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North Atlantic: Virtual airlines protest too much?

A SIDE-EFFECT of the US carriers' political attack on the Gulf super-connectors has been a new focus on the profitability of the North Atlantic market, which might just provoke a regulatory response.

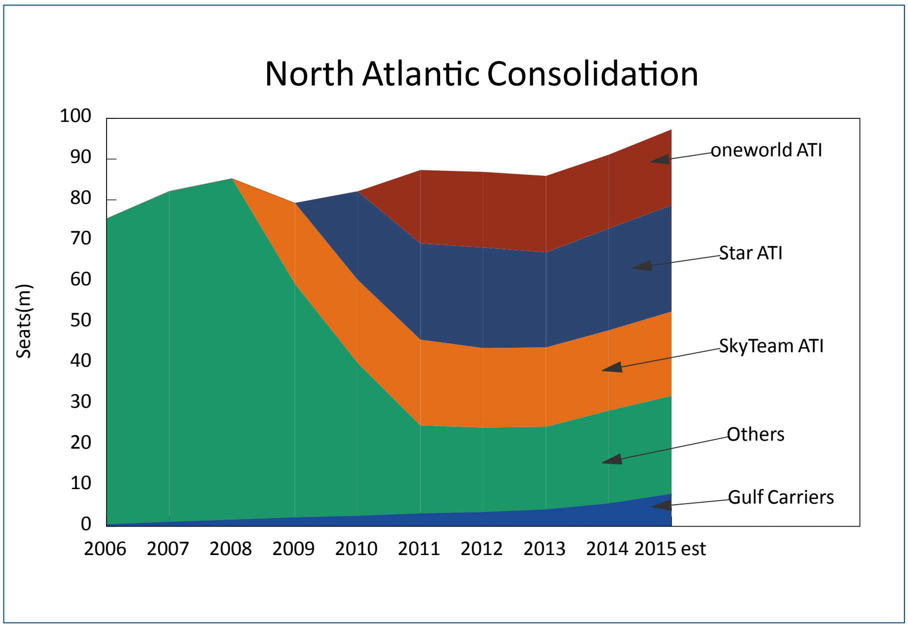
At first sight, it is not obvious why the US carriers have chosen to attack the Gulf carriers so vehemently. There are, remarkably, only two routes where the US carriers compete directly with the Gulf carriers: Dubai to Washington (Emirates and United) and Milan — New York (Emirates, Delta, American), using fifth freedom rights.

Moreover, according to a study by Oxford Economics commissioned by Emirates, the true O&D markets of the two groups of carriers are markedly different. For the Gulf carriers, the passenger profile is dominated by Asian, Middle Eastern and African originating or destined passengers — 95% in total. By contrast these regions only account for about 18% of passengers on US airlines, their traffic being dominated by the Americas (60%) and Europe (22%).

Nevertheless, the Gulf carriers have been increasing their presence on the North Atlantic market (defined as all flights from West and East Europe, the Middle East and Africa across to North America) — their capacity share is now about 8% of seat capacity, up from just 0.6% ten years ago. It is perhaps not the relatively small current share that is important, rather it is the potential threat to the concentrated market structure on the Atlantic — about 72% of capacity is shared among three JV carriers, with each virtual airline (Star, SkyTeam and **one**world) having varying but generally very high degree of control in their own sub-markets (see table, page 2).

Over the past five years the North Atlantic market has been turned into the major profit generator for both US and European network carriers. European airlines' investor presentations frequently allude to positive trends in Atlantic unit revenues, though they have all stopped providing regional profitability analyses. The US DoT does compile this data for US airlines (Form 41 data), and this illustrates how important the Atlantic has become for the profitability of the US carriers (and for their European partners which in effect act as one airline on the North Atlantic, coordinating prices and capacity, and ultimately sharing profits).

For the US Big 3, Atlantic margins



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Oligopolisation of the North Atlantic.

Capacity shares on Alliance JV European hub to North American hub routes

STAR ALLIANCE							
	EWR	**IAD**	**ORD**	**YYZ**	**LAX**	**SFO**	**TOTAL ATLANTIC**
FRA	100%	100%	100%	100%	100%	100%	87%
MUC	100%	100%	100%	100%	100%	100%	89%
ZRH	100%	100%	100%	100%	100%	100%	82%
SKYTEAM							
	JFK	**ATL**	**DTW**	**MSP**	**SLC**		**TOTAL ATLANTIC**
CDG	75%	100%	100%	100%	100%		67%
AMS	100%	100%	100%	100%	100%		88%
FCO	83%	100%	100%				55%
ONEWORLD							
	JFK	**ORD**	**MIA**	**DFW**	**LAX**	**PHL**	**TOTAL ATLANTIC**
LHR	59%	61%	73%	100%	53%	84%	56%
MAD	63%	100%	81%	100%	100%	100%	78%
DUB	79%	100%				100%	71%

Source: OAG, May 2015
Notes: North Atlantic includes hub to hub and all other routes to/from the hub airport.
*Dublin analysis assumes Aer Lingus to join **one**world JV*
Rome analysis assumes Alitalia remains in Skyteam JV

in 2014 averaged 15.9%; the consolidated US domestic market, 10.2%; the Pacific, where ATI alliances with JAL/AA and ANA/UA are currently being implemented, 7.4%; the financially stressed Latin American market, -5.9%; and the total system, 9.4%. Over half the $2bn improvement in the Big 3's operating profit between 2013 and 2014 was generated by the North Atlantic sector.

The US carriers' economic rationale then becomes clearer. Their aim is to protect their major profit-generator — the North Atlantic — by maintaining "disciplined" capacity growth which the Gulf carriers are beginning to threaten, and to stem the traffic loss to the Gulf carriers from their European partners on Asian, Middle East and African routes to North America, which directly impacts their joint services across the Atlantic. Over the past five years the three JVs have grown in total by 1% pa, the Gulf carriers have expanded by 20% pa but from a low base, and the overall market capacity has increased by 2% pa.

The risk for the US carriers, and some of their European partners, is that by using aeropolitical action (in which they are supported by the labour unions) to combat the Gulf carriers they may provoke a regulatory backlash. The US DoJ is showing signs of unease with the degree of consolidation within the US, launching an investigation into possible price and capacity collusion. It seems unlikely at present that they will find any damning evidence for this, but next the US DoJ could turn to the Atlantic where it has always been unhappy about the antitrust immunity afforded to former competitors.

One issue might be that the academic economic analysis which was used by the US DoT to justify the virtual mergers — "horizontal double-marginalisation" (don't ask). Essentially though, the assumption was that virtual mergers would result in lower fares, net of fuel and other external cost changes. Intuition and evidence suggest otherwise; to take one example, a July 2015 survey by CWL Solutions (a travel consultancy, owned by Carlson Wagon Lit) observed that bookings on North Atlantic JVs had jumped from 16% of the total in 2009 to 94% in 2014 and that the average fare recorded for the Atlantic had risen by 17%, compared to 11% on average for all intercontinental routes.

Rising fares by themselves do not necessarily point to anti-competitive behaviour; the industry has to rationalise to earn its cost of capital over the long term. But the degree of concentration in sub markets can only be justified if there is clear effective inter-network competition.

The table on page 2 summarises the current situation as regards transatlantic hub to hub traffic flows, showing capacity shares on routes between each alliance's Euro-hubs and those of the partner airline in North America.

Star has been able to build up total dominance. All the traffic between Star's Euro-hubs and its US hubs belongs to the JV. Connecting traffic at both ends is guaranteed to be funnelled into the JV, ie onto one single virtual airline.

SkyTeam has achieved near dominance on its hub-to-hubs, with the exception of the well contested JFK market.

oneworld cannot achieve the same degree of dominance simply because its hubs at London and New York are also top global destinations, served from numerous other alliance hubs, and the volume of Atlantic traffic at LHR, Europe's prime O&D point, is over twice that at CDG or FRA. There is also of course the presence of a local rival, Virgin Atlantic: allied with Delta, this virtual airline commands 39% of the LHR-JFK market and 23% of the total LHR-US market against **one**world's 59% on LHR-JFK and 56% on the total market.

Davies Commission exposes pre-funding dilemma

It is now several weeks since the Davies Commission issued its final report on new runway capacity for the South East of England. Given the enormous amount written about the report, you might think that there is not a great deal more to say. In fact, the spin generated by the reactions to the report means that it is sometimes difficult to see the forest for the trees. It is time to try to identify the key issues and how they might play out over the coming months and years, and one major issue in particular.

The starting point is the fact that the UK is rapidly running out of airport capacity in the South East of England, especially for hub operations on which Howard Davies was asked to focus. Davies found that for aircraft movements Heathrow has been full since 2010 and that Gatwick will be full by 2020, London City by 2024, Luton by 2030 and Stansted by 2041. (It may be worth reminding ourselves that the last Labour Government's Airports White Paper outlined proposals for two new runways, one at Stansted to be opened by 2012 and one at Heathrow to follow in 2020.)

This underlying problem of capacity shortage has been recognised for many years, and studies of what to do about it have almost become a growth industry in the UK.

