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Why hasn't the US industry undergone "creative destruction"?

The US industry remains in the midst of a structural battle between two sectors following vastly different business models. This competitive battle has been well understood by industry observers for many years (see *Aviation Strategy*, July/August 2002 for example) but few expected that there would still be no sign of an industry shakeout more than seven years after the battle began and, four years after the financial collapse of the Legacy/Big Hub sector (American, United, Delta, Northwest, Continental and USAirways have lost $27bn since 2000). Industries in the midst of structural change - the "creative destruction" of free markets - usually create profit opportunities for those driving the innovation and restructuring. The extended stalemate in US aviation has had the opposite effect - wiping out profits, growth prospects and access to capital for everyone.

In his article, Hubert Horan explores the causes of the current stalemate, the types of restructuring that could drive a shakeout to restore a more stable equilibrium, and the major factors blocking needed reform.

Disequilibrium: structural LCC-Legacy battles

Ten years ago, the Low Cost/Quasi-Network sector operated 7% of industry capacity, heavily concentrated in short-haul market niches (such as intra-California/Texas) and did not directly compete with any of the large Legacy hubs. Today's structural battle began in the late 90s when the Legacy carriers bloated both their fare and cost structures allowing the LCCs to rapidly expand into the core of traditional Legacy markets. Now the LCCs operate more than a quarter of all domestic capacity, and compete with the Legacy business model from coast to coast. The six Legacy mainline carriers have not only lost share to the LCCs, but have also been steadily shifting operations to the smaller aircraft of their regional partners. There is no hope of sustainable industry profits until the market share battle between the two sectors has been played out, and a new competitive balance emerges.

The underlying economics of the Legacy/Big Hub business model suggest it could have profitably captured the dominant share of US traffic. The vast majority of O&D markets are small,

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and the Big Hub business model is expressly designed to serve a diverse range of low-volume flows. However, the Legacy carriers extended the Hub model well beyond the markets where it had clear advantage, attempting to provide nearly universal coverage of all US-based O&Ds, large and small, hub and non-hub. The Low Cost/Quasi-Network model deliberately avoided both ubiquitous networks and the costs and complexity of large connecting hubs, in order to serve the largest O&D markets at the lowest possible cost. The structural battle, and today's unprofitable disequilibrium will be resolved when the Legacy sector restructures around sustainable capacity levels in the markets where they have competitive advantage.

The underlying strengths of the Legacy/Big Hub model have been badly damaged by the $27bn in losses, and the related damage to balance sheets and brand reputations. One internal Legacy carrier analysis from the early 90s found that if LCCs (then serving 3% of national demand) expanded to serve all markets where they had an inherent competitive advantage, they could grow to perhaps 20% of the industry, with the inherent advantages of the Big Hubs allowing them to profitably serve the other 80%. Had the Legacy group fully reformed costs and network approaches several years ago, it might have profitably retained 65-70% of the market. Without rapid cost and network restructuring, the profitable Legacy share of a post-shakeout industry could easily fall below 50%. None of the six Legacy carriers are viable going concerns if the current stalemate continues indefinitely.

Comparisons between industries are always imperfect, but there are many analogies between the US Legacy airlines and other industries where old-line companies survived but permanently lost share to newer business models: e.g. the business model of the large retailers (Sears, Macy's) focused on serving all possible market segments, rather than maximising efficiency in any specific segment, and struggled to respond to new models (Wal-Mart, Target) that targeted narrower segments at much lower cost. In each case, the "legacy" companies remained in denial about the inevitable loss of market share, allowing the new competition to capture much more of the market that they might have otherwise.

Financial collapse of the entire Legacy sector

The Legacy sector's financial collapse resulted from the convergence of four factors:

• Massive over-expansion in the late 90s, when 750 mainline and 575 regional jets were added; any capacity growth was foolhardy given the inevitable loss of Legacy share, and few of the expensive new aircraft arrived before the dotcom economic boom had faded.

• Excessive focus on boosting short-term earnings, leading to astronomical increases in business fares, and a major breakdown of cost discipline as employees demanded permanent raises in line with the temporary growth in quarterly earnings and management compensation.

• Accelerated competition from LCCs anxious to exploit the growing Legacy cost and pricing disadvantage, and the breakdown of Legacy customer loyalty.

• Normal cyclical demand weakness after the dotcom boom ended in 1999/2000, exacerbated by the impact of the late 2001 terrorist attacks, and internet distribution channels that intensified the pace of normal price competition.

The Legacy cost and pricing structures of the mid-90s gave them a natural (but modest) advantage in serving many medium-sized markets (Cleveland-Phoenix, Boston-San Diego) via their hubs. These four factors destroyed that advantage, creating the opportunity for expanding LCCs to profitably capture a sizeable share of those flows. Legacy over-expansion cannibalised existing traffic, and added huge costs but very little new revenue. Fare increases (to cover the cost of expansion, and to boost quarterly earnings) allowed LCCs to easily capture the largest of these markets. The strong customer loyalty Legacy carriers had developed in the 80s and early 90s collapsed in the face of superior value offered by the LCCs and the weakening of frequent flyer and travel agency programmes by carriers focused on short-term cash preservation.

