

Why the US Majors are in such trouble

Three facts define the circumstances of the US Majors (American, Delta, United, Northwest, Continental and US Airways):

- They have a cost problem, not a revenue problem - while their unit revenues compare favourably to those of their low cost competitors, their unit costs are far higher;
- Labour costs, driven by below average productivity, are the defining problem that must be fixed; and
- Past excesses have created a pension plan crisis - this, surprisingly, may be the big aviation issue in the US in 2004, as statutory cash contributions to their defined benefit pension funds could act as a catalyst for new bankruptcies.

This analysis by Vaughn Cordle explains the reasons for the impending implosion of the US Majors.

As pension plans are now less than the funding threshold required by law - almost \$50bn in obligations and \$22bn in underfunding (see table 1, below) - US Majors will be required under special pension funding rules to pay hefty surcharges known as "deficit reduction contributions." These cash contributions are estimated at about \$5bn in 2004, in contrast to the \$400m incurred in 2001.

The Senate is scheduled to consider the pension issue in December after failing to agree on a proposal for easing pension-funding requirements for the airlines and other industries with underfunded pension plans. The House of Representatives recently approved a two-year moratorium that would allow the airlines to defer 80% of what they are currently required to contribute toward the underfunded plans.

The stock market bubble of the mid to late 1990s masked the true costs of the plans because plan asset returns were higher than assumed returns. Even though this year's stronger stock market will help the pension funds somewhat, it will not erase the deficits or the future costs of the plans. Recurring annual expenses are estimated to be approximately \$2.4bn in 2004, reflecting the annual service and

Airline	1999	2000	2001	2002	2003F	2004F	2005F
AA	(346)	(703)	(1,940)	(3,434)	(3,777)	(3,758)	(3,112)
UA	1,320	(741)	(2,520)	(6,380)	(5,968)	(5,571)	(4,396)
DL*	148	1,135	(2,353)	(4,907)	(4,620)	(4,169)	(3,141)
NW	519	(486)	(2,275)	(3,950)	(3,795)	(3,450)	(2,658)
CO	(287)	(282)	(587)	(1,190)	(1,211)	(1,142)	(943)
US**	(722)	(301)	(2,344)	(2,445)	(2,573)	(2,403)	(1,920)
AS	68	9	(53)	(223)	(101)	(175)	(177)
Total	700	(1,369)	(12,072)	(22,529)	(22,045)	(20,668)	(16,346)

Notes: * = as of 12/12/02, 31/12/01, 31/12/00, 30/6/99; ** = US Air is calculated as if the pilots' plan had not been taken over by the PBGC.
Source: Company reports and AirlineForecasts

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interest costs of the plans. This is double the amount spent in the late 1990s (and in addition to the \$5bn of cash contributions).

Underfunding creates even more competitive problems for the majors because their low-cost competitors offer a different variety of the retirement programs, known as 401(K) plans, and are not required to make large future cash requirements to fund defined

pension obligations. Airlines like Southwest, JetBlue, America West, AirTran and Frontier have defined contribution plans, which are more transparent and pay employees in cash. (The majors also have these plans.)

Companies must make deficit reduction contributions when the fair value of assets in their defined benefit plans drops below 80% of the current pension liability to current and future retirees (see table 2, above). Accelerated "catch-up" contributions then kick in to ensure that future obligations can ultimately be met. The airlines do not have to cover their entire pension shortfall all at once because US accounting rules allow the gains and losses to be spread out over three to five years. Pension "smoothing" calculations involve numerous lags, and therefore the pension funds are only beginning to show the full effects of the three year bear stock market and historically low interest or discount rates used to calculate the present value of the obligations. Low interest rates make future pension obligations look larger because they approximate the rate of investment return on the pension fund over time.

After running plan surpluses of more than \$700m at the peak of the stock market bubble in 1999, pension plan funding for the seven US airlines with the defined benefit plans will end 2003 with a \$22bn deficit. Due to pension accounting convention, airlines, until now, have been able to avoid the unpleasant reality of lower plan asset returns and interest rates at historical lows. Smoothing mechanisms, origi-

Table 2 PLAN ASSETS AS % OF PENSION LIABILITY

	1998	1999	2000	2001	2002	2003F	2004F	2005F
American	89	94	89	74	61	61%	62%	65%
United	95	118	92	75	51	51%	57%	63%
Delta *	110	102	112	78	62	62%	63%	68%
Northwest	87	111	91	66	51	51%	55%	62%
Continental	63	78	81	62	45	45%	48%	55%
US Airways (1)	69	83	93	57	54	54%	56%	62%
Industry	92%	102%	96%	72%	56%	54%	57%	63%

Notes: *as of 12/12/02, 31/12/01, 31/12/00, 30/6/99, 30/6/98, 30/6/97;
US Air is calculated as if the pilots' plan had not been taken over by the PBGC
Source: Company reports and AirlineForecasts

nally designed to reduce reported earnings volatility, have led to misleading financial statements that mask the real costs and future cash requirements of the plans. The funding deficits have reached a point where they are affecting earnings, balance sheet values, and perhaps even the very survival of the high-cost "legacy" airlines. The magnitude of the problem becomes apparent when the deficits are measured against revenue or market values (see table 3, opposite). In the worst-case scenario, the airlines could be forced into bankruptcy or even liquidation.

The pension crisis will hit at a time when the legacy airlines are making a feeble financial recovery. But, even with a robust economic expansion underway, Big Six revenue levels are expected to be 18% less in 2003 than in 2000. And, based on current assumptions, the Big Six US airlines will lose \$5.8bn in 2003, \$500m in 2004 and eke out \$1.5bn in net earnings in 2005 (see table 4, opposite - all these results are before the effect of pension cash contributions).

This is hardly good news when considering the \$4bn in profits generated during the peak of the last business cycle. Cumulatively, the group will have negative earnings of almost \$25bn for the years of 2001, 2002 and 2003. Moreover, United, US Air, Northwest, American and Delta will end the year with \$16bn in negative equity on the balance sheets (see table 5, on page 4).

Even with across-the-board cost cutting and better unit revenue trends, these airlines

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Table 3 MARKET VALUE AND PLAN DEFICITS

Data as of 2/12/2003	Market Cap (\$m)	Sales (\$m)	Mkt Cap To Sales	Employees	Pension Deficits (\$m)	Deficits per employee	Deficits as % of market
Composite	27,965	80,986	0.35	394,849			
JetBlue	3,515	923	3.81	3,823	0	0	0
Southwest	14,114	5,820	2.43	33,705	0	0	0
AirTran	1,219	879	1.39	4,700	0	0	0
SkyWest	1,026	859	1.19	5,079	0	0	0
Frontier	560	547	1.02	2,651	0	0	0
Atlantic Coast	505	857	0.59	4,311	0	0	0
Alaska	745	2,359	0.32	10,114	(101)	\$ (9,970)	14%
Continental	1,201	8,662	0.14	42,944	(1,211)	\$ (28,198)	101%
AMR Corp	1,985	17,153	0.12	92,800	(3,777)	\$ (40,695)	190%
Northwest	1,086	9,442	0.12	38,722	(3,795)	\$ (98,008)	349%
Delta	1,478	13,213	0.11	70,100	(4,620)	\$ (65,909)	313%
US Airways	375	6,695	0.06	26,300	(2,573)	\$ (97,830)	687%
UAL Corp	156	13,578	0.01	59,600	(5,968)	\$ (100,136)	3816%
	27,965	80,986		394,849	(22,045)	\$ (55,831)	

Note: (1) US Airways' pension deficits are based on estimates prior to the PBGC takeover of the pilots' plan.

(2) United's pension deficits do not consider any new labour agreements as a result of the bankruptcy.

Source: Company reports and AirlineForecasts

face substantially higher claims on operating cash flow until 2008 as a result of large debt repayment needs and required pension plan funding. United's situation is the most dire.

Liquidation or plan termination

Documents filed in federal bankruptcy court revealed an ugly surprise for United's employees. The total deficits of United's four main domestic pension plans may be as high as \$7.5bn - \$1bn more than the \$6.4bn deficit disclosed in the most recent annual report, and in total contrast to the \$1.3bn funding surplus reported as recently as 1999. The \$6.4bn figure represents the estimated shortfall if it terminated its major pension plans in April and tried to use the assets of each plan to cover the benefits already earned by its workers. United will most likely postpone some of its annual pension contributions and has disclosed that it may have to contribute \$4.8bn to its four pension funds by the end of 2008. The company built up credit balances during the good times and avoided making large cash contributions over the last several years because of strong plan returns achieved during the stock market bubble.

In the absence of changes in the pension rules regarding required contributions or a termination by the PBGC, analysts at Fitch Ratings estimate that cash funding require-

ment of \$1.5bn-\$1.8bn will be required over the 2004/2005 period. United is proposing a new "Uniform Pension Plan" that would provide \$1.87bn in savings over a six-year period, of which \$789m of the savings would come from the pilots. Fitch believes that the cash flow effect of existing pension plan funding obligations is simply unmanageable for United in a post-bankruptcy emergence scenario, and will impede its ability to attract interest from outside

NET EARNINGS (\$m)

Table 4	1998	1999	2000	2001	2002	2003F	2004F	2005F
American	1,314	985	813	(1,762)	(3,511)	(1,310)	(19)	395
Continental	464	337	343	(95)	(451)	(220)	47	199
Delta	1,078	1,096	987	(1,230)	(1,287)	(651)	(315)	254
Northwest	(285)	300	296	(423)	(798)	(275)	(115)	213
United	827	781	322	(2,145)	(3,212)	(2,643)	200	420
US Airways	538	28	(154)	(2,117)	(1,646)	(695)	(340)	(100)
Big Six	3,937	3,526	2,606	(7,772)	(10,905)	(5,794)	(542)	1,382
AirTran	(41)	(99)	47	(2)	11	56	70	81
Alaska	134	125	1	(43)	(119)	(36)	28	64
Amer West	109	120	(4)	(148)	(430)	(28)	32	52
ATA Holdings	41	47	(16)	(82)	(175)	(6)	12	18
Frontier	(18)	31	26	55	17	24	35	24
JetBlue		(14)	(21)	22	49	93	118	153
Southwest	433	474	625	511	241	307	488	611
Low Cost	658	683	659	313	(407)	410	783	1,002

Source: Company reports, consensus earnings estimates and AirlineForecasts

Table 5 BOOK EQUITY AND LEVERAGE (IN \$m)

						Year End	Sept Qtr	Equity as % of Assets
	1999	2000	2001	2002	3Q 03	Book Equity	Assets	
Southwest	2,836	3,451	4,014	4,422	4,868	4,947	9,699	51.0%
Jetblue	115	109	324	415	640	663	2,010	33.0%
Alaska	931	862	819	656	683	662	3,239	20.4%
Amer West	714	667	522	128	127	124	1,663	7.4%
Continental	1,593	1,610	1,161	848	764	712	10,878	6.5%
Delta	4,908	5,343	3,769	893	(600)	(805)	25,761	-3.1%
American	6,858	7,176	5,373	957	(521)	(714)	29,943	-2.4%
NWAC	(52)	231	(431)	(2,262)	(2,573)	(2,726)	13,749	-19.8%
United	4,846	4,885	3,033	(2,579)	(5,871)	(6,182)	21,626	-28.6%
US Air (1)	(117)	(358)	(2,630)	(4,956)	(5,818)	(5,923)	8,488	-69.8%
Industry	22,632	23,977	15,954	(1,478)	(8,301)	(9,243)	127,056	-7.3%
Big 5	16,443	17,277	9,114	(7,947)	(15,383)	(16,350)	99,567	-16.4%

Notes: (1)a This is what the US Air's equity would look like without (post-bankruptcy) fresh start accounting
 (1)b US Air reported a book equity value of \$356m for the quarter ending June 30, 2003
 Source: Company reports and AirlineForecasts

equity investors in support of the reorganisation plan. Estimated annual cash funding requirements of \$1bn or more by 2005 represent an enormous claim on United's operating cash flow even after a restructuring of its debt and lease obligations has taken place in Chapter 11. Therefore, United probably will be forced to terminate one or more of its employee-defined plans, with the PBGC assuming the terminated obligation.