In terms of scale and thoroughness, the Roskill Commission, which reported in 1970, is usually regarded as the first major analysis undertaken, but it was by no means the first, nor of course the last.

Not one of the many studies got anywhere in terms of implementation of their recommendations for increased runway capacity, overwhelmingly because of the lack of political commitment. To say that after all the hard work the aviation industry has been frustrated is something of an understatement.

In his book "*Great Planning Disasters*" (1980), Peter Hall commented that: "After the biggest inquiry, by the Roskill Commission,… someone unkindly said that the documentation, suitably pulped and compressed, could provide all the material needed for the runways." Heaven knows how many airports could have been built with all the subsequent reports, submissions and responses.

It might be thought, therefore, that by 2012 yet another study was the last thing needed. But politicians faced with an awkward policy commitment and an approaching election didn't see it like that.

London's Runway Options

Net present value and social benefits assessment (2014£bn)

	Gatwick		**Heathrow**			
	Second runway		Extended runway		Northwest runway	
	High	Low	High	Low	High	Low
Consumer benefits	47.1	27.2	46.5	29.1	54.8	33.6
Producer surplus	-41.8	-24.7	-31.6	-21.9	-38.4	-25.8
Government revenue	2.5	1.0	1.5	1.3	1.8	1.9
Delays	2.4	2.6	0.8	2.4	1.0	3.0
Wider economic impacts	8.1	5.5	10.0	6.6	11.5	7.7
Other dis-benefits	-1.6	-1.1	-2.8	-2.3	-2.7	-3.0
Total benefits	60.1	36.3	58.7	39.3	69.1	46.2
Total dis-benefits	-43.3	-25.8	-34.4	-24.3	-41.1	-28.8
Net social benefit	16.8	10.5	24.4	15.1	28.0	17.4
Scheme and surface access cost	-6.0	-5.0	-14.1	-14.0	-16.1	-16.0
NPV	**10.8**	**5.5**	**10.2**	**1.0**	**11.8**	**1.4**

Source: Davies Commission Final Report.
Note: High case based on carbon-traded assumptions. Low case based on carbon-capped assumptions.

Hence the Davies Commission, an exercise set up with the resources to at least match those of Roskill, but with the added, and politically useful, objective of delaying any final decision until after the 2015 General Election.

Davies' final report in July this year came to a unanimous (unlike Roskill) and unequivocal set of decisions, in particular that there is a need for one, and eventually two, additional runways in the South East of England, and that the first one should be built at Heathrow rather than Gatwick.

Over a sixty-year period, the Commission estimated, the benefits to the UK could be as high as £214bn, with GDP expected to be up to 1% higher by 2050 than it would be without this additional airport capacity.The consultation generated some 63,000 responses and by any measure was thorough and comprehensive, which is not to say, of course, that its conclusions attracted universal support.

Whatever the Commission had decided, there would always have been some opposition. Having fought what many regarded as a very negative campaign against Heathrow, it would be extremely surprising if Gatwick were now to concede defeat.

Similarly, the Mayor of London, Boris Johnson, has spent political capital on supporting a new hub airport to the East of London and is clearly unwilling to give up, even in the face of enormous opposition from the aviation industry and others, including Howard Davies himself.

Finally, the environmental lobby will inevitably continue to oppose airport expansion anywhere, irrespective of the economic benefits and commitments to reduce the environmental impact of additional capacity.

Assessed scheme capacities, air transport movements

	Do minimum	Expansion	Capacity increase
Gatwick second runway	280,000	560,000	280,000
Heathrow Extended Runway	480,000	740,000	260,000
Heathrow Northwest Runway	480,000	700,000	220,000

Source: Davies Commission Final Report

It is important to recognise, however, that the political environment today is very different from what it was just five or six years ago when David Cameron made his ill-judged commitment not to build any new runways in the South East.

Aviation is no longer widely regarded as the toxic industry it once was. The economic downturn helped to focus attention on the importance of growth and employment and the role aviation plays in generating prosperity. Companies in both manufacturing and services, once unwilling to be seen supporting the expansion of air transport, are now openly and willingly campaigning for more runways. The Labour Party (at least under its current leadership) has committed to support Davies' recommendations, and it seems a majority of the Conservative Party is similarly leaning in that direction.

The old debate about expanding Heathrow or regional airports has been laid to rest and shown to be a false choice; growth at Heathrow not only does not prevent growth at Manchester, Edinburgh or Newcastle, it positively helps it.

None of this means that the battle has been won. Noisy, and perhaps even violent, opposition is likely and the Government will still be faced with a difficult political decision.

This should not come as a surprise to anyone given the history of UK airport planning since the Second World War. Even the briefest of studies of that history highlights two clear and recurring themes, both of which have emerged again in recent years.

Two recurring themes

The first, and perhaps less expected, is that despite the seriousness of the subject matter and the amounts of money involved, airport expansion has attracted some crazy ideas.

There are plenty of examples, but a particularly "innovative" one emerged in 1967, when Sir Donald Gibson, Director General of Research and Development at the Ministry of Public Buildings and Works, and one might assume a serious senior civil servant not prone to smoking certain substances, proposed that a new airport made of expanded polystyrene should be constructed to float on mud flats in the Thames Estuary. Passengers could travel to the new airport, he argued, by hovercraft.

The more recent suggestions for a Thames Estuary airport, while lacking Sir Donald's more visionary innovation, might nevertheless be placed into the same category of the totally unworkable.

The second recurring theme in post-war UK airport planning is more serious and at the end of the day far more damaging.

The absence of political will to

take what are admittedly difficult decisions has been seen time and again. More specifically, what we have had is a cycle whereby a political party sees electoral gain in opposing airport expansion, is elected and soon realises the error of its previous judgement, sets up a review of some form to dig itself out of the hole it has found itself in, concludes that more capacity is after all needed, only to be replaced by another party which has identified opposition to more runways as a vote winner.

The pattern isn't perfect over the decades, but it is sufficiently clear to act as a guide.

The current Conservative Government and its Coalition predecessor are, of course, a good example. Labour's commitment to two new South East runways was overturned by David Cameron in the hope of winning marginal seats near Heathrow. Instead of a long-term strategy for aviation, we had a political slogan: *Better not Bigger.*

The result was inevitable, although it took some time to emerge. The increased focus on economic growth, employment and trade led to growing doubts about the sustainability of a "no more runways" policy, resulting in a lengthy review by the Davies Commission and eventually, after the General Election, to a potential political U-turn. As the saying goes, it's déjà-vu all over again.

Where now?

So where do we go from here? On balance the signs for a positive decision on a third runway for Heathrow are actually quite positive, but you would be foolish to bet your house on it.

The Davies Commission, combined with strong business support and reduced environmental opposition (the proposal to ban night flights if a third runway is built could be crucial here), have certainly made it easier for the Government.

On the other hand, we have been here before and history suggests that at the end of the day the politicians will lack the commitment (or bravery) to support expansion. For a politician, as former Secretary of State for Transport Lord Adonis has recently noted, doing nothing is often the easiest way out.

But let's assume that on the last day of Parliament before the 2015 Christmas recess the current Secretary of State for Transport announces that, subject to a raft of safeguards and conditions, the Government will support a third Heathrow runway. Inevitably that would not be the end of the saga; it would barely be the beginning of the end.

The Government should be able ensure that the necessary Parliamentary legislation is passed relatively smoothly, especially if the Labour Party maintains its support, despite strong opposition from some of its own MPs, not least Boris Johnson.

There will almost certainly be noisy and aggressive protests and legal challenges, but it is probably reasonable to assume that one of the reasons for the Government's delay in announcing its conclusion is that it is determined to make such a decision as challenge-proof as possible, just as Howard Davies did with respect to his report.

Capital raising not a problem

However, the position taken by certain airlines highlights one major issue which has to be addressed, but to which at present there is no obvious solution acceptable to all stakeholders. Raising the capital for a third Heathrow runway should not be a major problem, despite the size of the investment involved. This was not only the conclusion of the Airports Commission, but also of the regulator, the Civil Aviation Authority.

In his Beesley Lecture in October last year, the CAA's former Group Director for Regulatory Policy noted unequivocally, for example, that "runway expansion should be achievable with private capital, with or without a regulatory under-pinning."

Such a conclusion is hardly surprising. Heathrow is after all a monopoly where demand for access far exceeds supply. A new runway will fill up quickly, to some extent at Gatwick's expense, which at least partly explains the Surrey airport's opposition to Heathrow's expansion. Finance will probably be needed from the public purse for improved road access etc, but most will be raised privately. The overall picture is clear; the devil is in the detail.

One of the most interesting and surprising developments to emerge in the course of the Davies Commission's consultations was the decision by easyJet to support Heathrow rather than Gatwick expansion. It seems a reasonable conclusion that this decision played a significant role in the Commission's eventual choice.

easyJet is Gatwick's largest customer by some way, and Gatwick is easyJet's largest base. The airline currently has no presence at Heathrow and has declined to bid for free slots available for UK domestic and possibly Irish services as a result of IAG's acquisition of bmi and Aer Lingus.

