jul - Sep 10	5,394	4,859	535	387	9.9%	7.2%	61,134	52,534	85.9%	22,253	42,700
United/Continental	Oct-Dec 10	8,433	8,515	-82	-325	-1.0%	-3.9%	100,201	82,214	82.0%	35,733	80,800
Pro-forma FY 2010	**Year 2010**	**34,013**	**32,195**	**1,818**	**854**	**5.3%**	**2.5%**	**407,304**	**338,824**	**83.2%**	**145,550**	**81,500**
	Jan - Mar 11	8,202	8,168	34	-213	0.4%	-2.6%	96,835	75,579	78.0%	32,589	82,000
US Airways Group	Oct - Dec 09	2,626	2,612	14	-79	0.5%	-3.0%	32,456	25,509	78.6%	18,801	31,333
	Year 2009	**10,458**	**10.340**	**118**	**-205**	**1.1%**	**-2.0%**	**136,939**	**110,171**	**80.5%**	**77,965**	**31,333**
	Jan - Mar 10	2,651	2,661	-10	-45	-0.4%	-1.7%	31,957	24,659	77.2%	17,931	30,439
	Apr - Jun 10	3,171	2,800	371	279	11.7%	8.7%	35,517	29,461	82.9%	20,642	30,860
	Jul - Sep 10	3,179	2,864	315	240	9.9%	7.5%	36,808	30.604	83.1%	20,868	30,445
	Oct - Dec 10	2,907	2,802	105	28	3.6%	1.0%	33,823	27,271	80.6%	20,118	
	Year 2010	**11,908**	**11,127**	**781**	**502**	**6.6%**	**4.2%**	**138,107**	**111,996**	**81.1%**	**79,560**	
	Jan - Mar 11	2,961	3,000	-39	-114	-1.3%	-3.9%	33,034	25,762	78.0%	18,851	30,621
JetBlue	Oct - Dec 09	832	768	64	11	7.7%	1.3%	12,855	10,208	79.4%	5,457	10,704
	Year 2009	**3,286**	**3,007**	**279**	**58**	**8.5%**	**1.8%**	**52,396**	**41,769**	**79.7%**	**22,450**	**10,704**
	Jan - Mar 10	870	828	42	-1	4.8%	-0.1%	13,557	10,412	76.8%	5,528	11,084
	Apr - Jun 10	939	845	94	30	10.0%	3.2%	13,981	11,468	82.0%	6,114	10,906
	Jul - Sep 10	1,039	890	140	59	13.5%	5.7%	14,648	12,390	84.6%	6,573	10,669
	Oct - Dec 10	940	883	57	9	6.1%	1.0%	13,727	11,239	81.9%	6,039	11,121
	Year 2010	**3,779**	**3,446**	**333**	**97**	**8.8%**	**2.6%**	**55,914**	**45,509**	**81.4%**	**24,254**	**11,121**
	Jan - Mar 11	1,012	967	45	3	4.4%	0.3%	13,696	11,143	81.4%	6,039	11,281

Note: Annual figures may not add up to sum of interim results due to adjustments and consolidation. 1 ASM = 1.6093 ASK. All US airline financial year ends are December 31st.