As traffic fell, Legacy carriers shifted more and more hub routes to 50-seat RJs, which required even higher fares in local markets and could not provide the large volumes of connecting revenue needed to cover high hub infrastructure costs. Continued LCC growth and the huge supply/demand imbalance ensured that low fares rapidly spread beyond the small number of traditional high-volume point-to-point markets, undermining hub pricing nationwide, and permanently reducing the Legacy revenue base.

The LCC growth crisis

The Low Cost/Quasi-Network group operated just under 900 jet aircraft at the end of 2003, and anticipating strong, profitable growth, had 488 aircraft on firm order (equivalent to 55% of their current fleet) and options for several hundred more. Most of this growth assumed steady ongoing share shift from the Legacy carriers - markets they expected the Legacy group to lose because of either natural disadvantage or financial mismanagement. These plans have been frustrated as that hopelessly unprofitable capacity shows no sign of exiting the market. LCC profits will collapse if they cannot use their new aircraft profitably, and the added capacity drives industry-wide fares down to even less economic levels.

Atlantic Coast Airlines (rebranded as Independence Air) targeted United's unprofitable Washington Dulles hub as a market that would never be viable as a Legacy operation, and that they thought they could successfully serve under an LCC model. While there were a number of problems with Atlantic Coast's strategy (including excessive reliance on 50-seat aircraft), United has not only refused to withdraw its unprofitable capacity, but actually increased capacity (acknowledged in Court documents to also be unprofitable) in an attempt to weaken Atlantic Coast's new service. While it is normal and proper for airlines to respond to competitive attack, there is no evidence that United could ever operate a sustainably profitable hub at Dulles in an LCC-dominated industry, and United's short-term response while under bankruptcy protection hardly reflects normal marketplace competition.

Whatever the outcome at Dulles, these 488 aircraft could become a major financial drain for the LCCs if the Legacy sector continues to lose billions on its current hubs and capacity. Expansion capital, which LCCs had ready access to in 2003, is no longer available, and all plans for new entrants (such as Virgin America) have been moved to the back burner. Even the LCCs that are best positioned for any eventual industry shakeout such as Southwest, have seen their share prices punished by investors who see poor (and excessively volatile) short-term yield and growth prospects.

Legacy restructuring needs

The return of stable industry profitability will require major new progress in at least the following five areas:

• Further large cuts in Legacy capacity serving high volume connect markets, (especially at the weakest hubs) where far too much expensive hub infrastructure is chasing very low yield traffic, and in non-hub (point-to-point) markets that are most vulnerable to oversupply and uneconomic pricing

• A much more rigorous segregation between operations and network strategies in LCC/Quasi-network markets, traditional high-demand hub markets (potentially exposed to LCC pricing), and very low-volume "regional" markets that will never be exposed to LCC pricing. No carrier has yet demonstrated an ability to compete successfully in all three sectors, and mixed approaches tend to reduce competitiveness in each. The desire to be all things to all people usually reflects much greater concern for market share than for profits.

• Network (pricing/capacity) models must be completely restructured around more realistic, longer-term views of competitive supply/demand/pricing dynamics and the mature aggregate industry revenue base, and around simpler and more stable approaches that can consistently provide a standard of value that customers can appreciate and rely on. Carriers must abandon models where exogenous economic factors justify capacity and revenue growth. Carriers must abandon traditional approaches designed to aggressively exploit "market power" or short term market fluctuations.

• Further large cuts in overly complex operational and marketing systems, usually supporting connecting traffic or small traffic niches where the marginal revenue is more than offset by the marginal costs.

• More aggressive movement to the routes, capacity levels and pricing approaches that are clearly sustainable over the longer term in a post-shakeout environment, that can generate returns sufficient to cover higher fuel prices, and the ongoing replacement of fleet, computer systems and other capital.

In simplest terms, costs must be reduced, most importantly in areas where they do not add value that customers are willing to pay for. Capacity must be carefully aligned with the Legacy sector's future revenue base and must be eliminated from markets where its costs are uncompetitive. Changes of this nature would raise industry revenues by eliminating the pricing pressure created by excess capacity and carriers focusing on short term cash. It would eventually stabilise the LCC-Legacy market share battle, as Legacy carriers demonstrate sustainable profits at reasonable profits in their natural markets. The industry would regain access to capital once market stability allowed carriers to plausibly plan on returns from sensible investments.

Clinging to 80s/90s Legacy strategies

Each of these issues have been widely recognised, but no Legacy carrier has made substantive progress in more than one or two areas, and most have clung desperately to the competitive thinking developed ten to twenty years ago. Some carriers recognised the longer-term need for change, but kept high fares and excess capacity in place to protect short-term cash. This simply created unrealistic employee expectations about the level of jobs that could be sustained, and like US Airways at Philadelphia, made it easier for new competition to attack and cause much more lasting damage.