Fresh start accounting - a function of emerging from Chapter 11 bankruptcy - has allowed US Airways to eliminate \$5.9bn in negative equity cumulated through the third quarter of 2003, and has also allowed it to alleviate its pension underfunding problem. The pension plan for US Airways' pilots was underfunded by \$2.5bn, with \$1.2bn in assets to cover \$3.7bn in benefit liabilities. Of the \$2.5bn in underfunding, the PBGC estimates that it will be liable for approximately \$600m, making the US Airways' pilots plan the sixth-largest claim in the agency's 28-year history.

Fragile balance sheets

Shareholder equity is hugely negative for the big five US airlines and it is becoming increasingly clear that if they are to recover,

they must find a way - perhaps with the assistance of appropriate legislation - to defer payment of past pension obligations across a time span of many years. In the meantime, they must become profitable; failing that, no amount of pension deficit deferral will be helpful. The present problem can be attributed to both management foolishness and excessive union power. Managements bear responsibility for succumbing to the siren song of Wall Street and using billions of dollars to buy back stock during the prosperous 1990s. Any experienced airline manager knows that the business is deeply cyclical and will never be able to offer its investors the high returns offered by less competitive and less cyclical industries. Thus, buying back stock in the name of "enhancing shareholder value", acquiring competitors who would have been better left to expire naturally and buying too many types of aircraft are management errors.

On the other hand, the excessive labour costs of the major carriers primarily arose as a consequence of strong unions, which have historically been willing to enforce their demands with threats of and actual strikes. Since no airline can logically accept a work stoppage - the cost of a strike is always many times the present value of the incremental labour cost demanded - managements resisted as long as they could and then, typically, caved. The result has been inflated labour costs.

The shrunken big six airlines must now find a way to make a profit in an industry which will never generate the revenue levels of years past (see table 6, opposite) while simultaneously earning enough to eventually meet past pension obligations. Revenue for the group is estimated to be \$69bn in 2003, which is \$16bn less (19%) than it was in 2000. The old-line airlines have a major problem because retirees receiving health care benefits and pensions outnumber the current workers on the payrolls.

The future has caught up with these underperforming businesses and the real economics are much worse than investors and employees appreciate. For example, US Airways used aggressive accounting assumptions to minimise cash contributions required for the defined benefit plans. Pilots believed that pen-

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sion plans were 93% funded based on accounting rules (using US Airways' pension assumptions) during the bankruptcy proceedings. However, using more conservative assumptions, including a lower discount rate, the PBGC found the plans to be only 35% funded.

The labour cost issue

With as much as 80 % of all US domestic markets now having low-cost competition, the major airlines are forced to retreat or restructure costs. The key competitive difference between the low-cost and high-cost airlines is labour costs - in all of its forms. As the low-cost segment gains greater market share, the industry averages for wages and labour productivity move lower and the majors' labour cost disadvantage becomes even more apparent. As an example, the average per employee cost for Delta, United, US Airways, American and Northwest in 2002 was \$90,500 per year and they collectively lost \$9.5bn in operating profits. Southwest's labour costs were 35% lower at \$59,000 per employee. (see table 7, below)

If Southwest had the labour costs of the biggest five carriers, the company's costs would have been \$1bn greater in 2002 and they would have reported operating losses of almost \$600m versus \$417m in operating profits. Conversely, if the big five airlines had Southwest's labour costs, operating expenses would have been \$9.8bn less in 2002. In other words, the legacy airlines would have produced \$300 m in operating profits during one of the worst years in aviation history. (Operating profits are calculated before interest, taxes, and non-recurring restructuring charges; the number of employees used in the calculation was based on average employee levels in 2002.) These data illustrate clearly that the majors have cost, and not a revenue problem.

The old-line airlines have legacy costs that make them uncompetitive relative to the new gener-

Table 6

	REVENUE (\$m)					
	2000	2001	2002	2003F	2004F	2005F
American	19,703	18,963	17,299	17,399	18,062	18,705
Continental	9,899	8,969	8,402	8,829	9,196	9,665
Delta	16,742	13,879	13,305	13,207	13,766	14,247
Northwest	11,108	9,905	9,489	9,400	9,729	10,070
United	19,352	16,138	14,248	13,480	13,952	14,510
US Airways	8,388	8,288	6,977	6,776	6,945	7,119
Big Six	85,192	76,142	69,720	69,091	71,650	74,315
AirTran	624	665	733	926	1,200	1,474
Alaska	1,749	2,141	2,218	2,031	2,600	2,800
Amer West	2,288	2,066	2,047	2,255	2,500	2,700
ATA Holdings	1,292	1,275	1,277	1,500	1,600	1,700
Frontier	330	473	445	637	797	957
JetBlue	105	320	635	981	1,400	1,800
Southwest	5,650	5,555	5,522	5,893	6,600	7,300
Low Cost	12,038	12,496	12,877	14,222	16,697	18,731

Source: Company reports, consensus estimates and AirlineForecasts

ation airlines, where labour claims a far smaller share of revenue. As an example, if US Airways had paid market-level rates of pay over the last 18 years, the company would have accrued \$7.5bn in additional earnings. Instead, they had the highest labour costs in the industry, and ended its legal life in bankruptcy with \$5.8bn in negative equity. In contrast, Southwest had one of the lowest labour costs in the industry; will end the year with over

Table 7

	EMPLOYEE COSTS					
	Year 2002	3Q 2003	Annualised	2003E		
	Per employee	Number	Total	Per employee	03 vs 02	03 vs 02
	Annual costs	Employees	Labour costs	Annual costs	change	% change
			(in \$ '000s)			
America West	\$45,800	11,175	626,492	\$56,062	\$10,262	18%
Delta	\$82,100	70,100	6,256,000	\$89,244	\$7,144	8%
Southwest	\$59,100	32,563	2,216,000	\$68,053	\$8,953	13%
Continental	\$61,600	42,944	3,112,000	\$72,466	\$10,866	15%
AMR	\$89,800	92,800	6,772,000	\$72,974	-\$16,826	-23%
Alaska	\$69,600	10,114	794,800	\$78,584	\$8,984	11%
UAL	\$90,200	59,829	4,840,000	\$80,897	-\$9,303	-11%
US Airways	\$103,700	26,300	2,348,000	\$89,278	-\$14,422	-16%
Northwest	\$86,700	38,722	3,925,333	\$101,372	\$14,672	14%
Sum		384,547	30,890,625		-\$2,259	
Average	\$76,511			\$78,770		3.3%

Source: Company reports and AirlineForecasts

\$5bn in equity on the books, and produce almost \$500m in net earnings. Unfortunately, US Airways' costs are still too high post-bankruptcy and many believe the company is headed toward a second trip to bankruptcy court.

The fat is in the overstaffing

The real fat in the legacy airlines has been in overstaffing, resulting from a huge array of workrules designed to increase the number of personnel and reduce hours actually worked for active employees. Flight crew working rules are the most egregious problem, but these are compounded by union agreements that require as much as seven weeks of vacation for some employees, restrictions of many kinds of cross utilisation of ground personnel, requirements for double and triple compensation for those who work on holidays, contractual restrictions which prevent effective monitoring of sick time usage, and a host of other limitations on management's right to realise effective utilisation of available personnel.

Based on the head count and wage/benefit reduction that has taken place over the last three years, it could be argued that as much as 10% of the big six legacy airlines' total cost structure represented excessive staffing. In terms of total labour costs, unnecessary staffing represented about 18% to 20% of the annual costs. In other words, bloated payrolls

have inflated labour costs by about \$6.5bn per year. The magnitude of the cost savings is quite spectacular when one considers the \$7.3bn in total labour savings achieved this year over year 2000 by the big six. Only \$840m (or 11.5%) of that was from wage and benefit reductions. In terms of total cost reductions for the group, third quarter year-over-year results show that 57% of the savings were from labour.

The hidden costs of anachronistic work rules (i.e., featherbedding and payroll padding) can be quantified by examining the annual savings derived from reducing the number of employees per aircraft for the big five US network airlines.

The big five "legacy" US airlines averaged 139 employees per aircraft two years ago but have improved labour productivity 21% by reducing head count to 110 this year (see table 8, below). Roughly speaking, each head count reduction saves the group \$225m in annual labour costs. In other words, the big five saved \$6.3bn a year by simply rationalising head count toward industry averages. This represents 88% of the \$7.1bn total in labour savings from 2000, which includes wage and benefit reductions. In other words, the real savings are based on reducing unnecessary employees on the payroll. The bulk of these productivity savings is a function of changing collective bargaining agreements.

American and United account for 63% of the group's cost improvement and collectively have lowered labour costs by \$4.5bn annually. Both of these companies had head count and wage/benefit levels that defied logic when compared to industry averages. ALPA (Air Line Pilots Association) and the IAM (International Association of Machinists) legally killed the golden goose at United Airlines by padding payrolls for too many years. Almost 60% of the mechanics have lost their jobs since the company filed bankruptcy and the ramp employees no

Table 8

HEAD COUNT REDUCTION AND SAVINGS

	3Q 2003 Aircraft	Headcount per Aircraft yr 2000	Headcount per Aircraft yr 2003E	Headcount 00 vs 03 Change	Savings per head count reduction	Total annual Labour savings (\$'000s)	% Change
UAL	539	165	111	54	\$43,604	\$2,354,595	-33%
AMR	799	150	116	34	\$58,306	\$1,973,950	-23%
Northwest	427	129	101	38	\$43,286	\$1,644,865	-22%
Delta	829	145	127	18	\$49,260	\$886,677	-12%
US Airways	279	106	94	12	\$24,908	\$292,295	-11%
Continental	352	131	122	9	\$25,508	\$229,574	-7%
America West	140	94	79	15	\$7,849	\$117,730	-16%
Alaska	109	104	93	11	\$8,566	\$96,030	-11%
Southwest	385	86	85	1	\$26,200	\$37,225	-2%
	3859	129	94	35		\$7,632,940	

Source: Company reports and AirlineForecasts

longer make three times the market rate of pay, in fact, those jobs have now been contracted out to third party service providers. The payroll bloat at United showed up in the head count numbers that exceeded industry averages by 28% during the union-controlled, employee-owned ESOP (Employee Stock Ownership Plan). American was almost as bad at 16%.

Saving \$7bn a year in labour costs is a major accomplishment for these five big airlines. It took a September 11, a war in Iraq, SARS, an economic recession, two bankruptcies, and a threat of liquidation to change the collective bargaining agreements.

Collective bargaining agreements (CBAs) became far too restrictive in terms of what an airline can do competitively. Every aspect of an airline's operation is impacted by these labour contracts: marketing, sales, pricing, market values, scheduling, aircraft orders, and growth. The full savings reflected in the head count rationalisation programmes under way at United and American have yet to be realised or recognised. Northwest and Delta have yet to achieve adequate labour savings and they most likely will not be as successful as those that have had the leverage (or threat) of bankruptcy.

Special treatment

Unions and airline management have now joined forces to push aggressively for legislation that would allow the airlines to defer these cash contributions. The measure favoured by the airlines - "The Airline Pension Act" - is supported by politicians representing nine states with Major airline operations. The proposed legislation would exempt all the major airlines from the rules governing pension funding and would allow an airline whose asset values fall below 80% of the fully funded level to defer making cash contribution payments for five years. During the five-year period, only interest payments will be required. The contribution debt would then be amortised over 15 years with annual instalments.

It would also allow all companies to assume a more generous rate of return on their pension funds for two years, thereby reducing their pension liabilities. This is not the plan the

unions and airlines were hoping as reflected in the "Airline Pension Act" but it does dramatically lower the amount of cash required in 2004 and 2005. If the Senate goes along, and the President signs the bill into law, the airlines could reduce the \$5bn in required cash contributions in 2004 by approximately \$4bn.