It has stated that the number of slots available is too small for a viable operation, but such an argument is hardly credible given the scale of its operations at many other airports where it similarly faces a major legacy competitor. It is far more likely that easyJet is only too well aware of the fact that entering the Heathrow market now would put it at a major disadvantage later when/if slots for a new runway are allocated.

And this highlights the critical regulatory problem which the Government, the regulator and the whole industry will have to face eventually, but which so far has attracted only limited public attention.

If easyJet's decision to support Heathrow was a surprise, so surely was the announcement by Willie Walsh that IAG was not in favour of a third runway there.

Over several years the IAG Chief Executive had maintained that a new runway would never be built because the political will to overturn decades of inaction did not exist. But that wasn't the same as actively opposing construction. (Ironically, BA itself had continued to lobby for a third Heathrow runway until quite recently.)

Walsh now argues that the costs of expanding Heathrow are "outrageous" and can't be financed. "I think the issues that need to be addressed are so very, very significant, not just the politics…. I think there is a major issue to address in terms of the cost of the infrastructure, and I fail to see how the airport will be able to finance it given the impact that it would have on the operating costs for Heathrow."

Not surprisingly, Gatwick Airport seized on IAG's opposition to argue that the Davies Commission report was "unravelling fast", ignoring the rather obvious point that Willie Walsh would almost certainly have been even more opposed to a new Gatwick runway for exactly the same reasons.Talk of the ability or inability to finance airport expansion really serves only to obfuscate the argument.

As already noted, a monopoly such as Heathrow with an operation where demand for airline access far exceeds the supply of slots, and will in all probability continue to do so even with a third runway, is unlikely to experience difficulties in persuading investors and banks to provide the finance. After all, under the current RAB-based regulatory system, generally the more investment at the airport, the higher the profits for Heathrow Ltd.

The only potential problem is that the regulator, the CAA, may not allow the airport to pass on all the additional costs to its captive customers, and as explained below, at present that seems unlikely. The CAA itself, like the Airports Commission, certainly sees no problem in raising the finance.

Slot Allocation regulation and the issue of pre-funding

To understand why easyJet and IAG have taken such different positions on a third Heathrow runway it is necessary to turn to the European Regulation on Slot Allocation at congested airports, and perhaps not surprisingly, the EU element greatly adds to the complexity involved.

This Regulation specifies (in general terms — the actual conditions are far more complicated) that at least 50% of any new slots which become available — as distinct from those which are sold/exchanged between airlines — must be offered to new entrant carriers. This is normally not a significant issue with only a small number of slots (or in the case of Heathrow, none) becoming available each season.

A whole runway's worth of slots, however, accompanied by high demand, is a totally different matter.

The next and closely associated problem is how airlines pay for the additional airport facilities.

The traditional approach, at least in the UK, has involved a high degree of *pre-funding*. In other words, the airlines currently using a regulated airport pay higher fees while the new capacity is being built. By the time it comes online, a significant proportion of its funding will have been met.

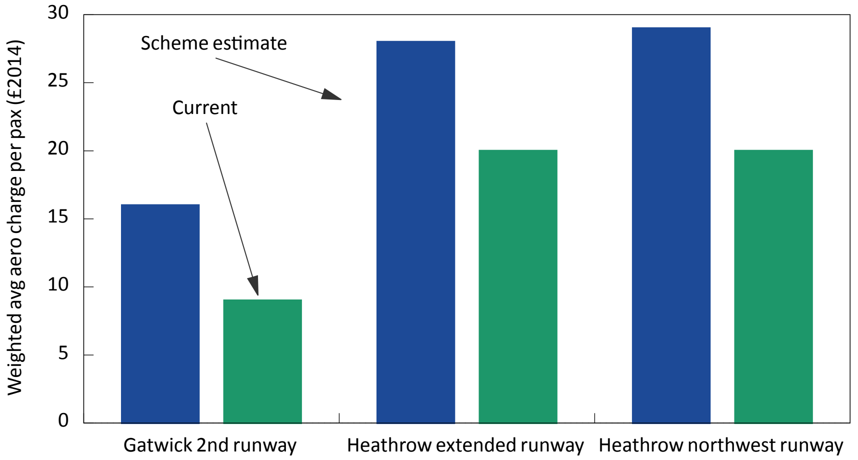
This approach has never been popular with airlines, who view it as favouring the airport owner, but they have tended to acquiesce as pre-funding has not resulted in significant competitive distortion among carriers.

For example, BA gained from the construction of Terminal 5 at Heathrow, which was paid for by all airlines serving the airport, but the other carriers subsequently gained, or will do so, from the construction of the new Terminals 1 and 2 and the refurbishment of Terminal 4, to the costs of which BA contributed.

It doesn't take a genius to see that this cosy arrangement breaks down if at least half of any new facilities, in this case a new runway, is required by law to be offered to new entrant airlines, defined as carriers with no more than a very limited current presence at Heathrow, who will not have contributed to the pre-funding. The incumbent airlines will be hit twice in such a situation: they will face increased competition from carriers which they have effectively had to cross-subsidise.

Not surprisingly, such blatant market distortion has found few supporters among Heathrow's current airline customers.

Whether to approve pre-funding or not will almost certainly be a decision for the airport regulator, the CAA, which has already consulted on the subject. It has given every indication of favouring such an approach, Paying for a runway: aeronautical charges



Source: Davies Commission Final Report

combined with increased commercial agreements between the airport and its airline customers.

In his address to the RunwaysUK conference in London in July, for example, the CAA's Chief Executive, Andrew Haines, commented : "We are certainly open to the idea of allowing pre-funding." He quite rightly pointed out that the arguments pro and anti pre-funding are complex and by no means all one-sided. However, "allowing airports to increase charges to start paying for expansion before a new runway is open could be beneficial to users and investors:

✈ it reduces the amount of finance required and brings forward the point where investment is paid back, and so reduces the risk and hence the cost of that risk; and

✈ by spreading cost over a longer period, it reduces the size of the price uplift when the runway opens."

The CAA's Iain Osborne went even further in his Beesley Lecture in arguing that "pre-funding is, one way or another, a natural aspect of market operation," a statement with which far from everyone would agree.

Such arguments are not likely to impress the current airline customers of Heathrow, but they do help to explain the positions taken by easyJet and IAG to the Davies Commission recommendations.

easyJet clearly expects to be a major beneficiary of a third Heathrow runway, gaining a large number of slots because of its new entrant status. At Gatwick, on the other hand, it is already the largest airline and would potentially have had to contribute substantially towards the cost of building new runway capacity, much of which might have gone to new competitors and little of which is really needed, at least in the short/medium term, by easyJet itself.

It is interesting, however, that the airline has firmly opposed pre-funding at Heathrow, despite the fact that it would benefit from it. It claims that such an approach would be "unfair", but a cynic might suspect it is more concerned about setting future precedents for other airports where easyJet is an incumbent.

Reading IAG's position

IAG's position is more difficult to read. It already has over 50% of Heathrow's slots. The acquisition of bmi's portfolio combined with the extra flexibility provided by the addition of Aer Lingus' slots, despite the fact that most of the latter will have to continue to be used on Irish routes for the foreseeable future, probably means that it can meet its long-haul expansion plans for some years to come.

Why, therefore, would it want more competition at its main base? BA fought for a long time to keep most of the US carriers out of Heathrow, to its obvious benefit; all it is doing now, the argument goes, is repeating the exercise to protect *Fortress Heathrow*, despite the negative impact this might have on the extent of its short-haul network out of the airport, especially with respect to UK domestic feeder services. That is a perfectly logical approach from IAG's commercial perspective.

However, it is equally possible that the stance adopted by Willie Walsh, who to be fair has not been associated with regulatory protectionism, is just an opening shot in the approaching battle on how new runway capacity should be financed. If this is the case, IAG is lucky to have easyJet as a co-lobbyist.

BA/IAG has long since lost its role as a cosy partner of the Government in developing UK aviation policy. Today easyJet is considerably more influential in the corridors of Whitehall. Of course, none of this will be at all relevant unless the Government decides to approve a third Heathrow runway, and that is far from a done deal.

New entrant solution

There is one possible solution to the slot allocation/new entrant conundrum.

It is likely that those who drafted the 50% new entrant rule were really focused on airports where capacity expanded gradually, in relatively small chunks. The rule is not nearly as effective where there is a one-off substantial increase in slot availability and high demand for all the new slots.So the obvious answer is to reform the Regulation.

Economists might argue that a far better approach, for example, might be to auction the new slots and use the money thereby raised to pay for at least part of the new runway. New entrant airlines would not then have a free ride.

Most Heathrow slots acquired by incumbent carriers in recent years have been paid for, often involving substantial sums, including BA's acquisition of bmi's portfolio. Such an approach, while not a total solution, would appear to be fairer to all concerned and remove much of the risk of market distortion inherent in pre-funding.

Admittedly most slots currently used by Heathrow's airlines were not paid for, but they were obtained at a time when the airport still had unused capacity, and therefore are not distorting of competition. The airlines involved simply have what economists would call a *first mover advantage*.