After inflation, the Legacy passenger revenue base fell 22% between 1997 and 2003 while ASMs fell only 9%. Given billions in ongoing losses and the inevitable further expansion of LCC competition and pricing, the sustainable revenue base is obviously a much lower level. Instead of shrinking capacity to sustainable levels, the Legacy carriers actually added 6% capacity in 2004. Most recent Legacy cuts occurred as a reaction to either a serious liquidity squeeze, or bankruptcy-process driven lease terminations, rather than any serious attempt to optimise long-term capacity. Rather than fixing the mistakes of the past, many Legacy carriers continue to play a dangerous game of "chicken", making as few painful changes as possible, hoping that someone else liquidates first.

The Legacy carriers operated 24 large hubs throughout the 1990s. Only two small hubs have been completely abandoned (see table, opposite), although several others have been transferred to the regional partner. However it is possible that as few as seven hubs are sustainable in the long-term, with the hubs at the largest cities (ORD, ATL, DFW) and the least vulnerable to LCC competition (EWR, MSP) among the most likely survivors. It is unclear how hubs based predominately on high cost 50-seat aircraft can survive at any large scale, especially in markets like PIT, CLE, CVG IAD or STL that are heavily exposed to very low prices. Some level of regional service will undoubtedly continue in those markets, but it cannot support any significant volume of connecting traffic, and would provide very little synergy with hubs in other cities.

Northwest and Continental have rigorously avoided LCC-type operations and markets, following strategies established in the early 90s.The other Legacy carriers continue to operate a somewhat muddled mixture of hub and point-to-point routes, and continue to experiment with "airlines-within-the airline" (Delta's Song, United's Ted) that attempt to mimic LCC practices. The net result has been scheduling and pricing practices that are confusing for customers and do not make money in either type of market. Most of this appears driven by the desire for ubiquitous national networks, and the desire to serve every category of airline traffic that became common in the late 80s when LCC competition was insignificant and the Legacy carriers had a 97% market share.

Delta recently introduced a much lower and simpler pricing system (see SimpliFares analysis, this issue), the only major Legacy attempt to move to the type of approach that will likely emerge in a "post-shakeout" industry environment (Alaska and America West converted to this approach some time ago). However pricing approaches can only succeed when carefully aligned with all other elements of network strategy. Delta's network remains a mish-mash of ultra-competitive point-to-point markets (Transcon, Northeast-Florida), a classic Big Hub (Atlanta) and high-cost regional operations (Cincinnati, Salt Lake City). There is no obvious link between Delta's network and its new pricing approaches, and it is unclear how any single pricing approach could serve the needs of the different types of routes it operates. Northwest and Delta publicly argued over the initiative, illustrating two different perspectives on Legacy competitive incoherence. Northwest has carefully managed its network to minimise LCC price competition, and argues that its traditional (high-fare) pricing approach (which Delta is undermining) is the best way to maximise revenue. Thus Northwest has sensibly aligned its network and pricing approaches, but may have been unrealistic about its ability to sustain the high fare environment its network needs. Delta understands the need to deal with the future of airline pricing but doesn't seem to have figured out how its 300 high-cost regional aircraft can make money in that environment.

Excessive Legacy focus on cost cuts

Carriers have made multiple rounds of large labour cuts since 2002. Large cost cuts are a necessary part of any eventual restructuring but have clearly been inadequate. They failed because carriers have been focusing narrowly on the labour cost of operating their late-90s network strategies, without addressing the shortcomings in those strategies, including the industry-wide oversupply they create. Labour cuts alone are also not sufficient to address the full magnitude of the Legacy late-90s cost bubble, when a 22% CASM increase added nearly $10bn of annual costs with little offsetting benefit. While new union contracts were a huge factor, there were also many aircraft, facility, financial and other new obligations that are even more difficult to reverse.

Legacy unit labour costs fell 7% in the first six months of 2004, driven by 11% declines at United and American. When financial performance continued to deteriorate, United and US Airways triggered another round of labour cuts by filing petitions with their respective Bankruptcy Courts, asking them to impose the lowest wages in the industry on their workforce*. The other Legacy carriers initiated their own efforts to negotiate further cuts. Vaughn Cordle of Airline Forecasts, who has become one of the leading analysts of industry financial trends, estimated the annual wage cost for a senior narrowbody Captain (see table, page 6), assuming the proposed Legacy cuts are fully implemented. After decades where Legacy workers enjoyed a huge wage premium, United and US Airways would become the low-wage airlines, while

THE FATE OF THE HUBS

	Surviving Hubs	Possible Survivors	Very Marginal	Closed
DL	ATL		CVG, JFK*, SLC	DFW, MCO
AA	ORD, DFW, MIA*		STL	
UA		ORD, DEN	SFO*, IAD, LAX	
NW	DTW, MSP		MEM	
CO	IAH, EWR		CLE	
US		PHL, CLT	PIT	

Note: * = only viable as international gateway - not competitive as a domestic hub

Note: * = Petitions were filed under Section 1113 of the US Bankruptcy code, which allows distress termination of collective bargaining agreements under certain conditions, Section 1114, which governs cuts in retiree benefits, and under the Employee Retirement Income Security Act (ERISA) which governs distress termination of pension programmes.