Duane Woerth, president of the Air Line Pilots Association, the union spearheading the drive for the legislation, said the industry suffered unique damage as a result of September 11: "everyone knows the airlines can't afford to make the cash contributions and fund operations". Treasury officials, the Bush Administration and the PBGC, the agency that insures pensions (see box, page 11), oppose the legislation on the grounds that it would prompt other troubled industries to demand relief as well, leading to further pension deficits and eventually a bankrupt PBGC.

Administration officials don't like the legislation because when weak companies reduce the amount of cash contributions, the plans typically get weaker over the contribution holiday. The fear is that some of the weakest pension plans could fail if the rule were rolled back for two years, because the sponsoring companies might still be unable to come up with the needed cash when the two-year reprieve expired. If this were to occur, the PBGC would end up with a bigger burden than if it simply took over the plans now. The Director of the PBGC was quoted as saying "giving a special break to weak companies with the worst-funded plans is a dangerous gamble. The risk is that these plans will terminate down the road even more underfunded than they are today". His agency has a large deficit, and would be about \$350bn short if it had to assume all of the plans that it believes are in danger of going bust.

Pension-relief legislation will not solve funding problem

Pension relief is likely to happen by the first quarter of next year. \$5bn in required cash contributions - needed to close the \$22bn pension-funding gap - will be reduced and delayed in 2004. This will help the cash flows of the big six airlines but will have the negative effect of

making the pension obligations larger once the temporary relief is lifted. The obligations will grow larger as benefits accrue and the workforce ages and required contributions are lowered. Strong stock market returns will boost plan assets but the funding gap will not decrease because higher obligations will offset higher plan returns. Other things held constant, the obligations will be about 5% to 8% higher next year because the discount rate used in the calculations will be lower by about 50 basis points.

The balance sheets and the underfunded pensions remain big problems for the legacy airlines. Excluding US Air, which no longer has a major funding problem, about \$8bn of the funding shortfall is not reflected on the balance sheets of the big five. For example, NWAC has a negative \$2.7bn book value. This would be worse by \$1.4bn if the part of the pension liabilities not reflected in the financials were considered. For the industry as a whole, \$26bn in equity has disappeared over the last three years. It will take a very long time to accrue this level of equity and it means that the majors will not be growing capacity as fast as they did during the last economic recovery. The airlines that grow too fast will be the ones filing for bankruptcy during the next shock or downturn.

Solving the pension problem is something both the government and airlines need to worry about because of the impact of airline plan failures on the PBGC, which may ultimately come back to the taxpayers.

The airlines with the big funding liabilities are trading for pennies on the (sales) dollar in the marketplace. The market-to-sales multiple (see table 3, page 3) compares the relative valuation of each airline and it is easy to see who is creating the greatest value. Clearly, the big airlines promised (or the unions demanded) more than the airlines could afford. As these airlines shrink to stop the losses, the deficits and cash contributions per employee increase. In other words, relative unit-labour costs move further away from market averages and the airlines become even less competitive with those that can afford to grow. The defined benefit plan deficits are significantly larger than the market values of the DB airlines. This means that there may not be anything left for the owners of the assets or enough money to properly

reinvest in the competitive resources of the business.

A window of opportunity

There is a window of opportunity to fix the legacy airlines and it will only be open during the expansion phase of the current economic recovery underway. Earnings estimates over the next few years suggest that the airlines will make slim profits during the good times but will not be able to cover true capital costs or fix the balance sheet over the full business cycle. If management and labour do not get the economic house in order during the upside, a bankruptcy judge will help them sort it out during the downside. Reducing labour costs and improving customer service is the key to reinventing the legacy airlines.

Hub airlines and point-to-point airlines can coexist and an expanding economy will lift all boats, albeit at different levels of profitability. Legacy airlines will continue to lose market share until they repair the balance sheets and narrow the fare differentials with the low cost airlines. Reducing debt is a top priority and there will be little cash remaining to "reinvent" or reinvest in the airlines until a certain amount of debt is paid down. This will take five to ten years and even then the reduction may not be enough for the next downturn.

United and Delta are experimenting with lower-cost "branded" operations, but, unless labour's cost differentials are narrowed with the low-cost airlines, no amount of branding will fix the high fares required to compensate for the higher costs. Branding an airline with out-of-line costs is like putting perfume on a pig. Regardless of the new (branding) smell, it's still a pig of a competitor and passengers' perceptions and expectations will not change as long as fares are too high.

There are hidden savings in the collective bargaining agreements with the various labour groups. United and American are on the right path with their new labour agreements and Northwest and Delta will have to follow their lead. Bankruptcies will be postponed as pension relief legislation delays and reduces the contributions required to close the \$22bn funding gap, and, as the economic expansion lifts

all boats. Several of the legacy airlines are raising equity capital and this will help shore up the balance sheet. Capacity contraction will not be necessary during the recovery phase because passenger traffic will increase as average fares continue to fall and economic growth stabilises around its long run potential.

The legacy airlines as a group will not be able to match the operating profits of a Southwest or JetBlue, however, there is reason to believe that they can achieve a 5% to 10% operating profit during the economic expansion. Northwest, Continental, Alaska, and America West did quite well during the September quarter and will be producing positive earnings next year. United's unit costs will most likely fall below nine cents next year and this implies a 5% operating margin. This would also imply that unit costs will be 20% higher than Southwest's, however, unit revenue does not need to be 20% higher for United to achieve adequate profitability. Maintaining a 12% unit revenue premium could do the trick, and is lower than the historic 18% premium that resulted in lost market share, which was a function of higher average fares.

Delta will most likely achieve concessions from their pilots and will also regain profitability by 2005. During the first nine months of 2003, Delta has had the highest labour costs in the industry - 48% of every dollar of revenue went to labour versus the industry's 36%. The magnitude of this difference becomes apparent when considering the \$1.6bn in additional "above market" annual labour costs that Delta must endure. In other words, with market-level labour costs, Delta would make \$900m in profit this year. The company can continue to pay a labour premium but they will have to cut at least \$500m more out of labour to be viable. Delta will end the year with negative \$800m of book equity and incur \$700m in net losses. They have \$4.6bn in unfunded pension liabilities, of which about \$1.2bn is not reflected on the balance sheet. Bottom line: Delta will end 2003 with a negative net worth of around \$2bn.

As a group, the US Majors will post positive operating margins next year and be profitable in 2005, albeit at perhaps half the level of the peak of the last business cycle. US Airways is in deep trouble and will have to go back to labour for more relief. It is losing market share

with a 23% unit revenue premium above Southwest's and can't make money because they have a 50% unit cost disadvantage.

What it takes to make the Majors viable

The legacy airlines are viable when they can cover their true capital costs over a full business cycle. This would include a "normal" rate of return charge for equity capital and this is the difference between GAAP-based accounting earnings. Normal return is risk-adjusted and based on the opportunity cost concept. The airlines are viable if they did not have the cash contributions required to close the funding gap over the next 5 years and if their labour costs - in all of its forms - was closer to that of the industry average. Under these conditions, the legacy airlines can make money and thrive. Retirees and current employees must understand this simple concept and accept appropriate concessions before it's too late.

Government policy makers should take advantage of the leverage they have with pension legislation. This means: no temporary relief unless:

(1) Unions and management fully understand and agree that there is a crisis and that they are on the path toward bankruptcy or liquidation;

(2) The future costs of the plans are reduced significantly; and

(3) Labour and management agree on labour contracts that bring unit costs within, say, 5% of Southwest and labour agrees that all future contracts will be subject to some type of binding arbitration. This means that all new employees will not be in the defined benefit plans and the airlines switch to cash contribution plans or modify/freeze the current plans.

Unfortunately, even this may not be enough - several airlines will end up meeting the "distressed termination" criteria in a bankruptcy court by the end of the current business cycle.

Labour leaders persist in telling members that labour costs are not the problem and that it is a revenue problem. Apparently many believe that a rebounding economy and higher future revenues will solve the non-competitive

Table 9 PENSION EXPENSE AND CONTRIBUTIONS PER EMPLOYEE (\$)

	2001	2002	2003	2004	2005
Alaska	8,517	7,900	23,965	4,449	5,537
American	4,066	9,029	13,422	16,078	15,949
Delta	(327)	3,266	21,049	21,517	20,600
Continental	4,103	8,644	11,805	13,463	13,129
Northwest	6,122	11,869	30,740	34,415	31,309
United	7,190	10,234	31,695	34,663	30,923
US Airways	5,688	13,185	20,529	28,801	26,736
Composite	4,445	8,727	21,127	23,441	21,938

Source: Company reports and AirlineForecasts

cost and pension problems of the legacy airlines. Higher revenues and expanding traffic will help but it will not solve these two problems. Everyone one should clearly understand that the legacy airlines have a cost problem and not a revenue problem. They have a pension funding and expense problem, a "deficit reducing" cash contribution problem (see table 9, above), and a wage/benefit/productivity problem. And, they have an earnings and balance sheet problem. Simply stated, they have a labour cost problem.

Based on reasonable revenue estimates for the industry, the big six will produce approximately \$74.5bn in 2005. This is \$11bn less than that produced during the market-bubble years in the late 90s and 2000. The Majors have become price-takers because 80% of their markets now have low-cost, low-fare competition. The big six's revenue-share of the industry (17 airlines) will be down to 75% in 2005 from almost 90% in 1998. Estimated profit-share will be down to 54% from 85% over the same time period. Southwest as a contrast will capture 25% of the profits in 2005, but only 7.4% of the revenue.

The \$1.5bn in estimated net earnings for the big 6 in 2005 do not reflect the billions in "deficit" reducing cash contributions required to close the DB funding gap. They are no longer viable businesses because operating cash flows will not support operations and the cash contributions at the same time. Negative book equity, combined with large off-balance sheet pension liabilities and large losses make raising money difficult if not impossible. The legacy airlines have loaded up with debt and the revenue will not support the costs of the total

assets. Basically, revenue levels in 2003 will be the same as those produced in 1994 and 95. Corporate assets, on the other hand, are larger by 73% - and this does not include a large portion of the off-balance sheet pension liabilities. Estimated total assets for the big 5 in 2003, \$99.5bn; book equity, -\$16.4bn; pension liabilities in 2004, \$57.7bn; pension assets, \$37bn; net pension assets: -\$20.7bn; net pension assets as a percentage of corporate assets, 23%.

Pension reporting (SFAS 87) is deeply flawed. It allows companies to treat assumed rates of return as actual rates of return for accounting purposes, and it permits them to bring "excess" and entirely fictional earnings onto the income statement. It's truly Alice in Wonderland stuff. Pension accounting is in need of serious reform and so are the legacy airlines. United is the test case for the PBGC. If United terminates one or more of their plans in order to emerge from bankruptcy, the other legacy airlines will have no choice but to follow United's lead, and if they don't, they will surely die on the vine of lower-cost competition. This is the base-case scenario in my opinion and the economics that support this scenario are quite compelling.

Labour's power to negotiate collective bargaining agreements (CBAs) that these legacy airlines cannot afford gets to the heart of the problem and must be addressed by policy makers who must deal with the funding crisis. If the taxpayers don't bailout the airlines' underfunded pension plans, the taxpayers will eventually be asked to bail out the PBGC. Either way, the employees - specifically the pilots - will only receive a fraction of the pension benefits promised in the current CBAs. The government has a rare opportunity to leverage its ability to help legislatively by requiring airline and union action as a condition of any legislative pension relief. But election year expediency and politics may prevent the industry from swallowing the bitter pill of reality. If President Bush signs off on temporary pension-relief legislation, legacy airlines will use the extra cash to expand capacity. They believe this the best strategy to reclaim lost market share. Union leaders will push for growth to bring back unemployed workers onto the payrolls. The downside to the extra growth is that it pushes

THE ROLE OF THE PBGC

The Pension Benefit Guarantee Corporation (PBGC) is the government agency that insures pension plans and protects benefits. It was designed to serve as a "safety net" (or type of insurance) for employees and retirees in the event that a severely financially distressed plan is in danger of failing. When the PBGC has made a determination that a company cannot continue to administer a pension plan, it may agree to allow the company to terminate the plan. In a "distress termination," an employer ends a plan that does not have enough money to pay all benefits that are owed. In order to end the plan, however, the employer must prove to the PBGC that it is unable to support the plan - something PBGC does not just accept at face value. Union consent must be obtained if a plan is maintained pursuant to a collective bargaining agreement. If union consent is not obtained, the collective bargaining agreement must be abrogated under Section 1113 of the US Bankruptcy code. The PBGC must find that the distress termination criteria have been satisfied. In a Chapter 11 proceeding, the termination of a pension plan may not violate a collective bargaining agreement. Thus, in absence of an agreement with its union, the airline must obtain the approval of the Bankruptcy court to terminate its collectively bargained pension plan.