This is not a new idea. Indeed, Heathrow Airport itself suggested something similar in a submission to the Davies Commission: "There are alternatives that Heathrow is keen to explore with our airline customers. It may be possible to replace a proportion of the existing airport charges with a direct purchase of landing rights by airlines, with proceeds going either to the Government (and in turn used as a contribution towards the funding of the capacity expansion), or directly to the airport itself. This would need to be consistent with European rules on allocation of airport slots." (May 2014).

The Airports Commission itself noted that if the EU Slot Regulation could be modified to recognise an incumbent airline's potential contribution relative to a new entrant, this might be helpful in raising finance for the new capacity.

However, if the Commission was thinking here of differential charging, rather than avoiding pre-funding altogether, there is an added EU complication in the form of the Airports Charges Regulation, which requires all airport charges to be non-discriminatory.

Thus, it is evident that some form of reform of the EU Slot Regulation would be a way out of the problems associated with the funding of new UK airport capacity. Such an approach would have a number of benefits, but unfortunately one major drawback: it would require agreement by the 28 Members of the European Union, and the chances of that happening any time soon make getting government approval for additional runways in the South East of England seem like child's play.

By Dr Barry Humphreys

Dr Barry Humphreys is an aviation consultant and formerly a Director of Virgin Atlantic Airways and Chairman of the British Air Transport Association.

Rolls-Royce: Under financial pressure, will it be broken up?

WARREN East's first task as he became chief executive of Rolls-Royce Holdings in July was to give yet another profits warning. A month later he was confronting an activist investor, ValueAct from San Francisco, which had bought a 5.4% stake, raising fears that the company might come under pressure to be broken up, with its marine and land power businesses sold off.

Mr East wrote to its 54,000 employees trying to play down that prospect, but admitting that nothing had been ruled in or out, while he did a quick review of the company's operations this autumn. He has previously stated that the current strategy of being in power systems on land and sea as well as aero was broadly right. But that view might be challenged by his new investors, known for breaking up or shaking up many companies in America, such as Sara Lee and Microsoft.

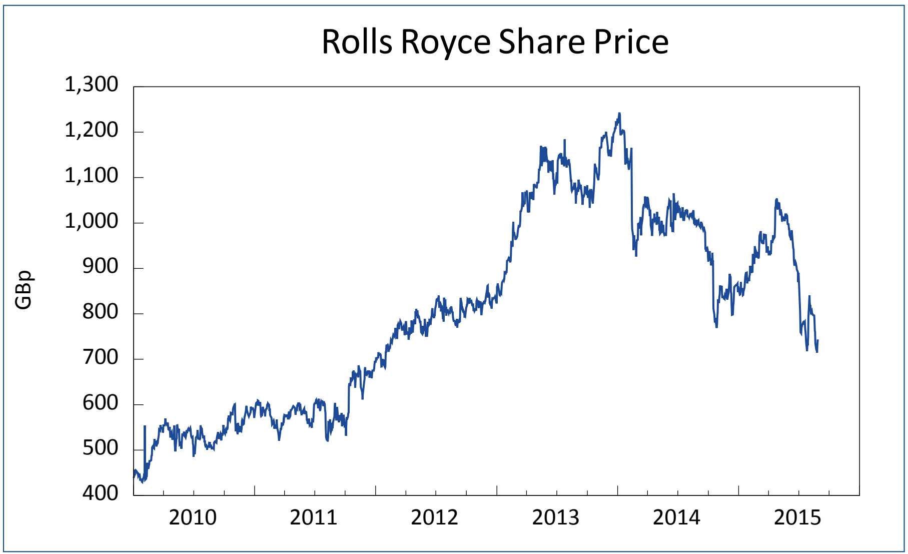
The fourth profits warning in 12 months, downgrading civil aerospace profits by over 25% for 2016 and 2017, has added to confusion about what is happening to a company that until two years ago seemed to be on a roll. Now it is beset with difficulties on all fronts, raising the question of whether there is just an unfortunate combination of trading difficulties in its markets or whether the good times were maybe not as good as they were painted in previous accounts, and now is time for a more sober look at the company's underlying profitability. The answer is: probably a bit of both.

Rolls-Royce's complicated accounts have ever been a headache for investors and analysts. Now, after four profit warnings and a queue of business woes, they are a persistent migraine. Traditional concerns per-

Rolls Royce Financial Data

		Actual					Forecast					
	YE Dec	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Revenue £m	Civil Aerospace	4,919	5,572	6,437	6,655	6,837	7,097	7,109	7,407	7,604	7,820	7,937
	Defence Aerospace	2,123	2,235	2,417	2,591	2,069	2,028	2,028	2,088	2,151	2,216	2,282
	Marine Systems	2,591	2,271	1,829	2,037	1,709	1,333	1,133	1,167	1,237	1,361	1,497
	Nuclear	1,233	1,083	1,382	667	684	701	722	744	766	789	813
	Power Systems	0	331	287	2,831	2,720	2,530	2,530	2,605	2,697	2,805	2,861
	Intra-segment sales	0	-215	-143	-147	-155	-155	-155	-155	-155	-155	-155
	Group revenue	**10,866**	**11,277**	**12,209**	**14,634**	**13,864**	**13,533**	**13,366**	**13,857**	**14,300**	**14,835**	**15,235**
EBITA (adjusted) £m	Civil Aerospace	392	499	743	844	942	843	532	568	675	788	853
	Defence Aerospace	309	376	395	438	366	355	345	345	344	355	365
	Marine Systems	332	287	235	233	138	13	11	58	87	122	150
	Nuclear	27	16	78	10	45	46	47	52	57	63	65
	Power Systems	0	80	109	294	253	215	220	242	270	286	300
	Intra-segment/central	-50	-52	-54	-54	-53	-65	-65	-65	-70	-70	-70
	Group EBITA	**1,010**	**1,206**	**1,495**	**1,767**	**1,678**	**1,407**	**1,090**	**1,200**	**1,362**	**1,544**	**1,663**
EBITA margin	Civil Aerospace	8.0%	9.0%	11.5%	12.7%	13.8%	11.9%	7.5%	7.7%	8.9%	10.1%	10.7%
	Defence Aerospace	14.6%	16.8%	16.3%	16.9%	17.7%	17.5%	17.0%	16.5%	16.0%	16.0%	16.0%
	Marine Systems	12.8%	12.6%	12.8%	11.4%	8.1%	1.0%	1.0%	5.0%	7.0%	9.0%	10.0%
	Nuclear	2.2%	1.5%	5.6%	1.5%	6.6%	6.5%	6.5%	7.0%	7.5%	8.0%	8.0%
	Power Systems	N/A	N/A	38.0%	10.4%	9.3%	8.5%	8.7%	9.3%	10.0%	10.2%	10.5%
	Group margin	**9.3%**	**10.7%**	**12.2%**	**12.1%**	**12.1%**	**10.4%**	**8.2%**	**8.7%**	**9.5%**	**10.4%**	**10.9%**

Source: Rolls Royce and Berenberg



sist: treatment of upfront finance from risk-bearing partners (Rolls adds to profit; others would see loans); pulling forward profits on long service contracts to make up for little or no profit on actual engine sales; aggressive capitalisation of the cost of developing new engines with slow depreciation being applied in order to flatter yearly profits. Add to that the lack of transparency on the pile of financial derivatives the company runs to handle currency uncertainty and other risks.

Now that Rolls-Royce is facing real business problems on all fronts, its financial prospects and aggressive accounting are coming under scrutiny. The share price has collapsed from over £12 at the start of last year to £7.2 towards the end of August. Net profits have sunk to nearly nothing in the marine division which sells mainly to offshore oil customers, hit hard by the halving of the oil price. The aeroengine business, which accounts for some two thirds of revenues and profits, is going through an expensive transition to new products such as the Trent XWB (for Airbus's A350) and the Trent 7000 to replace the Trent 700 (Rolls-Royce's breadwinner for two decades) on the latest version of the A330. Profit margins on both outgoing and incoming products are squeezed—the latter while production costs fall as the learning curve steepens, the former to lure customers to the outgoing Airbus A330, rather than its re-engined successor.

There is more woe. Military engine sales are being hurt by the widespread curbing of defence spending, and a downturn in the markets for both executive jets and regional aircraft are hurting. Rolls sold out of International Aero Engines, which makes engines for Airbus A320s, and so is out of the narrow-body market (80% by volume) for the foreseeable future. Pratt & Whitney, its erstwhile partner, has meanwhile achieved a prime position on the biggest and best new private jets at the expense of Rolls, while the company's position in the regional jet market has been hurt by reverses to the Brazilian Embraer 145's progress in the market. The profit impact of the Trent 700 run-down alone is put by the company at £150m this year, £250m next year and £200m in 2017.

An analysis by Berenberg investment bank suggests that more engine sales contracts now being done without a link to long-term service contracts. This means future profits cannot be pulled forward to make the short-term look better. In effect it means less aggressive accounting (Rolls hired a new finance director from outside the company in the past twelve months) and reported profits that are closer to actual cash flow. On the brighter side, long-term service business should continue to grow and be very profitable as the number of the new engines in service grows over the next five years.