ANNUAL WAGES FOR A 12th YEAR NARROWBODY CAPTAIN

1	Alaska	$184,392	128%
2	Southwest	$170,352	118%
3	Northwest	$168,480	117%
4	Continental	$167,544	116%
5	Delta	$161,928	112%
6	Frontier	$146,952	102%
7	American	$146,016	101%
8	AirTran	$143,208	99%
9	Hawaiian	$138,528	96%
10	Aloha	$136,656	95%
11	ATA	$135,720	94%
12	Midwest	$134,784	93%
13	jetBlue	$130,104	90%
14	America West	$129,168	90%
15	Independence	$123,552	86%
16	United	$117,000	81%
17	US Airways	$117,000	81%
	Average	**$144,199**	**100%**

Note: table assumes an average of 78 hours per month
Source: Airline Forecasts
Contact: vaughn@airlineforecasts.com

Southwest pilots would be nearly the highest paid in the industry. Yet Southwest remains profitable, with significant long-term growth potential, while there is no clear evidence of anyone willing to finance United's or USAirways' emergence from Bankruptcy.

The larger problem is illustrated by the next table (opposite) which compares actual labour and overall unit costs for the year ending 2Q2004 with and without the unit costs the Legacy carriers might achieve if they operated that level of capacity at the lower wage rates they are currently pursuing.

While the current round of Legacy labour cuts, if fully implemented, would reduce unit labour costs by 18%, overall unit costs would only fall 6%. Even if UA and US achieve the lowest wages in the industry (and with all Legacy carriers paying less than Southwest), overall costs would still be 25-30% higher than Southwest and the LCC sector as a whole. Legacy and LCC costs are beginning to converge but there is still a sizeable gap. Wage cuts alone are simply not enough to make the Legacy carriers competitive.

Paralysis because the whole sector is bankrupt

In past airline crises, and in most analogous cases of business model battles in other industries (retailing, freight railroads) there was always a split between companies that suffered, but remained relatively strong and well-run (Dayton-Hudson, Union Pacific) and competitors on the verge of collapse (Montgomery Ward, Penn Central). Having a core of strong survivors accelerated the process of reallocating industry assets from weaker to stronger uses, and replacing failed management practices with better ones. Better run companies can acquire worthwhile assets at a discount, and immediately make them much more productive. Companies can spur financial recovery by copying practices and hiring managers from the better companies.

Following the early 90s airline downturn, major network assets that were struggling at Eastern, TWA and Pan Am, flourished after being acquired by United and American. Northwest and Continental became much more profitable after a major influx of new, outside management talent. But today there are no strong companies in the sector capable of financing assets shifts, or sharing profitable practices. LCCs have money and capable managers, but have no use for any Legacy assets, and LCC practices cannot be readily transferred to Legacy networks.

Legacy carriers desperately need, but cannot afford the major management shake-ups that NW and CO achieved ten years ago. Legacy management cultures remain dominated by the same thinking (and, with the exception of US Airways, by many of the same individuals) that destroyed Legacy competitiveness in the late 90s. Despite $27bn in losses, Legacy sector management seems far more focused on self-preservation than on the changes needed to restore profitability.

No profitable opportunity for outside investors

The early 90s US airline recovery was driven by outside investors attempting to profit from the restructuring process. While the magnitude of new equity investment in the early 90s was not very large, without outside money (such as from KLM, Texas Pacific and Air Canada) driving the process, the industry might have taken many more years to recover from the 90-92 downturn.

The returns needed to justify major turnaround investments normally comes from either the potential for dramatic near-term equity appreciation or from a merger/consolidation opportunity that management could not exploit on its own (in the 1993 Northwest case, KLM's small added equity investment led to the first (and most profitable) immunised transatlantic alliance, and to an option to acquire controlling ownership).

Today, new investors not only face a huge challenge figuring out how to rapidly improve the airline's financial performance, but also face an environment where equity appreciation is more difficult, and they must also overcome serious obstacles to establishing control over management and the new capital structure. None of the current Legacy Board/management groups have developed plausible plans and most appear actively hostile to any steps that would threaten their full control (for example, Delta and American's fierce resistance to Chapter 11 filings).

Investor returns will be limited by the magnitude of unpayable Legacy obligations; creditors will demand as much equity and future cash flow as possible. And years of disastrous losses have seriously weakened the potential for near-term equity appreciation. Airline stocks continue to provide a speculative vehicle for day traders, but broad-based investor interest is gone, and without that interest it would be much more difficult to realise the type of rapid equity appreciation achieved at NW and CO in the 90s. Broad-base investor interest would return if the industry went through the restructuring and shakeout it needs, and demonstrated several years of improved performance. This equity appreciation problem would significantly increase the (already huge) risks any new airline investor would face.

Mergers and consolidations hold even less prospect for potential investors. The models and theories that were used to justify consolidations in the 90s have been fully discredited. There are no cost or marketing synergies in any hypothetical intra-Legacy merger that would justify transaction costs, much less an acquisition premium. There continue to be occasional reports of consolidation talks between Delta, Northwest, and Continental but, aside from the payoffs individual managers and investment bankers might pocket, there is no reason to think consolidation would create any broader economic value. Remember that United pursued a $60 per share acquisition of US Airways until 2002, a transaction that would have made millions for a few individuals but would have completely destroyed both companies.