In a distress scenario, PBGC takes over the plan and uses its own assets and any remaining assets in the plan to make sure that current and future retirees receive their vested pension benefits, up to maximum dollar amounts set by law and subject to other legal limits. In addition to employer-initiated terminations, pension plans may also be terminated by the PBGC. An underfunded pension plan can be terminated by the unilateral action of the PBGC on a discretionary basis if:

- 1) The PBGC finds that an employer has not been satisfying the minimum funding standards under the Internal Revenue Code; or
- 2) It is determined that there is a possible long-run loss to the PBGC if the plan is continued in operation.

Pension Accounting rules are governed primarily by the Employee Retirement Income Security Act (ERISA) and the internal revenue code (IRS), while the Statement of Financial Accounting Standard (SFAS) No. 87 relates to how the information must be presented in the company reports. The accounting in SFAS No. 87, "Employers' Accounting for Pensions," is convoluted, misleading, and arguably the most technically complicated financial reporting pronouncement ever issued. It is important to understand that aggressive assumptions such as a high discount rate, a low rate of compensation increase, and a high expected rate of return can help improve operating results as well as improve the funding status of a plan. In addition, frequent changes to these assumptions can be a way for a company to effectively manage their earnings.

With the termination of the US Airways' pension plan for pilots, four of the ten largest claims in PBGC's history are now from airline companies. Overall, the airline industry accounts for 17% of total PBGC claims but fewer than 2% of insured participants. Losses suffered by the pension insurance programme must be covered by premiums paid by other companies that sponsor defined benefit pension plans. The PBGC receives no general tax revenue and is not backed by the full faith and credit of the US government.

down average yields. This type of industry capacity decision-making some call "destructive competition" and others call dumb management. Regardless, it's irrational at the industry level as it destroys the pricing environment and everyone suffers.

Temporary pension relief legislation sets

the airline industry up for a bigger fall once the relief goes away. Funding deficits and cash contributions will be larger in later years because contributions will be smaller during the relief years. Stated differently, the industry will appear to be sound for a few years, but will in fact be getting much sicker.

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India's untapped aviation bonanza

The Indian government's on/off privatisation programme for the two state airlines, Air India and Indian Airlines, may be back on, depending on the impending report of a government-appointed committee.

There is no doubt that there is massive untapped potential in the Indian market. Although there are more than 1bn Indians, just 14m passengers are carried on domestic flights each year - and of that, more than 10m are either foreign or business passengers. Daily passenger traffic on the railways is also 14m. But while the majority of India's population lives in abject poverty, there is an estimated "middle-class" of 120m people who could travel by air, yet currently only provide some 3m domestic journeys on aircraft per year - a figure that remains stubbornly flat.

Some in the industry blame high taxes, such as a 15% "inland air travel" tax and a 16% excise duty on fuel, but while fares do need to come down, the tax issue is misleading since most of the country's middle classes can afford air travel if they want to. More importantly, what is holding domestic air travel back is poor service standards at the state airlines, little competition from private carriers (though this is changing) and poor infrastructure, particularly at airports. In addition, Indian airlines are forced to allocate their capacity by a bureaucratic formula. Capacity equivalent to 10% of that deployed on trunk routes (Category 1 routes) has to be allocated to points in the northeast of India (category 2 routes), with 1% dedicated to intra-Category 2 services. Then, the equivalent of 50% of Category 1 capacity has to be dedicated to Category 3 routes, which are basically all other routes within India. Capacity is measured in ASKs.

This untapped domestic demand has long been something that Indian governments have tried to unleash. There was partial deregulation in the 1990s, which led to the emergence of private carriers such as Sahara Airlines, but today only a handful of private carriers offer any real competition to the state airlines. And their profitability is questionable anyway as they face the same infrastructure constraints as their state competitors, though private airlines are keen to expand and put

greater pressure on Air India and Indian Airlines.

The latest push to liberalise the aviation industry came in 2000/01, with measures such as the abolition of state-regulated fuel prices in April 2001. However, the government's most important step - the attempted privatisation of the state airlines in 2001 - was a failure. The government intended to sell 60% of Air India and 51% of Indian, but the effort collapsed after various bidders were either disqualified or withdrew their interest.

In April 2003, the Indian government officially declared that there were no immediate plans for the privatisation of the two state airlines, thus freeing them - theoretically at least - to make substantial aircraft orders. However, almost immediately - in July - the government set up a committee to prepare a roadmap for the aviation industry, including the possible privatisation of Indian and Air India. The five-man committee comprises civil aviation and finance experts, and at the time the Indian government said it would report within three months. As yet, there is no sign of its recommendations. However, some analysts are confident that when it does report, a timetable for another privatisation attempt will be laid out.

Other than privatisation (or perhaps before privatisation) the main option for Air India and Indian Airlines is a merger, or at least much closer cooperation. However, any move to rationalise routes and/or operations will face huge opposition from unions and politicians, afraid (with much justification) that this will lead to many redundancies. The government insists a merger is not on the agenda, but the government's hiring of a western consulting company - AT Kearney - in 2002 to advise it on the future of the two airlines, has increased the unease at unions worried about mass redundancies. Speculation was fuelled further in August when the Indian government announced that Sunil Arora, chairman and MD of Indian Airlines, was also to become the MD of Air India.

The on/off privatisation saga does the industry no favours, though it must be recognised that there are a lot of impediments to a successful sell-off, not least of which is the relatively poor performance of the state airlines in the last few years. The govern-

ment may want to wait until their profits pick up before selling stakes in them, though some in the airlines argue that they will never be profitable in a sustainable manner until aging fleets are replaced with new aircraft - orders that may not be approved (and therefore financed) by the government prior to a privatisation. It's a Catch 22 situation.

Also looming is the next general election in India, due in October 2004, which may discourage the current government from making a controversial decision over privatisation before then. Meanwhile, Air India and Indian Airlines stagnate, allowing the few private carriers in India to pick away at the state airlines' market share.

Air India

Air India has been operating since 1932 and is India's international flag carrier, flying to 44 destinations in Asia, Europe, Africa and North America and carrying 3.4 million passengers in the year to March 31 2003. Nationalised in 1953, the airline is still 100% owned by the Indian government and has more than 16,000 employees.

Air India reported a net profit of Rs 1.4bn (\$30m) for the financial year ending March 31 2003, compared with a \$3m profit in 2001/02. Operating profit figures were not released however (the airline has made an operating profit only once since the mid-1990s), and much of the net profit was due to lower finance costs and sales of aircraft and property.

For the current financial year, Air India expects to post a net loss of at least Rs 0.5bn (\$11m), due primarily to the impact of the Gulf War, SARS and industrial action by pilots. SARS forced Air India to cut services and suspend its route to Hong Kong in April. The airline also suffered a damaging dispute with cockpit crew in April and May after derecognising the pilots union - the Indian Pilots' Guild - following a union decision to stop its members flying to Kuwait during the Gulf War and Hong Kong during the SARS crisis. Air India has a fleet of 29 aircraft - 12 737s and 17 A310s, of which 10 aircraft are leased. Two 747-400s and two A310-300s will join in December 2003 on dry leases, to be used on existing services to Chicago via Frankfurt and a new route to Shanghai.

Air India was planning to acquire up to 35 new aircraft in the period to 2007/08 in a complete overhaul of the fleet and to replace leased aircraft.

Some reports suggested this may have been postponed or cancelled due to the inability to get government approval for the order, and one local report said that an internal Air India analysis found that the new aircraft would be unprofitable for the airline (although Air India denied this was the case). Air India had been evaluating A340-300s and 777-200ERs on long-haul and A320s and 737-800s on short-haul, and in November 2003 Air India formally decided to buy 10 A340-300s and 18 737-800s, slightly fewer than the order it was expected to make. Air India is now seeking government approval to firm up deals with the manufacturers - although it may take months, if not years, for permission to be given (see Indian Airlines, below).

Former managing director J N Gogoi previously stated that: "It's a life and death question for Air India. We have survived a couple of years purely by taking dry-leased aircraft, but that has its own limitations and its own constraints. We need to grow. If we remain static we will not survive." Air India is particularly keen to expand capacity to North America. In the last year Air India has doubled services to the US, which now total 20 flights a week, though these are all to eastern US destination. For the west coast, Air India relies on codesharing. It began codesharing with Asiana in November on services between Korea and Los Angeles, San Francisco and Seattle, and already codeshares on other routes to the western US with Singapore Airlines and Malaysia Airlines.

In 2002, the Indian government appointed management consultants to examine Air India (and Indian Airlines), and they recommended that Air India partially sell its IT, ground handling and engineering subsidiaries so that it can reduce the number of directly employed staff and concentrate on core airline activities. Among the subsidiaries that are now up for (partial) sale are ground-handling - which handles up to half of all ground handling in the Indian market and has revenues of \$75m per year - and its hotel and catering subsidiary, the Hotel Corporation of India. And, in August 2003, Air India signed an MoU for a co-operation pact with Lufthansa, which will cover commercial, engineering and IT areas. Although neither airline specified what this exactly meant, it may involve Lufthansa Technik becoming a joint-venture partner.

Air India also launched a voluntary retirement scheme in February as part of an effort to cut

employees by up to 1,500. Staff numbers have already fallen by 2,000 over the last few years through natural wastage and reducing the retirement age, but government rules do not allow Air India to make redundancies.

Indian Airlines

Indian Airlines is the country's domestic flag carrier. Launched in 1953, the airline employs almost 20,000 and carried 5.5m passengers in 2002. It operates throughout India via hubs in Delhi, Mumbai, Calcutta and Chennai, and also provides services to selected Asia and Middle East destinations.

Indian operates a fleet of 45 aircraft, including 40 A320s and three A300s, although it hasn't ordered any new aircraft for more than 10 years. Back in 2002, Indian selected the A320 family to upgrade its ageing fleet, and requested permission from the government to buy 43 of the aircraft - 20 A321s, 19 A319s and four A320s - in a deal worth more than \$2bn. The aircraft would be delivered over five years and some of them would replace 737s at subsidiary Alliance Air, which operates feeder routes throughout the sub-continent.

However, government bureaucracy or a lack of funds appears to have stalled a government decision and today - almost two years after Indian made its decision - the airline is still waiting for formal state approval. There may even be some nervousness about a Delhi court ruling in 2000 that the Indian government should not buy aircraft from Airbus until Indian police complete a longstanding investigation into alleged kickbacks from Airbus to Indian officials for an Indian Airlines' order back in the 1980s (for further details see *The Economist*, June 14 2003).

Some reports suggest the government would prefer the airline to lease the aircraft, not purchase them, but in any event the lack of approval has forced Indian to seek temporary solutions, and in September the airline even placed newspaper adverts in an appeal to find five A320s to lease for three-year periods. Indian is also believed to be considering a purchase of ATR 42 aircraft for regional feeder routes, a deal that ATR is keen to encourage through the promise of assembly work in India. The need for new aircraft at Indian is critical, the airline believes, as it is coming under increasing pressure from new entrants on high-density trunk routes. Indian accounts for approxi-

mately 40% of the domestic market, but this is falling fast and the state airline has been overtaken as domestic market leader by Jet Airways.

Although turnover has risen steadily over the last few years, Indian has not released any P&L figures since 2000/01, when it posted an operating loss of \$5m and a net loss of \$39m. However, Indian is trying to cut costs where possible. In August 2003, Indian extended a voluntary retirement scheme in a further attempt to trim 1,000 employees (though not pilots) from its workforce - around 5% of the total. Like Air India, Indian Airlines is restricted by labour laws from making redundancies.