		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.
ANA	**Year 2006/07**	**12,763**	**11,973**	**790**	**280**	**6.2%**	**2.2%**	**85,728**	**58,456**	**68.2%**	**49,500**	**32,460**
YE 31/03	**Year 2007/08**	**13,063**	**12,322**	**740**	**563**	**5.7%**	**4.3%**	**90,936**	**61,219**	**67.3%**	**50,384**	
	Year 2008/09	**13,925**	**13,849**	**75**	**-42**	**0.5%**	**-0.3%**	**87,127**	**56,957**	**65.4%**	**47,185**	
	Year 2009/10	**13,238**	**13,831**	**-582**	**-614**	**-4.4%**	**-4.6%**	**83,827**	**55,617**	**66.3%**	**44,560**	
	Year 2010/11	**15,889**	**15,093**	**796**	**269**	**5.0%**	**1.7%**	**85,562**	**59,458**	**69.5%**	**45,748**	**33,000**
Cathay Pacific	**Year 2007**	**9,661**	**8,670**	**991**	**900**	**10.3%**	**9.3%**	**102,462**	**81,101**	**79.8%**	**23,250**	**19,840**
YE 31/12	Jan-Jun 08	5,443	5,461	-18	-71	-0.3%	-1.3%	56,949	45,559	80.0%	12,463	
	Year 2008	**11,119**	**12,138**	**-1,018**	**-1,070**	**-9.2%**	**-9.6%**	**115,478**	**90,975**	**78.8%**	**24,959**	**18,718**
	Jan-Jun 09	3,988	3,725	263	119	6.6%	3.0%	55,750	43,758	78.5%	11,938	18,800
	Year 2009	**8,640**	**7,901**	**740**	**627**	**8.6%**	**7.3%**	**111,167**	**96,382**	**86.7%**	**24,558**	**18,511**
	Jan-Jun 10	5,320	4,681	917	892	17.2%	16.8%	55,681	46,784	84.0%	12,954	
	Year 2010	**11,522**	**10,099**	**1,813**	**1,790**	**15.7%**	**15.5%**	**115,748**	**96,548**	**84.0%**	**26,796**	**21,592**
JAL	**Year 2005/06**	**19,346**	**19,582**	**-236**	**-416**	**-1.2%**	**-2.2%**	**148,591**	**100,345**	**67.5%**	**58,040**	**53,010**
YE 31/03	**Year 2006/07**	**19,723**	**19,527**	**196**	**-139**	**1.0%**	**-0.7%**	**139,851**	**95,786**	**68.5%**	**57,510**	
	Year 2007/08	**19,583**	**18,793**	**790**	**148**	**4.0%**	**0.8%**	**134,214**	**92,173**	**68.7%**	**55,273**	
	Year 2008/09	**19,512**	**20,020**	**-508**	**-632**	**-2.6%**	**-3.2%**	**128,744**	**83,487**	**64.8%**	**52,858**	
Korean Air	**Year 2006**	**8,498**	**7,975**	**523**	**363**	**6.2%**	**4.3%**	**71,895**	**52,178**	**72.6%**	**22,140**	**16,623**
YE 31/12	**Year 2007**	**9,496**	**8,809**	**687**	**12**	**7.2%**	**0.1%**	**76,181**	**55,354**	**72.7%**	**22,830**	**16,825**
	Year 2008	**9,498**	**9,590**	**-92**	**-1,806**	**-1.0%**	**-19.0%**	**77,139**	**55,054**	**71.4%**	**21,960**	**18,600**
	Year 2009	**7,421**	**7,316**	**105**	**-49**	**1.4%**	**-0.7%**	**80,139**	**55,138**	**68.8%**	**20,750**	**19,178**
	Year 2010	**10,313**	**8,116**	**120**	**421**	**1.2%**	**4.1%**	**79,457**	**60,553**	**76.2%**	**22,930**	
Malaysian	**Year2006**	**3,696**	**3,751**	**-55**	**-37**	**-1.5%**	**-1.0%**	**58,924**	**41,129**	**69.8%**	**15,466**	**19,596**
YE 31/12	**Year 2007**	**4,464**	**4,208**	**256**	**248**	**5.7%**	**5.6%**	**56,104**	**40,096**	**71.5%**	**13,962**	**19,423**
	Year2008	**4,671**	**4,579**	**92**	**74**	**2.0%**	**1.6%**	**52,868**	**35,868**	**67.8%**	**12,630**	**19,094**
	Year 2009	**3,296**	**3,475**	**-179**	**140**	**-5.4%**	**4.3%**	**42,790**	**32,894**	**76.9%**	**11,950**	**19,147**
	Year 2010	**4,237**	**4,155**	**82**	**73**	**1.9%**	**1.7%**	**49,624**	**37,838**	**76.2%**	**13,110**	
Qantas	**Year 2007/08**	**14,515**	**13,283**	**1,232**	**869**	**8.5%**	**6.0%**	**127,019**	**102,466**	**80.7%**	**38,621**	**33,670**
YE 30/6	Jul-Dec 08	6,755	6,521	234	184	3.5%	2.7%	63,853	50,889	79.7%	19,639	34,110