LEGACY LABOUR AND OVERALL UNIT COSTS

YE 2Q 2004	Labour CASM	index-HP	Total CASM	index-HP
Legacy actual avg.	3.99	165	11.10	135
Legacy with cuts	3.29	126	10.41	127
WN	3.32	137	8.50	103
LCC (avg.)	3.01	124	8.58	104
FL	2.44	101	9.03	109
HP	2.44	100	8.22	100
B6	2.04	84	7.01	85

Source: GCW analysis based on DoT Form 41 data (year ending June 2004), Bankruptcy court documents describing proposed US Airways and United labour cost proposals and press releases describing the cost cutting programmes of other Legacy carriers.

Chapter 11 process can't cope

The US Chapter 11 bankruptcy laws are designed to keep as many assets profitably employed as possible, and to maximise financial recovery for the creditors whose contracts have been broken. It deliberately protects interim operations, since a company that can be profitably restructured will almost always provide greater returns for creditors than liquidation. The laws are not designed to protect employment or optimise industry conditions, and cannot be criticised merely because competitors find the process slow or the results inconvenient. The law relies on concrete reorganisation plans, and the self-interest of competing stakeholders to force the process to the best possible outcome for creditors in a reasonably timely manner.

Unfortunately, the current Chapter 11 process appears to be failing its primary missions of protecting creditors and maximising the base of assets that can be returned to profitable operations. Neither US Airways nor United have plausible turnaround plans or financing. Absent financeable plans, the two Courts lack the normal basis for deciding whether creditors will receive adequate compensation in aggregate, or whether each class of creditors will be treated fairly under the law. If nobody puts forward a reorganisation plan, and the airline's cash generation can cover its out-of-pocket costs, then interim operations could continue for years. But if the airline remains fundamentally unprofitable, this results in a de-facto slow liquidation process - the worst possible result for creditors whose repayment depends on either capturing the value of liquidated assets, or future profits from a successful reorganisation. Slow liquidation involves "burning the furniture to heat the house"- destroying asset values and making an eventual turnaround much less likely.

If there are no outside investors, the peculiar creditor mix at large airlines can undermine the Chapter 11's ability to maximise total creditor returns. Key creditor groups (labour, management, certain suppliers), and bankruptcy lawyers and consultants have limited interest in protecting capital assets or long-term going-concern value, and a huge incentive to prolong the status-quo as long as possible, especially in cases like these where successful reorganisation would require deep, painful cuts. Certain creditors (such as aircraft lessors) may not wish to risk long-term marketing relationships by aggressively challenging the types of large airlines their business depends on.

These interests can hijack the Court process, run the airline on a short-term cash basis, and fund status-quo losses by eroding the value of other creditor assets. Unless an outside investor or creditor group is willing to file a competing, financeable plan, (tantamount to mounting a hostile takeover bid) there may be little the Court can do. The Continental, Northwest and America West recapitalisation processes in the 90s and this year's Hawaiian case were expeditious and successful as there were serious investor plans driving the process. But Eastern, TWA and Pan Am lacked investors, and many creditors suffered as the Court was unable to force either viable reorganisation plans or final liquidation while interim operations dragged on and on.

United has been under Bankruptcy Court protection for 26 months and would have presumably filed many months earlier had $2bn in taxpayer (ATSB) funding not been on offer throughout 2002. It is currently working on the sixth major iteration of its business plan. There has been no evidence of any serious new equity from investors using private sector criteria, and the ATSB found that two of the earlier versions of United's plan did not even meet more lenient public sector standards. Each plan version to date has kept the basic United network strategy of the 90s (hubs, fleet mix, pricing, ubiquitous national network coverage) and United's 2003 capacity levels completely intact. Profit recovery in each plan is primarily driven by enormous, rapid growth in unit revenue (including a return to dotcom era business fares) that are hard to comprehend given the industry changes of the last seven years.

United's bankruptcy professionals have charged over $132m to date, making it one of the most expensive cases in US bankruptcy history, with no end in sight. United's expert Court witness testifying to the causes of United's current financial difficulties did not cite any problems with its basic business model or competitive strategy, or any problems created by any past United management decisions. United management has aggressively fought to maintain full control. It attempted to contractually link union pay cuts to control by current management, and recently announced a preference for debt financing over new equity investors (who would require control). The Judge overseeing United's case did not approve the contractual pay cut/control link but has blocked all outsiders from offering any competing reorganisation proposals.

In contrast, US Airways moved aggressively at the outset of the bankruptcy process to cut capacity, replace previous management, actively communicate with their workforce about the painful changes the bankruptcy process would require, bring in new equity financing and to emerge from bankruptcy as quickly as possible. The process was arguably distorted by the availability of non-market (ATSB) financing in the immediate aftermath of the 2001 terrorist attacks, but this was not an inherent flaw in the bankruptcy process. While it can be argued that US Airways made more substantive changes in 2002/03 than the other five Legacy carriers put together, they unfortunately did not go far enough. Their plan did not come to grips with magnitude of the Legacy-LCC market shift, tried to protect the many unsustainable pockets of high-fare markets they still enjoyed, and failed to rethink their hubs and pricing in post-shakeout terms. They re-filed for Chapter 11 protection in September 2004, and have begun new rounds of capacity and cost cuts, but they do not appear to have anything resembling a plausible turnaround plan.