Jet Airways

Jet Airways was launched in 1993 and is the largest privately owned airline in the country. Based in Mumbai, Jet does not consider itself a LCC, but instead targets business travellers. The airline has 6,500 employees and operates more than 250 flights a day to 40 destinations in the Indian sub-continent.

Today the airline is wholly-owned by the Indian entrepreneur Naresh Goyal, but up to 1997 Kuwait Airways and Gulf Air each held a 20% stake, until forced to sell after the Indian government declared that overseas companies could not hold equity in Indian airlines.

On its launch Jet had a fleet of four 737-300s, but today the airline operates 41 aircraft, 33 of which are 737s and the remainder ATR 72-500s. The ATRs carry passengers from feeder routes onto the main 737 services. Of the 737s, 27 are 7/8/900 models, and Jet has an average fleet age of just 3.4 years. However, Jet is slowing down its fleet expansion plan and has postponed an earlier plan to acquire another four new generation 737s in 2003/04. It currently has no new aircraft on order, although it will acquire a 737-400 on a dry lease in December 2003, which will be used to increase services on existing routes.

Jet also signed a Lol in 2002 to become the launch customer for the Embraer 175, an 86-seat derivative of the Embraer 170. Ten 175s were to be delivered from June 2004 onwards, partially as replacements for Jet's ATRs. This prospective order has also been delayed, and the first aircraft will not arrive until mid-2005 at the very earliest, assuming the order is confirmed at all. In August Jet also leased out two of its 737-400s to Japan's

Skynet Asia Airways on three-year contracts. All these moves suggest that Jet has overcapacity, or at least is worried about the effect of competition from low cost carrier Air Deccan (see below).

The postponements may also be due to financial considerations, although it is difficult to assess the company's profitability since it only releases revenue information. However, it is believed that Jet made a loss for the first time in its history in the 2001/02 financial year ending on March 31st, and recorded another loss in 2002/03. Thanks to the Gulf War and SARS, it is unlikely that Jet will make a profit in the current financial year either, and that may have been the spark for a management reshuffle in mid-year. In June 2003, Jet appointed Wolfgang Prock-Schauer as its CEO. Prock-Schauer was previously executive VP for alliances/long-term planning at Austrian, and he joined Jet just a month after a new COO - Peter Luethi, who was previously COO and executive VP external relations at Swiss.

If this team is responsible for the new cautiousness on capacity, it may have to reverse that decision now that the government has just allowed private airlines to operate to foreign destinations, an opportunity that Jet can't ignore. Jet claims to have a domestic market share of more than 46%, just ahead of Indian Airlines, but the market appears to be flattening out. After double-digit passenger growth at Jet every year from its launch through the 1990s, September 11 and a slowdown in the Indian economy has caused passenger growth to tail off.

Unless the new breed of LCCs expand the total market, traffic growth is more likely to come internationally. Sri Lanka would be an obvious first such destination for Jet, and it will be interesting to see how long it will take Jet to launch services out of India. Expansion internationally would also provide a good story for a major fundraising effort. Jet has been contemplating an IPO or private placement of equity for a while, but has so far put off a positive decision.

Others

In August 2003, Air Deccan became India's first new airline for many years. Launched by Deccan Aviation, an Indian helicopter charter operator, Bangalore-based Air Deccan is an LCC that operates 30 flights a day to seven southern Indian destinations using four leased ATR-42s. It plans to

expand services to other cities through the addition of three more ATR-42s.

The airline has a no-frills, one-class policy, and is targeting the vast majority of the Indian population that can't afford current fares and who currently travel by train or bus. Its prices are up to one-third lower than Indian Airlines' fares. Certain LCC operating policies are difficult in India however; for example, although Air Deccan sells via the internet, the penetration of this technology is very low and so most sales come from travel agents. Nevertheless, the airline expects to break-even in its first year of operation on revenue of more than \$50m, and if the LCC business model is successful then others are sure to copy the formula.

Air Sahara is an older airline, having been established in 1993 as Sahara Airlines. Owned by the Sahara Banking Group, the renamed Air Sahara has been expanding its operations and currently operates 19 737s and CRJ200s - many of them leased - to 20 domestic destinations, offering more than 11,000 seats each day.

The airline operates feeder routes from smaller Indian cities in the morning, which funnel passengers onto main trunk routes between cities such as Calcutta, Mumbai, Bangalore and New Delhi in the afternoon. Air Sahara says it plans to add larger CRJ700s in the future as it increases its challenge to Jet and Indian. Like Jet Airways, Air Sahara is keen to take advantage of the Indian government's declaration that it will allow private airlines to operate internationally, and the airline intends to launch services from Mumbai and Delhi to Colombo as soon as possible.

There is also increasing and serious competition from overseas. For example, AirAsia, a Malaysian LCC, is keen to operate routes to southern India to cater for ethnic Indians in Malaysia that want to visit friends and relatives in the sub-continent. Ethnic Indians comprise around 10% of the Malaysian population and AirAsia claims that at present flight choice between the two countries is limited and fares are high. AirAsia aims to launch services with 737-300s in 2004 or 2005.

Overall, it's clear that competition from private Indian airlines and foreign carriers is increasing, and the longer the Indian government delays making a decision on the privatisation of Air India and Indian Airlines, the tougher it will become for them to survive long-term.

Alaska: the smallest Major, the biggest turnaround

Alaska Airlines, the smallest of the US major carriers, is emerging from the post-September 11 industry crisis in relatively good shape, with strong liquidity, a reasonably healthy balance sheet and profits on the horizon in 2004. It will have to achieve further significant cost reductions in order to restore healthy annual profit margins, but the consensus opinion on Wall Street is that it will succeed in that task.

Alaska is also positioning itself nicely in the new industry environment as a high quality, leisure oriented point-to-point airline with unit costs "a notch above the low-cost carriers". Having already gained a foothold in some transcontinental markets to supplement its strong West Coast franchise, the airline has hinted at aggressive eastward expansion once the new cost targets are reached. It clearly has the potential to become an important player nationally.

Why is Alaska apparently succeeding in making the difficult transition to a new industry environment? How could it possibly get the labour cost savings that it needs? Could other medium-sized niche-type operators - perhaps US Airways or European carriers - learn from its strategies?

Other airlines can probably identify better with Alaska than, say, Southwest or JetBlue, because the Seattle-based company has struggled financially in recent years. Alaska Air Group (AAG, which also includes regional carrier Horizon Air) has lost money for four consecutive years (2000-2003) - one year longer than the large US network carriers generally.

AAG plunged into losses early because it had another crisis to deal with before September 11 - the January 2000 crash of an Alaska MD-83. The crash killed 88 people and resulted in a barrage of private lawsuits, a special safety audit by the FAA and a federal criminal investigation. (The airline was required to boost its maintenance staffing and safety and training practices, which contributed to a surge in unit costs, but all of it is now history since the criminal inquiry was closed last summer without the filing of charges.)

However, the financial losses themselves have not been that significant; for example, AAG's 2002 net loss before special items accounted for only

3% of revenues. In fact, in the post-September 2001 period Alaska's losses have been the lowest among the major carriers (except for Southwest, which has remained profitable).

AAG achieved an impressive 11.3% operating profit margin in the September quarter (virtually the same as Southwest's). However, the third quarter represents an unusually strong seasonal peak for the company because of summer vacation travel to the state of Alaska, and the latest profits were not enough to offset losses in weaker quarters. AAG is expected to report a (modest) \$35-40m net loss before special items for full-year 2003.

Next year, however, should see AAG return to profitability. The nine analysts reporting on the company to First Call/Thompson Financial expect a profit before special items in the \$25-50m range. The top estimate would represent a net margin of about 2%.

In a presentation at Citigroup Smith Barney's annual transportation conference in mid-November, AAG's chairman and CEO Bill Ayer provided some interesting insights into why Alaska has weathered the industry crisis so well and how it intends to move forward.

The key factors in the past two years have been, first, a quick traffic recovery, and second, revenues holding up better than competitors'. Alaska has reported year-over-year traffic growth every month since January 2002. Its 2002 revenues (\$2.22bn) were 2% above 2000's, contrasting with the 15-20% industry average decline in the two-year period. Alaska's traffic and revenues appear to have benefited from the resilience of the West Coast and Alaskan markets (the isolation factor) and the company's focus on the leisure segment. However, Ayer mentioned a third important factor: instead of parking aircraft and furloughing workers after September 11, Alaska redeployed its fleet in new markets.

In other words, the airline decided that operating its surplus aircraft, as long as at least variable costs could be covered, made more sense financially than parking them temporarily and having to also go through the upheaval and misery of furloughing employees. Of course, the added benefit was the ability to diversify the route network to

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include east-west operations.

This strategy illustrated Alaska's Southwest-style caring and respectful attitude towards its employees - probably one of its greatest strengths. However, in contrast to the large network carriers, Alaska was in a strong enough financial position to experiment with new types of markets.

Alaska has been able to maintain unit revenues more or less unchanged in recent years by increasing its load factor, which is at the low end of the majors' range because of its point-to-point, primarily domestic operation. It has benefited from a yield management practice that, in Ayer's claim, is the best in the industry in terms of technology, people and the way it focuses on markets and fare buckets. Of course, revenues have held up also because Alaska has maintained its traditional excellent service quality.

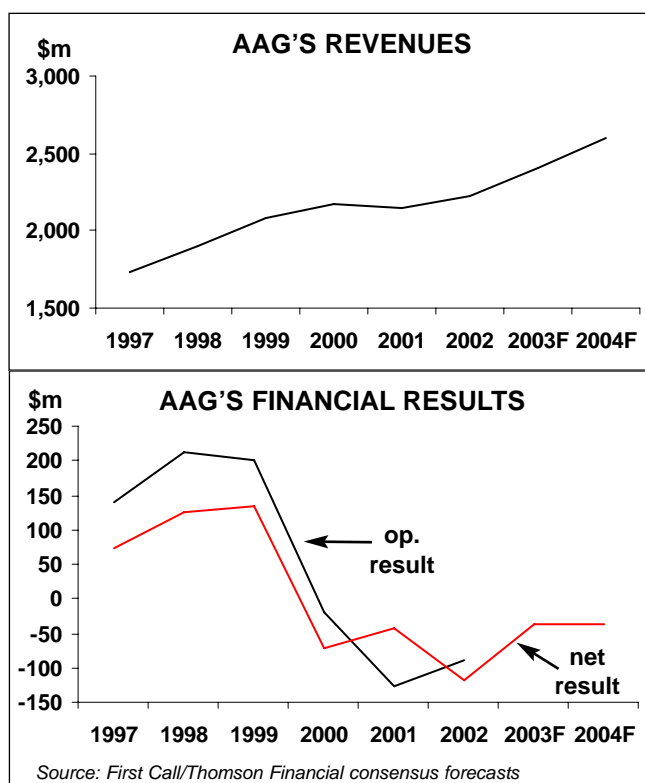
The company has a reputation for technological innovation and for being Internet-savvy. It was early to invest extensively in labour-saving technology and to provide electronic ticketing, and it claims to have been the first carrier to sell tickets on the Internet. In the September quarter, Alaska sold over 50% of its tickets directly to customers and issued 92% of its tickets electronically, while 45% of its customers checked in via the web or kiosk.

The only negative development, which contrasts with industry trends, is that Alaska's unit costs have surged in recent years. According to Ayer, in 1999 Alaska's ex-fuel CASM, at 7.49 cents, was close to the industry average - similar to Northwest's and about a cent higher than Southwest's. But by 2002 Alaska's ex-fuel unit costs had risen to 8.52 cents, which was half a cent higher than Northwest's and Continental's.

Including fuel costs also (the conventional way of presenting CASM information), Alaska's 2002 CASM was 9.85 cents. This looked alarming in light of the cost cuts implemented by American, United and US Airways this year.

Consequently, last June Alaska embarked on a new cost-cutting programme to reduce ex-fuel CASM to 7.25 cents by 2005. According to Ayer, the aim is to get back to the average in the ex-fuel CASM league, because that position produced strong profits in the past. "We really don't have to have the lowest costs in order to have a very successful business model."