	Year 2008/09	**10,855**	**10,733**	**152**	**92**	**1.4%**	**0.8%**	**124,595**	**99,176**	**79.6%**	**38,348**	**33,966**
	Jul-Dec 09	6,014	5,889	124	52	2.1%	0.9%	62,476	51,494	82.4%	21,038	32,386
	Year 2009/10	**12,150**	**11,926**	**223**	**102**	**1.8%**	**0.8%**	**124,717**	**100,727**	**80.8%**	**41,428**	**32,490**
	Jul - Dec 10	7,176	6,832	344	226	4.8%	3.1%	66,821	54,592	81.7%	22,948	32,369
Singapore	**Year 2005/06**	**6,201**	**5,809**	**392**	**449**	**6.3%**	**7.2%**	**109,484**	**82,742**	**75.6%**	**17,000**	**13,729**
YE 31/03	**Year 2006/07**	**9,555**	**8,688**	**866**	**1,403**	**9.1%**	**14.7%**	**112,544**	**89,149**	**79.2%**	**18,346**	**13,847**
	Year 2007/08	**10,831**	**9,390**	**1,441**	**1,449**	**13.3%**	**13.4%**	**113,919**	**91,485**	**80.3%**	**19,120**	**14,071**
	Year 2008/09	**11,135**	**10,506**	**629**	**798**	**5.6%**	**7.2%**	**117,789**	**90,128**	**76.5%**	**18,293**	**14,343**
	Year 2009/10	**8,908**	**8,864**	**44**	**196**	**0.5%**	**2.2%**	**105,674**	**82,882**	**78.4%**	**16,480**	
	Year 2010/11	**10,911**	**9,956**	**955**	**863**	**8.8%**	**7.9%**	**108,060**	**81,801**	**75.7%**	**16,647**	
Air China	**Year 2006**	**5,647**	**5,331**	**316**	**338**	**5.6%**	**6.0%**	**79,383**	**60,276**	**75.9%**	**31,490**	**18,872**
YE 31/12	**Year 2007**	**6,770**	**6,264**	**506**	**558**	**7.5%**	**8.2%**	**85,257**	**66,986**	**78.6%**	**34,830**	**19,334**
	Year 2008	**7,627**	**7,902**	**-275**	**-1,350**	**-3.6%**	**-17.7%**	**88,078**	**66,013**	**74.9%**	**34,250**	**19,972**
	Year 2009	**7,523**	**6,718**	**805**	**710**	**10.7%**	**9.4%**	**95,489**	**73,374**	**76.8%**	**39,840**	**23,506**
	Year 2010	**12,203**	**10,587**	**1,616**	**1,825**	**13.2%**	**15.0%**	**107,404**	**86,193**	**80.3%**	**46,420**	
China Southern	**Year 2006**	**5,808**	**5,769**	**39**	**26**	**0.7%**	**0.4%**	**97,044**	**69,575**	**71.7%**	**49,200**	**45,575**
YE 31/12	**Year 2007**	**7,188**	**6,974**	**214**	**272**	**3.0%**	**3.8%**	**109,733**	**81,172**	**74.0%**	**56,910**	**45,474**
	Year 2008	**7,970**	**8,912**	**-942**	**-690**	**-11.8%**	**-8.7%**	**112,767**	**83,184**	**73.8%**	**58,240**	**46,209**
	Year 2009	**8,022**	**7,811**	**211**	**48**	**2.6%**	**0.6%**	**123,440**	**93,000**	**75.3%**	**66,280**	**50,412**
	Year 2010	**11,317**	**10,387**	**930**	**857**	**8.2%**	**7.6%**	**140,498**	**111,328**	**79.2%**	**76,460**	
China Eastern	**Year 2006**	**3,825**	**4,201**	**-376**	**-416**	**-9.8%**	**-10.9%**	**70,428**	**50,243**	**71.3%**	**35,020**	**38,392**
YE 31/12	**Year 2007**	**5,608**	**5,603**	**5**	**32**	**0.1%**	**0.6%**	**77,713**	**57,180**	**73.6%**	**39,160**	**40,477**
	Year 2008	**6,018**	**8,192**	**-2,174**	**-2,201**	**-36.1%**	**-36.6%**	**75,919**	**53,754**	**70.8%**	**37,220**	**44,153**
	Year 2009	**5,896**	**5,629**	**267**	**25**	**4.5%**	**0.4%**	**84,422**	**60,918**	**72.2%**	**44,030**	**45,938**
	Year 2010	**11,089**	**10,248**	**841**	**734**	**7.6%**	**6.6%**	**119,451**	**93,153**	**78.0%**	**64,930**	
Air Asia (Malaysia)	**Year 2008**	**796**	**592**	**203**	**-142**	**25.5%**	**-17.9%**	**14,353**	**10,515**	**73.3%**	**9,183**	**4,593**
YE 31/12	**Year 2009**	**905**	**539**	**366**	**156**	**40.4%**	**17.3%**	**21,977**	**15,432**	**70.2%**	**14,253**	
	Year 2010	**1,245**	**887**	**358**	**333**	**28.8%**	**26.7%**	**24,362**	**18,499**	**75.9%**	**16,050**	