As noted earlier, both carriers asked their Courts to forcibly terminate all labour contracts and impose new long-term contracts with wages below those of most LCCs. While the current contracts at these two airlines are not sustainable, this raises serious legal issues, and the precedent could seriously distort the industry shakeout process. The new lower contracts would run for the rest of the decade, but have absolutely no link to an actual reorganisation plan with actual financing.

The legal requirement of a financeable plan is critical to ensuring the timely resolution of any Chapter 11 case - the company either develops a plan that can meet full creditor and Court scrutiny, or (if there is no hope of reorganisation) moves to liquidate. By periodically imposing permanent cost cuts despite the absence of a plan, the Court undermines the legal pressure for timely reorganisation, and encourages the case to drag on and on. It also endangers basic creditor rights. In this case it seriously undermines the ability of the employees (perhaps the largest creditor group) to negotiate terms under any final reorganisation plan (such as equity or other consideration for their concessions). Instead of focusing on the rights of creditors, the Courts appear to be giving higher priority to helping management sustain interim, status-quo operations. The two airline's requests for labour contract termination were based very narrowly on the argument that (a) other airlines have lower labour costs and (b) no one has offered to finance management's current plan at the old contract rates. There was no evidence that profits (or financing) would materialise under the new lower contract rates.

Since none of the normal Chapter 11 safeguards apply (concrete plans that creditors can review and challenge, opportunities for competing plans) there has been no Court review of the planning models used to justify the cost cuts. Instead of terminating a contract to support the best overall plan for all creditors (as the law allows), United and US Airways are using contract termination process to strengthen the interim position of certain creditor groups at the expense of others, while prolonging current management's ability to maintain control without having a financeable reorganisation plan.

This precedent creates the potential for every other Legacy carrier to file Chapter 11 and impose rock bottom wages on their work force. All they would need to demonstrate is the presence of competitors with lower wages, and the absence of investors anxious to finance management's preferred plan under the old, higher wages. If lower section 1113-driven wages allow the United/US Airways slow liquidation process to drag on longer, Delta, Northwest, American and Continental may have no choice but to follow suit, and the larger Legacy stalemate could remain in place for many years. All six carriers could be under Court protection, but with management still in full control and under little pressure to make the needed capacity cuts or painful changes in a timely manner.

Ending the stalemate

Hypothetically, independent action by each Legacy carrier could be sufficient to drive the needed shakeout. Rather than hanging on to weak capacity in the hope that competitors liquidate, each could unilaterally shut down weak hubs and other hopeless routes, restructure prices and continue to drive the current round of cost cutting. It would be possible for all current Legacy airlines to survive under this approach, but it is totally inconsistent with recent Legacy behaviour and it is unlikely to be embraced anytime soon.

The involuntary liquidation of US Airways in the second half of 2005 remains possible, but the latest round of Section 1113 labour cuts may provide enough of a cash cushion to sustain operations longer.

However, US Airways only operates 6% of industry capacity, most with a narrow geographic area, and its liquidation would not be sufficient to trigger an industry turnaround. While Southwest and others would backfill some of US Airways current Philadelphia operations, there would not be other opportunities for carriers to reallocate large blocks of unprofitable capacity to US Airways routes. Regional jets would rapidly fill US slots at La Guardia and Washington National, but this would not address the larger problems of high prices in the Northeast or excess RJ capacity nationwide.

In the longer term, the traditional US Airways, based on connecting hubs, has no hope of survival, and any hub-based plan will eventually fail. US Airways' only long-term hope would appear to be a much more radical restructuring, such as creating a short haul LCC based on its current slot portfolio at LGA, DCA, PHL and BOS, and its new LCC-level labour costs. All of current management's recent planning has been firmly based on 90s connecting hub approaches and it would probably require a strong outside investor to pursue this opportunity. A true Northeast LCC would primarily compete with high-fare, high-cost RJs, and would easily trigger major changes throughout the industry.

The United bankruptcy case will probably be the single biggest driver of industry conditions in the near-future. Involuntary liquidation of United (20% of industry capacity) appears highly unlikely at the moment, but if it occurred it would rapidly trigger several rounds of constructive changes. All of the other Legacy carriers would have the opportunity to move sizeable blocks of hopeless capacity to stronger positions (such as Tokyo, Heathrow and Chicago) as would certain LCCs (Dulles, Los Angeles). Excess capacity-driven pricing pressure would disappear overnight. Assuming United is not likely to self-destruct, this process could still be driven by outside investors willing to submit a breakup plan to the Bankruptcy Court. Industry consolidation only makes economic sense under this type of controlled liquidation approach, where carriers acquire a portion of a bankrupt carrier and shut down the rest.

Alternatively, an outside investor could also propose a plan keeping United intact, presumably with different managers and network thinking than United's current plan. However if United survives (as most assume is likely), 20% or so of other Legacy capacity would need to be liquidated before the needed industry shakeout can occur. A credible, well financed United plan would certainly force others to consider long overdue cuts in their own system, but the actual cuts might proceed very slowly.