While the revenue outlook remains modestly positive, Alaska assumes flat revenues for the pur-



poses of its financial recovery plan. This implies, first, that the focus is totally on the cost side to get the profit margin back. Second, there could be upside to the financial projections.

"Alaska 2010" plan

The 7.25-cent ex-fuel CASM target for 2005 is actually part of a broader seven-year vision to transform Alaska into a profitable, larger airline with a greatly expanded network. Entitled "Alaska 2010" (a reference to year 2010), the plan includes employee and customer elements in addition to the usual growth and financial targets.

- **Employee elements** The plan aims to provide "excellent job and retirement security" and make Alaska "one of the best places to work in America".
- **Service and brand** The aim is to provide "the best value" (a combination of product and price, not necessarily the lowest price) and have "one of the most respected brands in the USA". Since Alaska already has a strong brand, it will simply strive to continue building on it.

Ayer described the brand as having four pillars: "user-friendly" (as opposed to complicated), "engaging experience" (as opposed to routine),

"purposeful innovation" (as opposed to status quo) and "Alaska spirit" (as opposed to impersonal). The key goal is to "maintain differentiation". All of this basically means that Alaska will think twice before doing anything to reduce its on-board service. For example, it feels that the "buy-onboard" (food) programmes introduced by competitors would be detrimental to its brand. Nevertheless, short haul routes may see some changes as the airline continues to "refine our understanding of customer value".

- **Financial targets** The plan is to achieve an annual pre-tax profit margin of 10%. Alaska believes that profitability at that level would "weath-erproof" it to any economic downturn, enabling it to avoid dramatic capacity shifts.
- **Growth targets** Achieving the profit margin targets would permit annual capacity growth in the 8-10% range. In the plan, Alaska envisages having a fleet of 150-175 aircraft by 2010, up from 109 at the end of this year.

Ambitious cost cutting programme

The cost cutting programme aims to eliminate \$307m from Alaska's 2001 ex-fuel operating cost structure by 2005 - a relatively ambitious 20% reduction. In ex-fuel unit cost terms, this would represent a reduction from 8.73 to 7.25 cents in the three-year period. (These targets are for Alaska Airlines only; Horizon, which accounts for about 19% of group revenues, has a regional carrier-type higher cost structure.)

The programme is apparently running on target, with ex-fuel CASM of 8.52 cents achieved in 2002 and 8.35 cents expected in 2003. Nevertheless, getting from 8.35 to 7.25 in just over a year will be a formidable undertaking. There are three components. First, the airline targets \$120m annual savings from a variety of strategic initiatives. Efforts under way include boosting sales through Alaska's own web site from the current 29% to 50%, improving heavy maintenance efficiencies, lowering insurance costs and harmonising Alaska's and Horizon's flying (meaning more aircraft transfers between the two to better tailor capacity to demand on individual routes). About \$80m of these savings are already included in the 2003 results, leaving \$40m to be achieved in 2004.

The second component is a \$112m hoped-for

employee contribution to "bring labour costs in line with market and make some changes to employee benefit programmes". There is no specific time-frame. While it is too early to predict the outcome, an early positive sign is that the employee groups have agreed to begin a dialogue. The pilots, whose contract talks began last month, have reportedly been asked to take a 23% pay cut.

The \$112m request from labour amounts to about half a cent in CASM. In other words, it would make quite a big difference in Alaska's cost structure, but not getting it - or most likely, not getting all of it - would not be a serious problem.

On the positive side, Alaska has a history of great employee relations and appears to know how to deal with labour issues. However, it is always a tough challenge to persuade workers to make cuts when the company is in a relatively strong financial position.

The remaining \$75m annual savings would come from yet-to-be-determined product changes and cost initiatives. The intention is to finalise and implement those measures in 2004.

In a recent conference call, Alaska's top executives stressed that at this point the 7.25 figure was not offered as "guidance". Next year's goal excluding labour would be 8 cents, and labour could bring it to 7.5 cents, leaving 0.25 cents to be squeezed out in 2005.

While it is generally nice to see precise figures (as opposed to just vague talk about cost cutting), it is a little surprising that Alaska would want to publicly commit itself to a specific CASM goal. Other US carriers have avoided that, in part because they view CASM goals as a moving target but also because they remember Delta's disastrous "Leadership 7.5" programme.

But Alaska likes to do things differently and has an excellent track record in cost cutting. In the mid-1990s, when it got caught in fierce market share battles between Southwest and United's Shuttle, it staged a rapid and extremely successful cost cutting programme, reducing CASM drastically while maintaining excellent service quality.

Transcontinental expansion

Alaska has used the industry downturn to expand and diversify its route network. In 2000 it had an all-West Coast, north-south operation spanning from Alaska to Mexico. Now it also has

several East Coast spokes, operated non-stop out of Seattle. In the third quarter, the transcontinental and Denver markets accounted for 12.1% of its total ASMs, up from 5.7% a year earlier.

Going transcontinental was possible because of Alaska's new longer-range Boeing 737s. The airline is pleased with the economics of the routes today. Some of the markets, such as Atlanta and Florida, have responded well to the 737-900s, which provide more favourable economics than the 737-700s.

The transcontinental markets are still under development and have very low frequencies, typically only one or two per day. But despite that, they have already attracted significant flow traffic from Alaska and Western Canada, which has helped make them Alaska's best-performing segment in terms of average load factor (80.1% in the third quarter, 7.6 points higher than system average). Alaska believes that the new routes to the East Coast, as well as its airline partnerships, played an important role in securing a new corporate account with Microsoft - a major coup announced on October 1. Microsoft apparently switched accounts away from other airlines to make Alaska its preferred partner.

The new services also help save money on the FFP front. Previously Alaska's frequent-flyers, having earned their miles along the West Coast, typically claimed the miles on other airlines' coast-to-coast services, and Alaska had to pay its competitors. One of Alaska's aims now is to better penetrate the East Coast point of sale. It would like to secure corporate accounts in the East - something that could allow transcontinental frequencies to be increased more quickly.

After 2002's 8% capacity growth, Alaska managed another 7.3% ASM increase this year. Next year's plans currently envisage 5% ASM growth - the result of a net addition of seven aircraft in 2003 and a modest increase in utilisation. Alaska executives have hinted at the possibility of a couple of new cities in the East in 2004 or early 2005. But otherwise the message coming across loud and clear (undoubtedly aimed at the workers) is that while there are numerous good potential growth opportunities - in the eastern half of the country, as well as Hawaii, Caribbean and Mexico - the cost reductions will have to come first. As Ayer expressed it: "Low costs equal low fares and lots of possibilities".

It is easy to picture Alaska eventually carving

itself a successful niche in transcontinental markets and becoming a strong competitor nationally. After all, it has retained substantial market shares on many of its West Coast routes despite significant competition from Southwest and United. In the meantime, Alaska will continue to rely on its alliances with American, Continental, Northwest and others to connect across the country. The airline feels that, because of its geographical disadvantage and limited network, it benefits disproportionately from such partnerships.

As the latest alliance development, Horizon has partnered with Denver-based Frontier Airlines to operate up to nine 70-seat CRJ-700s as "Frontier JetExpress" under a 12-year agreement starting in January. Here AAG is trading off some reduced flexibility in the short term (fewer RJs available to help Alaska) for long-term broadening of opportunity. It is worth noting that Horizon differs from the typical US regional carrier model; like Alaska, it is essentially a point-to-point carrier and has only a 35% connecting traffic component. After a year of significant fleet activity at Alaska (11 new 737-700/900 deliveries and four MD-80 retirements), there now appears to be a natural pause. The 2004 fleet plan is very simple: receive one 737-900 and return to lessor one MD-80. Depending on the outcome of some lease negotiations, the airline may also end up returning additional 737-400s.

Horizon, in turn, is taking a year's break from RJ deliveries. Under a recent restructuring of its remaining Bombardier firm orders, it converted two CRJ-700s due in 2004 to two 70-seat Q400 turboprops - the only aircraft it is now taking next year. The other 10 CRJ-700s on firm order will be delivered at a rate of two per year between 2005 and 2009.

Some of this seems rather prudent in light of AAG's relatively healthy balance sheet. The company had an ample \$749m of cash at the end of September. Its lease-adjusted debt-to-capital ratio of 78% was the third best in the industry (after Southwest's 38% and JetBlue's 71%), well below the 95%-plus now recorded by the other major carriers.