Meanwhile the pain will be felt with civil aerospace margins falling from over 12% in 2014 to below 9% next year, before recovering, according to Berenberg estimates, to nearly 12% in 2020. (Rival General Electric has margins over nearly 20%). Even that recovery will require costs to be taken out of the core aeroengine business, something that was difficult to achieve on Mr Rishton's watch. Rolls is a very traditional company dominated by engineers. It seems that Mr Rishton—an outsider and a finance expert —could not command the authority to drive through changes. It would seem that after four bruising years, he decided to throw in the towel, even if he was not nudged out. On departure he talked wistfully of "a change in lifestyle".

Mr East made his name as an engineer who built up ARM, a UK start-up, to become the world's leading designer of the sort of microchips needed for mobile phones, though manufacturing was largely outsourced to Asia. Perhaps those skills of wringing value out of contractors in the supply chain will prove just as important as shaving pounds of costs in Derby.

An aviation tour of Central Eastern Europe

In the September 2008 edition of *Aviation Strategy* we looked at the developments in the markets in Central and Eastern Europe (CEE). At the time, most of the countries in the region, whether ex Warsaw Pact or former Yugoslavia, had experienced relatively strong economic growth starting in 2000, but 2008 brought about a long and deep recession. This coupled with the strong growth of Wizz Air and more recently the expansion of the Etihad Equity Alliance into the region has had a profound impact to the region's aviation industry.

Wizz Air has even become the de-facto 'national airline' in Hungary. The January 2012 bankruptcy of Hungary's former flag-carrier Malév left Wizz as the largest airline in the Hungarian market. It successfully fought off a strong challenge from Ryanair which moved quickly to base its aircraft at Budapest. Wizz has now secured designation on some of the bilaterally constrained markets, which were once the preserve of Malév, to destinations such as Moscow, Dubai, Tel Aviv, Kutaisi (Georgia) and Baku (though this point was subsequently dropped).

Budapest Airport, once a minihub for **one**world member Malév with its modern terminal (SkyCourt) built as a facility to facilitate transferring passengers, now finds itself with virtually no transfer traffic as Wizz does not yet offer a connecting product within its own network, let alone with other airlines. Whether Wizz will continue to remain true to its ULCC (Ultra Low Cost Carrier) founding principles remains to be seen as its fleet growth continues unabated over the coming years and will see it grow from its current fleet of 65 by the end of 2015 to 106 in 2018.

Star Alliance is the dominant network in the region, connecting traffic through hub airports at Munich, Frankfurt, Zurich and particularly Vienna where Austrian has exploited its historical connections especially to the Balkan states. However, Austrian has come under serious competition from THY which has expanded its footprint in the region considerably from its Istanbul Ataturk hub, offering a frequency-driven schedule to feed into its enormous network in the CIS countries of the ex-USSR as well as the Middle East and further afield into Africa and Asia. Istanbul's own rise as an economic and tourist centre has also resulted in a strong increase in point-to-point traffic from the CEE region.

Most countries in the CEE are too small for domestic flights and thus the vast majority of traffic in the region flows across national borders. Notable exceptions are Poland and Romania with populations of 38.5 and 20 million respectively. Romania has a distinct topographical barrier in the Carpathian mountain range that makes road and rail access between Bucharest and the lower Wallachia region of Romania to the northern half of the country in Transylvania and Banat very difficult and time- consuming (a motorway corridor through the mountains could be completed by 2020). These regions have experienced strong economic growth and are home to regional airports like Cluj-Napoca, Sibiu, Târgu Mureş and Timişoara.

Romania

Romania has been a major development market for Wizz which bases aircraft at five cities. It has a sizeable presence in the capital Bucharest where it is vying with national carrier TAROM for the number one position, with seven based aircraft at Otopeni Airport. The second airport in Bucharest which had formerly been home to most LCCs, Baneasa, was closed to commercial flights in 2012 with all carriers forced to relocate to Otopeni which expanded its terminal to accommodate the additional traffic.

Balkan Airlines' Traffic 2014

Airline (ex-Yugoslavia)	Pax (million)	Change (%)
Air Serbia	2.3	+68%
Croatia Airlines	1.8	+2%
Adria Airways	1.1	+8%
Montenegro Airlines	0.56	+5%
B&H Airlines	0.04	+17%

Wizz Air Route Network

TAROM operates a curious mixed fleet of 23 aircraft, consisting of two A310s (once used for long haul flights to New York), eight 737s, four A318s and nine ATRs (both -72s and -42s). It has been the subject of privatisation conjecture over the years with recent reports indicating the Romanian government in talks with THY. It is difficult to see a rationale for Turkish taking a minority stake (as it is non-ECAA, it could not take a majority stake in TAROM) unless perhaps the government were to include the four airports it owns (Timişoara in the west of the country, both Bucharest airports and Constanta on the Black Sea coast).

Romania had been the only CEE country with a regional network carrier, Timişoara-based Carpatair, but Carpatair filed for bankruptcy and ceased scheduled operations in 2013 following a protracted legal dispute with Wizz. Its business model had featured connections at Timişoara from Romania and neighbouring Moldova and Ukraine primarily to Italy where there is a diaspora of about one million Romanians.

Blue Air is a locally owned LCC with an all-Boeing fleet of 15 aircraft (both Classics and NGs) based in Bucharest, Bacau, Iasi plus Larnaca in Cyprus (following the bankruptcy of Cyprus Airways). Its future has also been the subject of much debate as it faces stiff competition from TAROM, Wizz and Ryanair.

Serbia

The past two years has seen a dramatic and unexpected change to the aviation landscape in Serbia, the largest of the former Yugoslav republics by population. Following several failed attempts to privatise or restructure Air Serbia's predecessor, Jat Airways (Yugoslav Airlines), in 2013 the Serbian government managed to sell a 49% stake in Jat to Etihad Airways in a deal believed to include other state owned assets in non-aviation industries. Jat was on the brink of bankruptcy in 2013, facing increasing competition from Wizz's Belgrade operations, while easyJet entered the market with three new routes in early 2013.

Jat operated a fleet of ageing aircraft, 10 of which were 737-300s (Jat was the European launch customer for the type in 1985), and five ATR 72s. Some of the Boeings were being cannibalised to keep the other 737s airworthy. The average age of the aircraft was over 20 years. The deal with Etihad included a management contract whereby Etihad replaced several senior members of the airline's management with its own hires, a complete re-branding from Jat to Air Serbia, and the introduction of 10 Airbus narrowbodies (A319s and A320s). Four of the 733s remain, being principally used for the airlines charter brand, Aviolet. The ATRs received extensive cabin upgrades and two newer 72-500s entered the fleet.

In 2007 the percentage of passengers connecting at Belgrade Airport was just 3%. Since the transformation of Jat Airways into Air Serbia and the focus on establishing Belgrade as a mini-hub, transfer passengers are estimated to have risen to over 30% of the total. Air Serbia's schedule is centred around three banks of flight arrivals/departures during the entire season and four banks (the fourth being in the midnight hours of 00:00-01:00) in the peak summer. This operation has doubled the utilisation of the fleet. The effect on passenger numbers for the first full year of Air

Serbia, calendar year 2014, and the contrast with other ex-Yugoslavian airlines is shown below.

During the first seven months of the year, Belgrade Airport handled 2.7m passengers in total, an increase of 6.9% on 2014, with 2015 expected to break the previous record set in 2014, with around 5m passengers, close to its capacity. As a result, the airport has announced plans to expand Terminal 2 with four new air bridge gates capable of handling widebody aircraft and additional bussing gates. This is expected to grow capacity to about 8m. Construction is expected to commence later this year and take between 14-16 months.

French concession and construction company Vinci signed a MoU with Belgrade Airport back in November '14 and recently confirmed its interest in a concession of Belgrade Airport earlier this year. It is still unclear which privatisation model, if any, the Serbian government will adopt. There has been widespread discussion of establishing a state run holding company called "Airports of Serbia" that would manage up to 25 of Serbia's airports, including Belgrade. Apart from Nis airport in the south of the country which has recently succeeded in attracting Wizz Air, none of the other airports operate commercial flights. Indeed, many are GA airports with grass runway strips or military airfields.

Serbia was updated to US FAA Category 1 status in 2014. Prior to that, Serbia's status as an FAA IASA category 2 country prohibited the establishment of any new direct commercial flights between Serbia and the US by a Serbian carrier. There have not been any scheduled direct flights between Belgrade and the US since Uzbekistan Airways ran services from Tashkent to New York City via the Serbian capital in 2004. A bilateral agreement between Serbia and the US was signed in May this year. According to local media reports, the FAA will perform a final inspection checks on Serbia's readiness to handle transatlantic flights this September which would remove the last remaining administrative barrier to flights.