Any plan that does not rapidly trigger a major shakeout would not offer investors rapid revenue and profit improvements, and as noted earlier, investors may not be able to count on the type of equity appreciation seen in past industry turnarounds. Any outside plan could force the Court to consider alternatives to the current slow liquidation process, and could eventually lead to a final resolution of the United case one way or another. However, any new investors will face the huge expense and risk of overcoming the resistance of the groups (including management, labour, and their large army of lawyers and consultants) benefiting from the status-quo.

Industry restructuring will only take place if airlines and/or outsiders with major financial resources propose major changes to today's unprofitable Legacy capacity and practices. Any such effort would face major obstacles, and might never justify the financial risk required. Unless outside force is brought to bear, the slow liquidation process at United could easily drag on, and other Legacy carriers (possibly all of them) could begin using Chapter 11 to sustain their status-quo and management control. The bankrupt Legacy carriers would steadily shrink, but there would be no industry recovery, and capital markets would remain totally alienated. If an extended stalemate keeps uneconomic capacity and practices alive, even the airlines with lower costs, motivated staff, smarter marketing, satisfied customers and other strong fundamentals would struggle to make money.

Boeing and Airbus - 2004 performance

Airbus maintained its lead position in terms of orders and deliveries ahead of Boeing in 2004. Its gross order total for the year was 370. With 12 recorded cancellations, the net order total for Airbus was 358. The largest single order of the year was for 60 of the A320 family (plus 40 options) from Air Berlin. 279 narrowbodies were ordered, representing 64% of the total market. Airbus delivered 320 aircraft, including 233 for the A320 family, which make up around 53% of deliveries of aircraft above 100 seats. The total firm orderbook for the A380 at year-end was 139 aircraft from 13 customers.

Boeing's net order total increased nearly 14% to 272 in 2004 from 239 in 2003, there were 285 deliveries in the year.

At year-end Boeing had logged 56 787s (formerly 7E7) as firm orders for three customers.

BOEING FIRM ORDERS 2004

	717	737	747	767	777	787	Total
Air Europa		5					5
Austrian Airlines		1					1
Blue Panorama						4	4
Cargolux Airlines			1				1
Hapag-Lloyd Flug		10					10
KLM					2		2
Turkish Airlines		15					15
European Total	**0**	**31**	**1**	**0**	**2**	**4**	**38**
AirTran	6	2					8
Aeromexico		8					8
Boeing Business Jet		4					4
Southwest		5					5
US Navy		5					5
WestJet		10					10
N.American Total	**6**	**34**	**0**	**0**	**0**	**0**	**40**
Copa Airlines		2					2
Gol Airlines		17					17
L. American Total	**0**	**19**	**0**	**0**	**0**	**0**	**19**
Air China		7					7
Air China Cargo			2				2
Air New Zealand					4	2	6
All Nippon Airways						50	50
Cathay Pacific					2		2
China Airlines			2				2
China Eastern Airlines		6					6
Korean Air			2				2
Nippon Cargo Airlines			3				3
Qantas		5					5
Singapore Airlines					18		18
Turkmenistan Airlines	2						2
Virgin Blue		2					2
Asian Total	**2**	**20**	**9**	**0**	**24**	**52**	**107**
Air Senegal Int'l		1					1
Emirates					4		4
Etihad Airways					5		5
Oman Air		1					1
Africa/M.East Total	**0**	**2**	**0**	**0**	**9**	**0**	**11**
Unidentified Total	**0**	**46**	**0**	**9**	**7**	**0**	**62**
Changes/cancellations							-5
Net Total	**8**	**147**	**10**	**9**	**42**	**56**	**272**

Source: Boeing and Airbus

AIRBUS FIRM ORDERS 2004

	A318	A319	A320	A321	A300	A330	A340	A380	Total
Air Berlin			60						**60**
Eurofly		1							**1**
Iberia							3		**3**
Lufthansa							7		**7**
Niki			10						**10**
Tarom	4								**4**
Turkish Airlines			19	12		5			**36**
European Total	**4**	**1**	**89**	**12**	**0**	**5**	**10**	**0**	**121**
America West Airlines		8	10						**18**
ILFC							3		**3**
Independence Air		11	5						**16**
JetBlue			30						**30**
Spirit Airlines		11		4					**15**
N.American Total	**0**	**30**	**45**	**4**	**0**	**0**	**3**	**0**	**82**
EVA Air						1			**1**
Govt. of Brazil		1							**1**
TACA		1	12	1					**14**
L. American Total	**0**	**2**	**12**	**1**	**0**	**1**	**0**	**0**	**16**
Air Deccan			2						**2**
Air China		6							**6**
Air Hong Kong					2				**2**
Air Tahiti Nui							1		**1**
Aust. Defence Force						5			**5**
Cathay Pacific						3			**3**
Chinese Eastern A/L						20			**20**
China Southern A/L		6	15						**21**
Cebu Pacific		12							**12**
Thai Airways							2	6	**8**
Vietnam Airlines				10					**10**
Qantas			11			1			**12**
Asian Total	**0**	**24**	**28**	**10**	**2**	**29**	**3**	**6**	**102**
Azerbajan Airlines		4							**4**
Emirates							2		**2**
Etihad Airways						12	8	4	**24**
Jazeera Airways			4						**4**
Qatar		1				4	2		**7**
Africa/M.East Total	**0**	**5**	**4**	**0**	**0**	**16**	**12**	**4**	**41**
Unidentified Total		**5**	**2**	**1**					**8**
Gross Total	**4**	**67**	**180**	**28**	**2**	**51**	**28**	**10**	**370**
Changes/cancellations									-12
Net Total									**358**

SimpliFares: a survival strategy for the US legacy carriers?