By Heini Nuutinen

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		Group revenue US\$m	Group costs US\$m	Group op. profit US\$m	Group net profit US\$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
Alaska	Year 2001	2,141	2,263	-121.8	-39.5	-5.7%	-1.8%	28,837	19,712	68.4%	13,668	10,742
	Jul-Sep 02	620	597	24	11	3.9%	1.8%	8,380	5,911	70.5%	3,978	10,465
	Oct-Dec 02	430	484	-60	-94	-14.0%	-21.9%	7,657	5,092	66.5%	3,367	
	Year 2002	2,224	2,313	-89	-119	-4.0%	-5.4%	31,156	21,220	68.1%	14,154	10,142
	Jan-Mar 03	519	597	-79	-56	-15.2%	-10.8%	7,577	5,058	66.7%	3,258	9,988
	Apr-Jun 03	576	581	-5	-3	-0.9%	-0.5%	7,932	5,427	68.4%	3,616	10,222
	Jul-Sep 03	702	623	79	41	11.3%	5.8%	8,380	5,911	72.5%	4,280	10,114
American	Year 2001	18,963	20,823	-1,860	-1,762	-9.8%	-9.3%	161,030	176,143	69.4%	99,235	102,093
	Jul-Sep 02	4,494	5,815	-1,321	-924	-29.4%	-20.6%	73,899	53,236	72.0%	24,952	99,700
	Oct-Dec 02	4,190	4,869	-679	-529	-16.2%	-12.6%	67,964	47,428	69.8%	22,857	93,500
	Year 2002	17,299	20,629	-3,330	-3,511	-19.2%	-20.3%	277,121	195,927	70.7%	94,143	93,500
	Jan-Mar 03	4,120	4,989	-869	-1,043	-21.1%	-25.3%	64,813	44,800	69.1%	21,021	92,200
	Apr-Jun 03	4,324	4,237	87	-75	2.0%	-1.7%	68,678	51,095	74.4%		
	Jul-Sep 03	4,605	4,440	165	1	3.6%	0.0%	69,234	52,653	76.0%		
America West	Year 2001	2,066	2,380	-316	-148	-15.3%	-7.2%	42,709	30,696	71.9%	19,576	13,827
	Jul-Sep 02	510	552	-42	-32	-8.2%	-6.3%	11,504	8,619	74.9%	5,165	12,320
	Oct-Dec 02	522	560	-38	-32	-7.3%	-6.1%	11,154	8,160	73.2%	4,906	
	Year 2002	2,047	2,246	-199	-430	-9.7%	-21.0%	43,464	33,653	73.6%	19,454	13,000
	Jan-Mar 03	523	569	-46	-62	-8.8%	-11.9%	11,027	7,841	71.1%	4,655	
	Apr-Jun 03	576	559	17	80	3.0%	13.9%	11,223	8,854	78.9%	5,185	11,309
	Jul-Sep 03	592	542	50	33	8.4%	5.6%	11,365	9,068	79.8%	5,322	11,175
Continental	Year 2001	8,969	9,119	-150	-95	-1.7%	-1.1%	135,962	98,393	72.4%	44,238	44,273
	Jul-Sep 02	2,178	2,132	46	-37	2.1%	-1.7%	33,839	25,625	75.0%	10,581	40,925
	Oct-Dec 02	2,036	2,094	-56	-109	-2.8%	-5.4%	31,496	22,382	70.6%	9,651	40,500
	Year 2002	8,402	8,714	-312	-451	-3.7%	-5.4%	128,940	95,510	73.3%	41,014	40,713
	Jan-Mar 03	2,042	2,266	-224	-221	-11.0%	-10.8%	30,699	21,362	68.9%	9,245	
	Apr-Jun 03	2,216	1,978	238	79	10.7%	3.6%	30,847	24,841	75.9%	10,120	
	Jul-Sep 03	2,365	2,191	174	133	7.4%	5.6%	33,071	26,450	79.1%	10,613	
Delta	Year 2001	13,879	15,124	-1,245	-1,216	-9.0%	-8.8%	237,914	163,693	68.8%	104,943	77,654
	Jul-Sep 02	3,420	3,805	-385	-326	-11.3%	-9.5%	59,287	44,037	74.3%	27,713	76,000
	Oct-Dec 02	3,308	3,670	-362	-363	-10.9%	-11.0%	56,776	40,419	71.2%	27,290	75,100
	Year 2002	13,305	14,614	-1,309	-1,272	-9.8%	-9.6%	228,068	172,735	71.9%	107,048	75,100
	Jan-Mar 03	3,155	3,690	-535	-466	-17.0%	-14.8%	53,435	36,827	68.9%	24,910	72,200
	Apr-Jun 03	3,307	3,111	196	184	5.9%	5.6%	51,552	38,742	75.2%	25,969	69,800
	Jul-Sep 03	3,443	3,524	-81	-164	-2.4%	-4.8%	55,535	42,704	76.9%	27,059	70,100
Northwest	Year 2001	9,905	10,773	-868	-423	-8.8%	-4.3%	158,284	117,682	74.3%	54,056	50,309
	Jul-Sep 02	2,564	2,556	8	-46	0.3%	-1.8%	40,321	31,787	78.8%	14,365	45,466
	Oct-Dec 02	2,339	2,951	-612	-488	-26.2%	-20.9%	37,115	27,611	74.4%	12,779	44,323
	Year 2002	9,489	10,335	-846	-798	-8.9%	-8.4%	150,355	115,913	77.1%	52,669	44,323
	Jan-Mar 03	2,250	2,576	-326	-396	-14.5%	-17.6%	36,251	26,653	73.5%	12,284	42,781
	Apr-Jun 03	2,297	2,370	-73	227	-3.2%	9.9%	34,434	26,322	76.4%	12,800	39,442
	Jul-Sep 03	2,556	2,410	146	47	5.7%	1.8%	37,476	30,491	81.4%	13,971	38,722
Southwest	Year 2001	5,555	4,924	631	511	11.4%	9.2%	105,079	71,604	68.1%	64,447	31,014
	Jul-Sep 02	1,391	1,300	91	75	6.5%	5.4%	28,342	19,180	67.7%	16,256	33,609
	Oct-Dec 02	1,401	1,313	88	42	6.3%	3.0%	28,296	17,835	63.0%	15,554	33,705
	Year 2002	5,522	5,104	417	241	7.6%	4.4%	110,859	73,049	65.9%	63,046	33,705
	Jan-Mar 03	1,351	1,305	46	24	3.4%	1.8%	28,000	17,534	62.6%	15,077	33,140
	Apr-Jun 03	1,515	1,375	140	246	9.2%	16.2%	28,796	20,198	70.1%	17,063	32,902
	Jul-Sep 03	1,553	1,368	185	106	11.9%	6.8%	29,296	20,651	70.5%	17,243	32,563
United	Year 2001	16,138	18,481	-2,343	-2,145	-14.5%	-13.3%	265,291	187,701	70.8%	75,457	96,142
	Jul-Sep 02	3,737	4,383	-646	-889	-17.3%	-23.8%	64,147	48,335	75.4%	18,900	79,900
	Oct-Dec 02	3,468	4,462	-994	-1,473	-28.7%	-42.5%	59,988	43,158	71.9%	16,823	77,000
	Year 2002	14,286	17,123	-2,837	-3,212	-19.9%	-22.5%	238,569	176,152	73.5%	68,585	78,700
	Jan-Mar 03	3,184	3,997	-813	-1,343	-25.5%	-42.2%	55,751	39,980	71.7%	15,688	70,600
	Apr-Jun 03	3,109	3,540	-431	-623	-13.9%	-20.0%	51,692	39,809	77.0%	16,381	60,000
	Jul-Sep 03	3,817	3,798	19	-367	0.5%	-9.6%	56,726	45,500	80.2%	17,635	59,700
US Airways	Year 2001	8,288	9,355	-1,067	-1,969	-12.9%	-23.8%	107,347	73,944	68.9%	56,114	43,846
	Jul-Sep 02	1,752	1,933	-181	-335	-10.3%	-19.1%	24,075	17,276	71.8%	11,994	33,302
	Oct-Dec 02	1,614	2,217	-603	-794	-37.4%	-49.2%	20,631	14,096	68.3%	10,354	30,585
	Year 2002	6,977	8,294	-1,317	-1,646	-18.9%	-23.6%	90,700	64,433	71.0%	47,155	30,585
	Jan-Mar 03	1,534	1,741	-207	1,635	-13.5%	106.6%	19,579	13,249	67.7%	9,427	27,397
	Apr-Jun 03	1,777	1,710	67	13	3.8%	0.7%	20,929	15,789	75.4%	10,855	26,587
	Jul-Sep 03	1,771	1,808	-37	-90	-2.1%	-5.1%	21,615	16,611	76.9%	10,584	26,300

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

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		Group revenue US\$m	Group costs US\$m	Group op. profit US\$m	Group net profit US\$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
Air France	Year 2001/02	11,234	11,017	217	141	1.9%	1.3%	123,777	94,828	76.6%		70,156
	Jul-Sep 02	3,264	3,122	142	57	4.4%	1.7%	33,806	26,366	78.0%		71,290
	Oct-Dec 02	3,396	3,392	4	2	0.1%	0.1%	32,581	24,558	75.4%		
	Jan-Mar 03	3,240	3,373	-133	-106	-4.1%	-3.3%	32,070	23,906	74.5%		
	Year 2002/03	13,702	13,495	207	130	1.5%	0.9%	131,247	99,960	76.2%		71,525
	Apr-Jun 03	3,442	3,453	-10	5	-0.3%	0.1%	31,888	23,736	74.4%		71,936
	Jul-Sep 03	3,715	3,598	117	56	3.1%	1.5%	35,255	27,544	78.1%		
Alitalia	Jan-Jun 01	2,348	2,504	-156	-228	-6.6%	-9.7%	26,437	18,953	71.7%	12,565	24,023
	Year 2001	4,745	5,007	-262	-818	-5.5%	-17.2%	51,392	36,391	70.8%	24,737	23,667
	Jan-Jun 02	2,462	2,574	-63	-49	-2.6%	-2.0%			69.7%		21,366
	Year 2002	5,279	4,934	-89	101	-1.7%	1.9%	42,224	29,917	70.8%	22,041	22,536
	Jan-Mar 03	1,097	1,226	-187		-17.0%		10,503	6,959	66.3	4,993	21,984
BA	Year 2001/02	12,138	12,298	-160	-207	-1.3%	-1.7%	151,046	106,270	70.4%	40,004	57,227
	Jul-Sep 02	3,323	2,931	392	240	11.8%	7.2%	35,608	27,301	76.7%	10,607	52,116
	Oct-Dec 02	3,025	2,939	86	21	2.8%	0.7%	34,815	24,693	70.9%	9,200	51,171
	Jan-Mar 03	2,721	2,988	-213	-216	-7.8%	-7.9%	33,729	23,439	69.5%	8,547	50,309
	Year 2002/03	12,490	12,011	543	117	4.3%	0.9%	139,172	100,112	71.9%	38,019	51,630
	Apr-Jun 03	3,023	2,957	59	-104	2.0%	-3.4%	34,962	25,102	71.8%	9,769	49,215
	Jul-Sep 03	3,306	2,980	333	163	10.1%	4.9%	35,981	27,540	76.5%	9,739	47,702
Iberia	Apr-Jun 02	1,245	1,134	98	76	7.9%	6.1%	14,004	10,105	72.2%	6,726	
	Jul-Sep 02	1,229	1,103	132	104	10.7%	8.5%	14,535	11,419	78.6%	6,624	
	Oct-Dec 02	1,236	1,219	18	-17	1.5%	-1.4%	13,593	9,695	71.3%	5,689	25,544
	Year 2002	5,123	4,852	272	174	5.3%	3.4%	55,633	40,647	73.0%	24,956	25,963
	Jan-Mar 03	1,128	1,183	-55	-24	-4.9%	-2.1%	13,200	9,458	71.6%	5,717	
	Apr-Jun 03	1,348	1,265	83	60	6.2%	4.5%	13,516	9,982	73.8%	6,472	
	Jul-Sep 03	1,434	1,301	133	93	9.3%	6.5%	14,819	11,846	79.9%	7,073	
KLM	Year 2001/02	5,933	6,018	-85	-141	-1.4%	-2.4%	72,228	56,947	78.7%	15,949	33,265
	Jul-Sep 02	1,844	1,523	140	86	7.6%	4.7%	19,448	16,331	82.7%		34,931
	Oct-Dec 02	1,693	1,760	-68	-71	-4.0%	-4.2%	19,063	14,722	77.2%		34,850
	Jan-Mar 03	1,487	1,521	-272	-483	-18.3%	-32.5%	20,390	15,444	75.7%		34,497
	Year 2002/03	7,004	7,147	-144	-449	-2.1%	-6.4%	87,647	69,016	78.7%	23,437	34,666
	Apr-Jun 03	1,621	1,483	-76	-62	-4.7%	-3.8%	17,261	13,077	75.8%		33,448
	Jul-Sep 03	1,878	1,537	152	104	8.1%	5.5%	18,905	15,874	84.0%		32,853
Lufthansa	Year 2001	14,966	14,948	18	-530	0.1%	-3.5%	126,400	90,389	71.5%	45,710	87,975
	Jul-Sep 02	4,431	4,254	454	369	10.2%	8.3%	32,409	25,189	71.1%	12,067	90,704
	Oct-Dec 02							30,282	21,476	70.9%	10,886	
	Year 2002	17,791	16,122	1,669	751	9.4%	4.2%	119,877	88,570	73.9%	43,900	94,135
	Jan-Mar 03	4,242	4,588	-346	-411	-8.2%	-9.7%	29,251	20,618	70.5%	10,391	
	Apr-Jun 03	4,423	4,214	209	-39	4.7%	-0.9%	30,597	22,315	71.7%	10,758	
	Jul-Sep 03	4,923	4,783	140	-20	2.8%	-0.4%	32,895	24,882		12,020	
SAS	Year 2001	4,984	5,093	-109	-103	-2.2%	-2.1%	35,521	22,956	64.6%	23,060	22,656
	Jul-Sep 02	1,821	1,587	233	56	12.8%	3.1%	8,701	6,281	70.2%	5,586	21,896
	Oct-Dec 02	1,984	1,826	158	-34	8.0%	-1.7%	8,334	5,463	65.6%	5,155	
	Year 2002	7,430	7,024	78	-15	1.0%	-0.2%	34,626	23,621	68.2%	21,866	
	Jan-Mar 03	1,608	1,654	-224	-188	-13.9%	-11.7%	8,040	4,900	60.9%	4,477	30,373
	Apr-Jun 03	1,906	1,705	201	8	10.5%	0.4%	12,258	7,840	64.0%	5,128	
	Jul-Sep 03	1,941	1,715	131	91	6.7%	4.7%	12,254	8,668	69.2%	8,301	
Ryanair	Year 2000/01	442	338	104	95	23.5%	21.5%	6,657	4,656	69.9%	7,000	1,476
	Year 2001/02	642	474	168	155	26.2%	24.1%	10,295	7,251	81.0%	11,900	1,547
	Jul-Sep 02	272	149	123	113	45.2%	41.5%	3,138			4,300	1,676
	Oct-Dec 02	201	149	53	47	26.4%	23.4%			86.0%	3,930	1,761
	Year 2002/03	910	625	285	259	31.3%	28.5%			84.0%	15,740	1,900
	Apr-Jun 03	280	220	57	46	20.4%	16.4%			78.0%	5,100	2,135
	Jul-Sep 03	407	237	170	148	41.8%	36.4%				5,571	2,200
easyJet	Year 2000/01	513	455	58	54	11.3%	10.5%	7,003	5,903	83.0%	7,115	1,632
	Oct-Mar 02	285	279	6	1	2.1%	0.4%	4,266		84.2%	4,300	
	Year 2001/02	864	656	111	77	12.8%	8.9%	10,769	9,218	84.8%	11,350	3,100
	Oct-Mar 03	602	676	-74	-76	-12.3%	-12.6%	9,594	7,938	82.2%	9,347	
	Year 2002/03	1,553	1,472	81	54	5.2%	3.5%	21,024	17,735	84.1%	20,300	3,372