The failure of other airlines in the region to make a success of direct transatlantic flights doesn't bode well — CSA from Prague, Malév and American Airlines from Budapest

CEE Airports ('000 pax)

Airport	2014	2013	2012	2011	Country
Prague	11,150	10,974	10,808	11,789	*Czech Republic*
Warsaw	10,590	10,656	9,586	9,338	*Poland*
Budapest	9,156	8,521	8,504	8,921	*Hungary*
Bucharest Otopeni	8,317	7,643	7,120	5,049	*Romania*
Belgrade	4,639	3,543	3,364	3,125	*Serbia*
Krakow	3,820	3,648	3,439	3,014	*Poland*
Sofia	3,815	3,504	3,467	3,475	*Bulgaria*
Gdansk	3,288	2,870	2,906	2,464	*Poland*
Katowice	2,696	2,544	2,551	2,544	*Poland*
Bourgas	2,530	2,480	2,381	2,253	*Bulgaria*
Zagreb	2,431	2,293	2,342	2,320	*Croatia*
Wrocław	2,084	1,920	1,997	1,657	*Poland*
Tirana	1,810	1,757	1,665	1,817	*Albania*
Chisinau	1,781	1,321	1,220	1,046	*Moldova*
Split	1,753	1,582	1,425	1,300	*Croatia*
Warsaw Modlin	1,703	344	898		*Poland*
Dubrovnik	1,584	1,523	1,480	1,350	*Croatia*
Poznan	1,445	1,355	1,596	1,464	*Poland*
Pristina	1,427	1,629	1,527	1,424	*Kosovo*
Varna	1,387	1,319	1,221	1,182	*Bulgaria*
Bratislava	1,356	1,373	1,416	1,585	*Slovakia*
Ljubljana	1,307	1,268	1,168	1,287	*Slovenia*
Skopje	1,211	984	836	764	*Macedonia*
Cluj Napoca	1,182	1,036	932	1,005	*Romania*
Tivat	911	898	725	647	*Montenegro*
Timişoara	735	750	1,036	1,203	*Romania*
Sarajevo	710	666	580	600	*Bosnia & Herzegovina*
Podgorica	702	691	637	612	*Montenegro*
Rzeszow	600	590	562	488	*Poland*
Zadar	497	473	371	285	*Croatia*
Brno	486	463	569	558	*Czech Republic*
Pula	375	354	367	353	*Croatia*
Kosiče	357	237	236	266	*Slovakia*
Târgu Mureş	344	357	300		*Romania*
Bacau	313	307	393	337	*Romania*
Bydgoszcz	289	344	340	280	*Poland*
Szczecin	287	348	356	262	*Poland*
Iaşi	273	232	173	184	*Romania*
Łodz	254	354	441	389	*Poland*
Sibiu	250	223	206	190	*Romania*
Lublin	188	190	6		*Poland*

and TAROM from Bucharest. All three cities are larger markets then Belgrade. The challenge for Air Serbia will be to generate enough feed into its Belgrade hub from regional airports such as Skopje, Podgorica, Sofia, Bucharest, and even Beirut and Tel Aviv, which it serves along with an interline or code share agreement on the US side. The Star Alliance will not take this incursion into what it sees as its "backyard" lightly; a fierce price battle is likely putting strong downwards pressure on yields. It also remains questionable whether flights from Belgrade to either or both of New York or Chicago would attract enough business passengers willing to pay a premium for a direct service that will save them 4-5 hours of total travel time to current one-stop products with Star Alliance or SkyTeam. The other challenge remains the seasonality of the market. At present, traffic flows between Belgrade and North America in the June-August period are 2.5 times greater than during the seven the 7 months between October and April.

Croatia

Despite its flag carrier Croatia Airlines lurching from crisis to crisis, with numerous industrial disputes disrupting its operations, the Croatian government managed to sell a 30 year concession in Zagreb Airport to an Aéroports de Paris (AdP)/ Bouygues led consortium in December 2013. The concession terms required immediate construction of a new terminal to replace the existing one which dates back to the 1960s and operates at over 100% of its design capacity. Partially as a result, Zagreb is somewhat unique amongst EU capital city airports (Croatia joined the EU as its 28th member in July, 2013) in not being served by either Ryanair, Wizz or easyJet. The new terminal which will boost terminal capacity to 5m-plus passengers. By the end of this year, the steel roof and the exterior of the terminal building will be completed with the transition of operations from the existing terminal expected in Q1 2017.

Croatian Airlines, with a fleet of 12 aircraft (2 x A320, 4 x A319 and 6 x Q400), recorded a net loss of €12.8m for the first half of 2015 with passengers totalling 802,559. This compares unfavourably with a €3.9 million loss in H1 2014. With existing Zagreb traffic accounting for about 50% of the capacity of the new terminal, it remains to be seen whether the Croatian government can find a sustainable solution for its flag carrier under private ownership; otherwise the pressure on the concessionaires to attract LCCs will be formidable.

Slovenia

The Slovenian government in 2014 sold its holding in the capital city airport, Ljubljana, to Fraport for a reported €234.4m. LJU handled 1.34 million passengers in 2014. Fraport has enjoyed a strong start to 2015 with pax numbers of 798,297 in the first seven months, an 11% increase on the same period in 2014. Other bidders included Vinci, but Adria's Star Alliance membership and near total domination of the airport by Star Alliance carriers may have tipped the balance in favour of Fraport. For now there are no plans for any major capital expenditure in the airport whose existing runway and terminal should be adequate for the foreseeable future.

Slovenia's flag carrier Adria Airways is itself the subject of a second privatisation attempt. The Slovenian government appointed KPMG as sell side advisors and they issued a call for expressions of interest for a 91.6% stake in the company in July '15. This follows a failed attempt in August 2012. Speculation has centred on a number of potentially interested parties, including: Air India, China Southern, Qatar Airways, Royal Jordanian and THY. Interestingly, Royal Jordanian came second in the privatisation of Bosnia's B&H Airlines, a process 'won' by Turkish back in 2008. China Southern is believed to have proposed a joint bid for Ljubljana Airport and Adria back in 2013. In the meantime, Adria has been busy taking advantage of its EU/ECAA status to base aircraft in niche markets in other parts of Europe where it sees opportunities. It now bases aircraft in Łódź in Poland — a secondary city 130km south west of Warsaw — along with Tirana in Albania.

Bosnia

Bosnia's flag carrier, B&H Airlines, had its AOC revoked in mid-July until October '15, marking the final nail in the coffin of the troubled flag carrier. The Sarajevo-based national flag carrier was established as Air Bosna in August 1994 by the government of Bosnia and Herzegovina and rebranded from its original name of "Air Bosna" in October 2006. During its existence, B&H Airlines was, for a short period, partly owned and managed by THY which purchased a 49% stake in 2008. THY returned the share to the Bosnian state for free in 2012 following disagreements with the government.

Icar Air is now the only Bosnian-registered carrier with a functional AOC. The privately-owned airline, holds a DHL contract and runs freight services between Sarajevo and the Italian coast with a Let L-410. The Federation government of Bosnia and Herzegovina is now considering setting up yet another successor flag carrier, with local media quoting the Prime Minister as being willing to commit the rather modest sum of €2.7m for a new airline that would initially operate with a single leased aircraft. The Bosnian government recently ruled out privatisation of the main airport in Sarajevo.

FYROM (Macedonia)

Turkish airport operator TAV entered the Macedonian market in 2010 having been selected to operate a 20 year concession for the landlocked country's two airports, Skopje (capital city) and Ohrid, a tourist destination in the west of the country. TAV quickly began the process of building a new terminal in Skopje. It also embarked on a process whereby the Macedonian government opened tender procedures for airlines to apply for generous subsidies to operate new routes over a three year period from Skopje, which has not had a based carrier following the 2009 bankruptcy of MAT Airways. Wizz successfully applied for the subsidies and now operates two based aircraft (with a third to arrive soon). With Wizz now the dominant airline in Skopje, TAV has been publicly supporting the business case for a government sponsored flag carrier in order to reduce dependence upon such a price sensitive LCC like Wizz Air. It remains to be seen if there would be any appetite for a rationale investor to enter a market of some 1 million passengers per year in one of Europe's poorest countries where Wizz dominates. The unstable political environment will not help either following months of violent protests aimed at the incumbent government of Nikola Gruevski.

Czech Republic

The Czech Republic was the first country in the region to secure a (minority) investment in its state owned airline. After a series of failed privatisation attempts. Korean Air acquired a 44% stake in Czech Airlines (CSA) for €2.64 million in 2013, and subsequently assisted in a restructuring effort. This saw CSA first exit a number of regional feeder routes and substantially de-hub Prague to focus on connecting bilaterally constrained markets to the CIS nations to the east with those western European markets that have strong O&D of their own from Prague. Korean leased an A330-300 to CSA to operate Prague-Seoul flights previously served its own 777.

Prague airport remains state owned and relatively expensive, and has shown an unwillingness to enter into airline agreements with high growth LCCs. This has acted as a barrier to entry for the likes of Ryanair and has kept Wizz and easyJet's growth in Prague to a minimum.

By Robert Cullemore
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JetBlue: At last, closing the margin gap with peers

The lofty second-quarter profit margins reported by US carriers have generally failed to impress airline investors, who remain concerned about negative unit revenue trends. As a result, US airline stocks remain down in the dumps after falling sharply in the spring.

But JetBlue Airways has been an exception. New York's hometown airline (the fifth largest US carrier) has bucked the negative industry trend and continued to report PRASM growth: 4.5% in Q1 and 1.4% in Q2. The latter outpaced the industry by as much as seven percentage points.