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 International		
	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %
1992	129.6	73.5	56.7	134.5	95.0	70.6	89.4	61.6	68.9	296.8	207.1	69.8	445.8	293.4	65.8
1993	137.8	79.8	57.9	145.1	102.0	70.3	96.3	68.1	70.7	319.1	223.7	70.1	479.7	318.0	66.3
1994	144.7	87.7	60.6	150.3	108.8	72.4	102.8	76.1	74.0	334.0	243.6	72.9	503.7	346.7	68.8
1995	154.8	94.9	61.3	154.1	117.6	76.3	111.1	81.1	73.0	362.6	269.5	74.3	532.8	373.7	70.1
1996	165.1	100.8	61.1	163.9	126.4	77.1	121.1	88.8	73.3	391.9	292.8	74.7	583.5	410.9	70.4
1997	174.8	110.9	63.4	176.5	138.2	78.3	130.4	96.9	74.3	419.0	320.5	76.5	621.9	450.2	72.4
1998	188.3	120.3	63.9	194.2	149.7	77.1	135.4	100.6	74.3	453.6	344.2	75.9	673.2	484.8	72.0
1999	200.0	124.9	62.5	218.9	166.5	76.1	134.5	103.1	76.7	492.3	371.0	75.4	727.2	519.5	71.4
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	73.5
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	71.4
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	74.7
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	74.2
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	75.5
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	76.9
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	77.4
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	78.0
2008	354.8	241.5	68.1	244.8	199.2	81.4	191.1	153.8	80.5	634.7	512.4	80.7	955.7	735.0	76.9
2009	322.1	219.3	68.1	227.8	187.7	82.4	181.2	145.8	80.5	603.8	488.7	80.9	912.7	701.1	76.8
2010	332.3	232.6	70.0	224.2	188.1	83.9	180.2	150.0	83.2	604.1	500.4	82.8	922.7	752.8	78.7
April 11	29.2	21.1	72.1	20.7	17.3	83.5	16.3	12.3	75.5	54.3	43.5	80.0	82.5	64.0	77.6
Ann. change	22.4%	30.5%	4.4	26.2%	26.1%	-0.1	26.2%	18.8%	-4.7	24.3%	22.9%	-1.0	23.9%	24.8%	0.6
Jan-April 11	107.1	70.6	65.9	73.2	55.9	76.3	64.6	50.4	78.0	208.5	162.7	78.0	311.8	231.2	74.2
Ann. change	8.9%	11.7%	1.7	14.5%	10.1%	-3.0	15.7%	9.1%	-4.7	13.4%	9.3%	-2.9	12.1%	9.8%	-1.5

Source: AEA.

JET ORDERS

	Date	Buyer	Order	Delivery/other information
Boeing	19 May	Lufthansa Cargo	5 x 777F	
Airbus	03 May			
Bombardier	01 June	Braathens Aviation	5 x CS100, 5 x CS300	plus 10 C-series options
Embraer				

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

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