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

Aviation Strategy

Databases

		Group revenue US\$m	Group costs US\$m	Group op. profit US\$m	Group net profit US\$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
ANA	Apr-Sep 00	5,228	4,793	495	359	9.5%	6.9%	47,586	31,753	66.7%	24,958	
	Oct 00-Mar 01	5,376	5,186	190	-486	3.5%	-9.0%	46,278	29,168	63.0%	24,471	
	Year 2000/01	10,914	10,629	285	-137	2.6%	-1.3%	85,994	58,710	68.3%	43,700	14,303
	Apr-Sep 01	5,168	4,811	357	136	6.9%	2.6%	45,756	30,790	67.3%	25,876	
	Year 2001/02	9,714	9,529	185	-76	1.9%	-0.8%	87,908	57,904	64.7%	49,306	
	Apr-Sep 02	5,322	5,194	127	-69	2.4%	-1.3%	44,429	29,627	66.7%	25,341	
Cathay Pacific	Year 2000	4,431	3,752	679	642	15.3%	14.5%	61,909	47,153	76.2%	11,860	14,293
	Jan-Jun 01	2,031	1,898	133	170	6.5%	8.4%	32,419	23,309	71.9%	5,936	
	Year 2001	3,902	3,795	107	84	2.7%	2.2%	62,790	44,792	71.3%	11,270	15,391
	Jan-Jun 02	1,989	1,753	235	181	11.8%	9.1%	29,537		78.1%		14,300
	Year 2002	4,243	3,634	609	513	14.4%	12.1%	63,050		77.8%		14,600
	Jan-Jun 03	1,575	1,672	-97	-159	-6.2%	-10.1%	26,831		64.4%	4,019	14,800
JAL	Year 1999/00	14,442	14,039	403	177	2.8%	1.2%	119,971	88,479	70.2%	37,200	18,974
	Year 2000/01	13,740	13,106	634	331	4.6%	2.4%	129,435	95,264	73.6%	38,700	17,514
	Year 2001/02	9,607	9,741	-135	-286	-1.4%	-3.0%				37,183	
	Year 2002/03	17,387	17,298	88	97	0.5%	0.6%	145,944	99,190	68.0%	56,022	
Korean Air	Year 2000	4,916	4,896	20	-409	0.4%	-8.3%	55,824	40,606	72.7%	22,070	16,000
	Year 2001	4,309	4,468	-159	-448	-3.7%	-10.4%	55,802	38,452		21,638	
	Jan - Mar 02	1,113	1,060	54	23	4.9%	2.1%	13,409	9,799	73.1%	5,399	
Malaysian	Year 1999/00	2,148	2,120	28	-68	1.3%	-3.2%	48,158	34,930	71.3%	15,370	21,687
	Year 2000/01	2,357	2,178	179	-351	7.6%	-14.9%	52,329	39,142	74.8%	16,590	21,518
	Year 2001/02	2,228	2,518	-204	-220	-9.2%	-9.9%	52,595	34,709	66.0%	15,734	21,438
Qantas	Year 1999/00	5,710	5,162	548	324	9.6%	5.7%	85,033	64,149	75.4%	20,490	29,217
	Year 2000/01	5,473	5,099	374	223	6.8%	4.1%	92,943	70,540	75.9%	22,150	31,632
	Year 2001/02	6,133	5,785	348	232	5.7%	3.8%	95,944	75,134	78.3%	27,128	33,044
	Year 2002/03	7,588	7,217	335	231	4.4%	3.0%	99,509	77,225	77.6%	28,884	34,872
Singapore	Year 2000/01	5,729	4,954	775	892	13.5%	15.6%	92,648	71,118	76.8%	15,000	
	Oct 01-Mar 02	2,807	2,508	299		10.7%		46,501	33,904			
	Year 2001/02	5,399	4,837	562	395	10.4%	7.3%	94,559	69,995	74.0%	14,765	29,422
	Apr 02-Sep 02	2,278	2,134	144	289	6.3%	12.7%	49,196	37,799	76.8%	7,775	
	Year 2002/03	5,936	5,531	405	601	6.8%	10.1%	99,566	74,183	74.5%	15,326	30,243

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

AIRCRAFT AVAILABLE FOR SALE OR LEASE

	Old narrowbodies	Old widebodies	Total old	New narrowbodies	New widebodies	Total new	Total
1998	187	125	312	67	55	122	434
1999	243	134	377	101	53	154	531
2000	302	172	474	160	42	202	676
2001	368	188	556	291	101	392	948
2002	366	144	510	273	102	375	885
2003 - Aug	317	137	454	316	131	447	901

AIRCRAFT SOLD OR LEASED

	Old narrowbodies	Old widebodies	Total old	New narrowbodies	New widebodies	Total new	Total
1998	482	243	725	795	127	922	1,647
1999	582	230	812	989	170	1,159	1,971
2000	475	205	680	895	223	1,118	1,798
2001	286	142	428	1,055	198	1,253	1,681
2002	439	213	652	1,205	246	1,451	2,103
2003 - Aug	25	11	36	55	12	67	103

Source: BACK Notes: As at end year; Old narrowbodies = 707, DC8, DC9, 727, 737-100/200, F28, BAC 1-11, Caravelle; Old widebodies = L1011, DC10, 747-100/200, A300B4; New narrowbodies = 737-300+, 757. A320 types, BAe 146, F100, RJ; New widebodies = 747-300+, 767, 777. A600, A310, A330, A340.

EUROPEAN SCHEDULED TRAFFIC

	Intra-Europe			North Atlantic			Europe-Far East			Total long-haul			Total Int'l		
	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 %
1995	154.8	94.9	61.3	154.1	117.6	76.3	111.1	81.1	73	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
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
Sept 03	18.5	13.1	70.9	19.4	15.6	80.6	11.4	9.5	83.6	42.9	34.7	81.1	64.5	50.1	77.7
Ann. chng	2.3%	1.4%	-0.6	7.1%	4.6%	-1.9	0.5%	-1.4%	-1.5	4.0%	2.1%	-1.6	3.6%	2.1%	-1.1
Jan-Sept 03	159.1	104.2	65.5	163.0	129.8	79.6	97.0	73.2	75.6	372.8	291.0	78.3	556.5	412.6	74.2
Ann. Chng	1.6%	0.4%	-0.8	5.5%	3.8%	-1.3	-3.4%	-10.1%	-5.7	-0.1%	2.0%	-1.7	0.0%	1.8%	-1.4

Source: AEA

US MAJORS' SCHEDULED TRAFFIC

	Domestic			North Atlantic			Pacific			Latin America			Total Int'l		
	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 %
1995	900.4	591.4	65.7	130.4	98.5	0.8	114.3	83.7	73.2	62.1	39.1	63.0	306.7	221.3	72.1
1996	925.7	634.4	68.5	132.6	101.9	76.8	118.0	89.2	75.6	66.1	42.3	64.0	316.7	233.3	73.7
1997	953.3	663.7	69.6	138.1	108.9	78.9	122.0	91.2	74.7	71.3	46.4	65.1	331.2	246.5	74.4
1998	960.8	678.8	70.7	150.5	117.8	78.3	112.7	82.5	73.2	83.5	52.4	62.8	346.7	252.7	72.9
1999	1,007.3	707.5	70.2	164.2	128.2	78.1	113.2	84.7	74.8	81.3	54.3	66.8	358.7	267.2	74.5
2000	1,033.5	740.1	71.6	178.9	141.4	79.0	127.7	97.7	76.5	83.0	57.6	69.4	380.9	289.9	76.1
2001	1,025.4	712.2	69.5	173.7	128.8	74.2	120.1	88.0	73.3	83.4	56.9	68.2	377.2	273.7	72.6
2002	990.0	701.6	70.9	159.0	125.7	67.2	103.0	83.0	80.5	84.1	56.8	67.5	346.1	265.5	76.7
Oct - 03	81.7	58.6	71.8	13.4	10.6	79.1	8.2	6.8	83.1	6.5	4.2	64.0	28.1	21.6	76.7
Ann. chng	-2.5%	2.6%	3.5	-6.4%	-2.9%	2.9	-9.1%	-3.3%	5.0	-1.9%	3.9%	3.6	-6.2%	-1.8%	3.5
Jan-Oct 03	802.4	591.2	73.7	124.6	98.6	79.1	78.6	60.5	77.1	69.2	48.7	70.4	272.4	207.8	76.3
Ann. chng	-3.3%	0.4%	2.7	-7.3%	-8.2%	-0.8	-8.1%	-12.9%	-4.2	-0.5%	3.8%	2.9	-5.9%	-7.2%	-1.0

Note: US Majors = Aloha, Alaska, American, Am. West, American Transair, Continental, Cont. Micronesia, Delta, Hawaiian JetBlue, MidWest Express, Northwest, Southwest, United and US Airways Source: ATA

JET ORDERS

	Date	Buyer	Order	Price	Delivery	Other information/engines
Boeing	12 Nov	Air China	5 737-700s		2005-06	Order placed by CASC
		Hainan Airlines	8 737-800s		"	"
		Shandong Airlines	3 737-700s, 4 737-800s		"	"
		Shenzhen Airlines	5 737-900s		"	"
		Xiamen Airlines	5 737-700s		"	"
Airbus	9 Dec	Qatar Airways	2 A380s 2 A340-600s		2009 2006	plus 2 options plus 8 options/Trent 500
	28 Nov	Sichuan Airlines	4 A319s		2004-05	IAE V2500
	26 Nov	Aer Lingus	7 A320s		2004-05	CFM 56-5
Embraer	8 Dec	Aerolitoral	5 ERJ145 LRs			plus 25 options (Aeromexico subsidiary)

Note: Prices in US\$. Only firm orders from identifiable airlines/lessors are included. Source: Manufacturers

ICAO WORLD TRAFFIC AND ESG FORECAST

	Domestic			International			Total			Domestic growth rate		International growth rate		Total growth rate	
	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK %	RPK %	ASK %	RPK %	ASK %	RPK %
1993	1,349	855	63.3	1,785	1,205	67.5	3,135	2,060	65.7	3.4	2.0	4.4	4.8	3.9	3.6
1994	1,410	922	65.3	1,909	1,320	69.1	3,318	2,240	67.5	4.6	7.9	6.9	9.4	5.9	8.8
1995	1,468	970	66.1	2,070	1,444	69.8	3,537	2,414	68.3	4.1	5.4	8.5	9.4	6.6	7.8
1996	1,540	1,043	67.7	2,211	1,559	70.5	3,751	2,602	79.4	4.9	7.4	6.8	8.0	6.0	7.8
1997	1,584	1,089	68.8	2,346	1,672	71.3	3,930	2,763	70.3	2.9	4.5	6.1	7.2	4.8	6.1
1998	1,638	1,147	70.0	2,428	1,709	70.4	4,067	2,856	70.3	3.4	5.2	3.5	2.2	3.4	3.4
1999	1,911	1,297	67.9	2,600	1,858	71.5	4,512	3,157	70.0	5.4	5.0	5.7	7.4	5.6	6.4
2000	2,005	1,392	69.4	2,745	1,969	71.8	4,750	3,390	70.8	4.9	7.2	5.6	6.0	5.3	6.5
*2001							4,698	3,262	69.4					-1.1	-3.9
*2002							4,607	3,294	71.1					-1.9	0.4
*2003							4,903	3,584	73.1					6.4	9.4
*2004							5,154	3,819	74.1					5.1	6.6

Note: * = Forecast; ICAO traffic includes charters. Source: Airline Monitor, June 2002

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