As a result, JetBlue was the best-performing US airline stock in January-July. The price surged by 46%, compared to a 10% decline by the NYSE Arca Airline Index (XAL).

The combination of enormous fuel cost savings, good cost controls and the PRASM improvement will mean JetBlue reporting extraordinary profit growth for 2015. Analysts' consensus estimates see JetBlue's EPS surging by 163% this year, compared to 35%-116% EPS growth for the four largest US carriers.

JetBlue's PRASM trends are all the more remarkable given the carrier's relatively brisk ASM growth, which is expected to be at the higher end of the 7-9% guidance, following 5.1% growth in 2014 and 6.9% in 2013. Although Southwest is also stepping up its growth this year, to 7% from 0.5% in 2014, the top three carriers will see 2.5% ASM growth at most.

JetBlue has had an eventful 12 month or so; the key changes have been the following:

✈ New leadership

Robin Hayes (formerly JetBlue's president, ex-BA) took over as CEO from Dave Barger when the latter's contract expired in February 2015. Barger had faced some pressure not to seek a new contract because of criticism from the financial community over JetBlue's lagging margins, ROIC and share price performance.

JetBlue had already implemented a sweeping management reorganisation in the spring of 2014, which had included the departure of COO Rob Maruster. And it had strengthened critical areas by promoting Marty St. George to SVP Commercial and bringing an airline analyst from Credit Suisse (Kevin Crissey) to the role of Director Investor Relations.

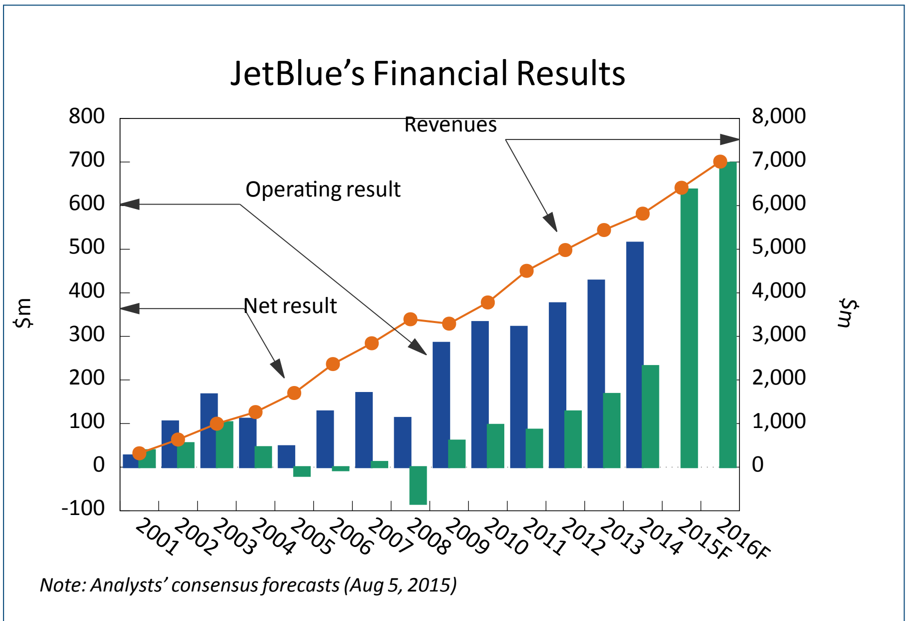
The management changes were interpreted as a shift in culture that would focus more on costs and margins and be more investor-friendly, rather than customer-friendly.

✈ New plan to drive shareholder returns

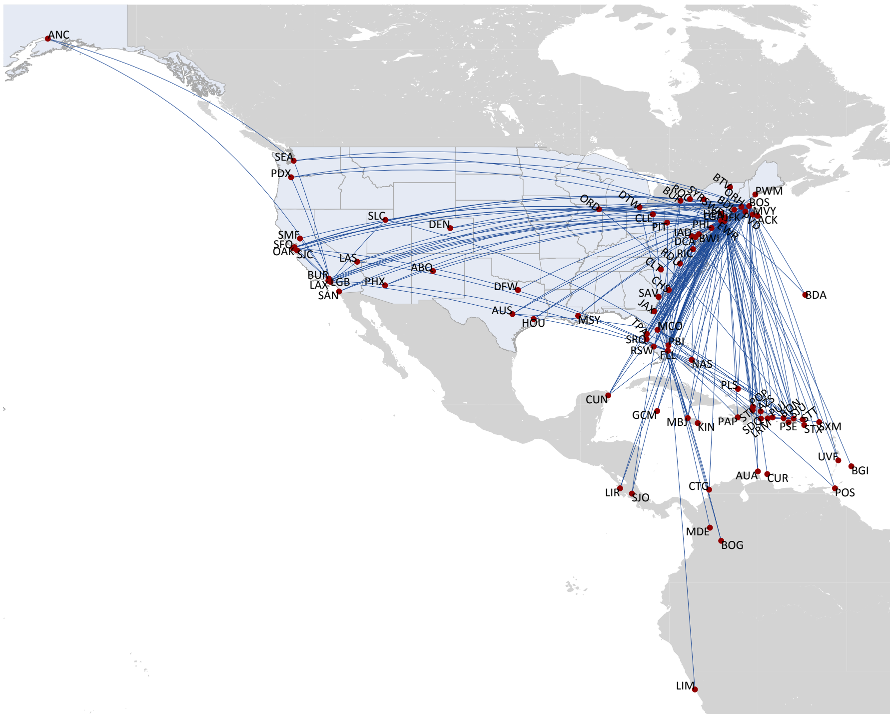
At its investor day in November 2014, JetBlue unveiled a "long-term plan to drive shareholder returns", which included measures to boost revenues, reduce capital commitments and maintain a competitive cost position.

JetBlue aimed to strike a compromise between pleasing Wall Street and remaining true to its core values. In addition to boosting profits, free cash flow and ROIC, the measures would enhance the airline's "product advantage and service-oriented culture". CEO Robin Hayes stated: "JetBlue's core mission to inspire humanity and its differentiated model of serving underserved customers remains unchanged".

The revenue initiatives outlined in the plan were expected to generate



JetBlue Route Network



$400m-plus in additional annual operating income beginning in 2017.

As part of the plan, JetBlue announced the deferral of 18 Airbus aircraft orders from 2016-2018 to 2022-2023 — a move that will reduce capital expenditures by $900m through 2017.

JetBlue also announced a commitment to maintain ex-fuel CASM growth below 2% through 2017. In the longer term, unit costs would benefit from strategies such as upgauging the fleet with larger A321s and increasing the number of seats on the A320s by 15 or 10% (to 165).

✈ New revenue initiatives

In the past year, JetBlue has had numerous new revenue initiatives in various stages of development. There is "Mint", the premium transcontinental product launched in June 2014 that has caused quite a stir in the market (see *Aviation Strategy*, June 2014). There is "Fly-Fi", which JetBlue claims is the fastest in-flight wifi product in the industry. There is the older-established "Even More" extra legroom product that offers "industry-leading comfort and value".

In June 2015 JetBlue also revamped its fare structure. It now has three branded fare bundle options known as "Fare Families" (Blue, Blue Plus and Blue Flex), each of which has different offerings, such as free checked bags, reduced change fees and additional FFP points. It is an alternative approach to the static fees employed by many other airlines.

JetBlue also talked about a revenue initiative called "A320 cabin refresh". It means outfitting the A320 fleet with a cabin similar to the A321's highly acclaimed cabin.

Given all of those changes, JetBlue faced intense questioning from analysts on its second-quarter call on exactly which revenue initiatives or strategies might help explain the sudden PRASM strength.

The answer was a surprise: core demand strength, reflecting JetBlue's exceptionally strong route network and revenue management. In addition to "strong execution", the executives mentioned maturation of the network and the benefit of having limited exposure to softer global markets and unfavourable currency developments.

The Mint routes represented only 7% of JetBlue's ASMs and the premium seats on those routes only 0.7% of ASMs in 2Q, so the overall PRASM impact was marginal. And many of the other revenue initiatives are too new to show much impact.

Core network strength

As JetBlue executives put it in the second-quarter call: "A big chunk of the benefit has come from a lot of the network investments we have made over the last several years, especially in Latin America". All six of the carrier's focus cities — New York, Boston, Fort Lauderdale/Hollywood, LA/Long Beach, Orlando and San Juan — were profitable and had margin expansion in 2Q.

Whether it is due to luck or smart earlier network decisions, JetBlue has benefited this year from having minimal exposure to the worst competitive hotspots, such as Dallas and Chicago.

This year JetBlue has benefited from competitive capacity reductions in its key markets. As a result, the airline has seen exceptionally strong PRASM performance especially in the Caribbean/Latin America region.

Thanks to Mint and competitors' capacity reductions, JetBlue is also doing extremely well in the transcon market. Even the more marginal transcon routes, such as those from FLL, are now solidly profitable.

JetBlue is predominantly a point-to-point carrier, with most of its routes touching at least one of the six focus cities and 86% of its customers flying on nonstop itineraries. Its route network now covers 90 cities.

JetBlue's greatest strength is its position in New York, the nation's largest travel market. JetBlue is the second largest operator at JFK in terms of domestic capacity (36% of the seats), and it serves all five New York area airports.

Having spotted an opportunity in 2009 to grow in Boston, JetBlue is now Logan's largest carrier, with 26% of total seats and almost 60 nonstop destinations. Boston was a major and risky investment but it is paying off handsomely. More growth is in the pipeline in Boston as JetBlue works towards a target of 150 daily flights.

The Caribbean/Latin America region (including Puerto Rico) has been a huge success story for JetBlue. The markets have year-round demand, have matured quickly, generally require minimal up-front capital and are nicely profitable. Almost a third of JetBlue's capacity is now in that region (compared to 26% on the transcon). JetBlue is already the largest US carrier in the Caribbean, dominating markets such as Puerto Rico and the Dominican Republic.

JetBlue has called the region "a natural out of New York". However, much of the growth now focuses on FLL (the lower-cost alternative to Miami) or on adding service to a destination from multiple focus cities. FLL now offers 40-plus JetBlue destinations and is seeing both domestic and international growth, with eight new cities launching in late 2015 or 2016.

This year's highlight is the addition of Mexico City to JetBlue's network in October (its 35th destination in the region). The airline will operate daily A320 flights from FLL and Orlando.

JetBlue's Fleet and Firm Order Book

at end June 2015	Aircraft in operation	Firm Orders†	Delivery Schedule
A321	19	27	2015-2018
A320	130		
E190	60	24	2020-2022
A321neo		45	2018-2023
A320neo		25	2020-2022
Total	209	121	

Note: † JetBlue has flexibility to substitute any of the Airbus orders for other variants of the A320 family.

JetBlue has been exceptionally successful in the US-Colombia market since first venturing there in 2009; it now operates to Bogota, Cartagena and Medellin. Lima (Peru) followed in 2013. A third South American country, Ecuador, looks set to follow in first-quarter 2016 (FFL-Quito).

JetBlue has long eyed South American markets such as Brazil but its A320s or A321s do not have the range. But the potential future availability of the A321LR may have brought such plans, as well as flights to Europe, a little closer (more on that below).

On the alliance front, JetBlue's focus has shifted from signing up new interline partners (now around 40) to deepening existing relationships (typically into codesharing).

Interestingly, JetBlue executives noted the positive effect Boston is having in many of its partnerships. For example, the combination of JetBlue's growth in Boston and the performance of its partnership with El Al in New York led the Israeli carrier to add Boston to its network in June. El Al was the sixth existing or new partner of JetBlue's that began operating to Boston. In other words, JetBlue is arguing that its growth is adding competition not only in the US but also in its partners' long-haul international markets.

In recent months JetBlue has been vocal in criticising the larger carriers' immunised JVs, going as far as calling for a review of the consumer benefits of such deals. "Left unchecked, this US government-sanctioned collusion will continue to stifle innovation and competition in international aviation and will directly harm JetBlue and consumers", the carrier wrote in its recent Gulf subsidies row related submission.

Of course, JetBlue can be expected to side with the Gulf carriers because Emirates, Etihad and Qatar are among its codeshare partners. But JetBlue is also concerned about some of the Latin American alliance developments, such as Delta/Aeromexico's ATI application, given the slot constraints at Mexico City. JetBlue itself found it hard to secure slots at MEX for its planned services.

Fleet considerations

JetBlue operates a 209-strong fleet (19 A321s, 130 A320s and 60 E190s) and has another 121 aircraft on firm order. In the past two years, the airline has deferred some orders (to reduce and smooth out near-term deliveries) and begun a switch to larger gauge aircraft (A321s).

All of the deliveries through 2017 are A321s. JetBlue operates the type in two seating configurations — regular and lower-density Mint. The planned expansion of Mint will mean JetBlue converting some of next year's A321 deliveries to the lower-density version.

JetBlue has flexibility to switch any of the Airbus orders for other variants of the A320 family. That raises the interesting prospect that JetBlue could become an early customer for the longer range version of the A321neo that Airbus is now pitching as an alternative to the 757. The A321LR is still under development but could be available from 2019.

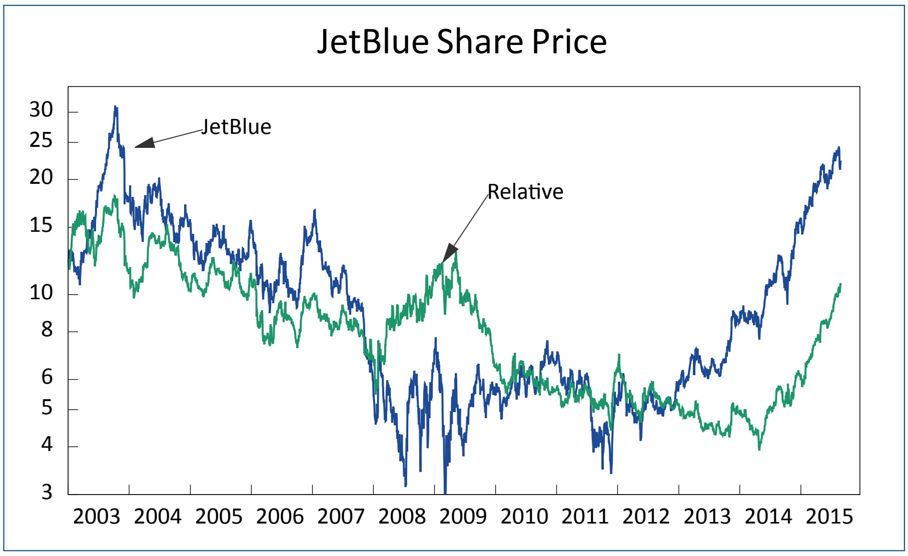
In recent months, JetBlue executives have gone on record to say that they are seriously interested in the A321LR, which would offer full commonality benefits with the existing Airbus fleet and facilitate expansion into markets further afield.

In the first place, JetBlue would use the aircraft for a push deeper into South America. JetBlue is currently not considering flights to Europe, but many of its customers have asked for such routes, so it may only be a matter of time.

Closing the margin gap

JetBlue has always been successful in the marketplace, inspiring customer loyalty much like Southwest and WestJet have done. Now JetBlue is proving that it is possible for an up-market, middle-sized, non-niche LCC to be also financially successful if it has the right route network and revenue strategies.

JetBlue's operating margin surged from 9.4% to 17.5% in the second quarter, meaning that the carrier effectively closed the margin gap with its peers. If the significant projected revenue growth from the new initiatives materialises, JetBlue could start outperforming the industry in margins in the next couple of years.



The signs are promising. Mint, which is currently available only on two transcon routes out of JFK, has won JetBlue many new corporate customers. It has significantly improved transcon margins. So JetBlue is bringing Mint to the Boston transcon markets in March 2016, as well selected Caribbean routes out of New York and Boston this winter.

Early results from the June fare revamp are also encouraging. JetBlue expects the move to generate at least $65m in incremental operating income this year and more than $200m annually by 2017.

However, the new strategies add complexity and could be challenging to execute. For example, while JetBlue sees many opportunities for Mint, in the Caribbean markets it will have to balance the incremental revenues from Mint against the significant economic benefits of operating A321s in the regular higher-density configuration.

The risks also include potential negative feedback from customers. The fare options clandestinely introduced first checked bag fees at JetBlue (for the cheapest "Blue" option). But paying for baggage has largely become accepted practice for US travellers; Southwest is now the lone holdout in that regard.

JetBlue hopes to mitigate a potential consumer backlash to the increased A320 seat count by maintaining a better than industry average seat pitch (it will be installing "lighter, more comfortable" seats) and by upgrading the interiors to include larger seatback screens, etc. A similar product on the A321s has generated positive customer feedback.

So JetBlue is very bullish about the future payoff of the A320 "seat densification" project, which is expected to begin in mid-2016. It is likely to have a highly favourable impact on unit costs and be a "very ROIC positive way to increase capacity".

The A320 project will help offset longer-term cost pressures in areas such as labour and maintenance. One risk area is pilot costs, because JetBlue's pilots unionised in 2014, but talks are still in the early stages and there is no near-term impact.

For the time being, JetBlue's unit cost performance remains exemplary. In 2Q non-fuel CASM inched up by only 0.6%, and the full-year prediction is 0-1.5%.

JetBlue is using the oil windfall, in the first place, to strengthen its balance sheet. It is opportunistically pre-paying debt and buying many aircraft with cash. Its interest costs have declined, leverage ratios have improved and as many as 46 of its aircraft are now unencumbered. S&P, Moody's and Fitch have all raised JetBlue's credit ratings this year.

Notably, JetBlue entered into an "accelerated share repurchase" with Goldman Sachs in June, paying $150m for an initial repurchase of its shares. But JetBlue executives described it as a "policy, not a commitment"; the programme is mainly aimed at offsetting dilution from stock issuance to management and employees.

So JetBlue is behind its peers in returning capital to shareholders. No-one is bothered about that, though, because the strong liquidity (25% of annual revenues) and accelerating profit and free cash flow generation mean that it is only a matter of time before JetBlue catches up.

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