Delta's new domestic fare structure, called SimpliFares, has been hailed as a "pricing revolution" and "nothing short of a historic change in US travel" (*The Wall Street Journal*). Pundits have predicted that, after a severe revenue hit this year, the surviving legacy carriers will gain in the long run through traffic stimulation and recapture of market share from LCCs. But will the legacies have the cost structures to pull it off? Could they really outwit Southwest and JetBlue?

The SimpliFares programme is regarded as the most important pricing development in the US legacy carrier sector since American's value pricing in 1992. Under Bob Crandall's leadership, American tried to change industry pricing by introducing a simplified and reduced domestic fare structure. But the move triggered a fare war, causing heavy losses for all airlines, and the change had to be abandoned. That was before the LCC era. Southwest, the only sizable LCC, was largely unaffected by the move.

The post-September 11 environment has seen many limited attempts to introduce LCC-style fare structures. They have fallen broadly into two categories: fare reforms by niche-type carriers looking to increase market share, or experiments by the larger majors, aimed at keeping LCCs at bay at specific hubs.

In the best example of the niche-type value pricing, America West (AWA) reformed its fare structure in March 2002 in response to business travelers' demands. The airline introduced a simple, flexible pricing structure, with fares 40-70% lower than competitors' walk-up fares. The other major carriers matched the fares only selectively, which meant that the move paid off for AWA in terms of market share gain and revenue generation. AWA avoided a hostile response from competitors because of its small size and geographically limited network. The pricing formula worked well because, as a leisure-oriented carrier, it did not have significant business segment revenues to lose in the first place. Moreover, it had a low cost structure.

US Airways came up with "GoFares" - a low-fare structure very similar to SimpliFares (with fare caps at $499 and no Saturday night stay requirement) - in response to Southwest's entry to its Philadelphia hub in May 2004. There were predictions that the move could lead to industry-wide fare reform, but US Airways has not been able to implement it fully because of its high cost levels and poor reserves - it is in Chapter 11 and fighting to stay in business. Nevertheless, GoFares have been expanded and are now used by 25% of US Airways' domestic passengers, adding to the competitive frenzy on the East Coast.

The latest hub fare experiments have included Delta's SimpliFares project in Cincinnati (the precursor to the nationwide programme) and a similar project by American in Miami. Delta launched its experiment in August as part of its "transformation plan". American began testing a simplified lower fare structure at its large Miami hub in November, with the aim of luring back passengers who had begun driving to secondary airports served by LCCs.

The common theme with the large legacy airlines' value pricing experiments in the past was that they were revenue-negative. Traffic and load factors increased, but that was more than offset by a decline in yields. Because of the adverse impact on the bottom line, no airline could justify implementing the changes.

Delta's SimpliFares represent the first attempt by a large legacy carrier to "switch sides" to the LCC camp in terms of revenue strategy. Unlike AWA in 2002, Delta expects competitors to match the fares - and it does not expect any market share gain from the other legacy carriers.

Why now?

Fare cuts were the last thing that the US airline industry needed at a time when domestic unit revenues are extremely depressed and the industry is headed for its fifth year of steep losses. So why did Delta choose to do it now?

The move obviously reflected both industry changes and company-specific factors. As regards to the latter, Delta was encouraged by the results of the Cincinnati experiment - a 30% traffic boost and, evidently, not-too-disastrous financial losses.

The timing also reflected the fact that Delta is now in a stronger position to withstand a near-term revenue hit, after narrowly avoiding Chapter 11 in October and obtaining $1.1bn in additional funds under new credit facilities in December. Nevertheless, analysts remain concerned about its cash position - one remarked that Delta "does not have much room for error".

On the industry side, the key development is that, after a decade of growth, LCCs have gained critical mass, have become a credible alternative to business travelers and now control pricing in the domestic market. The legacy carriers, in turn, rely much less on high-yield traffic and continue to lose market share. As Delta's CEO Gerry Grinstein put it, "the industry has reached a tipping point".

Once-risky pricing moves are now much less risky or even deemed necessary. S&P's Philip Baggaley noted recently that "ultimately for Delta, the risks of adopting a simpler, lower fare structure have decreased, while the risks of not taking action have increased." In other words, the short-term revenue loss, while material, is much less than it would have been in the late 1990s and the legacies "now stand to lose more by keeping the old fare structures".

Calyon Securities analyst Ray Neidl expressed well the sentiment among analysts that the move was necessary: "Delta has imposed a badly needed change on the industry in the way it prices its product". Delta cited customer feedback calling for "simpler, more affordable everyday fares" as a key reason. It wanted to fulfill the request to improve the travel experience and "win back customer trust".

That may sound like a meaningless slogan, but "trust" is an important concept in the US, helping to explain why many business travelers have switched to LCCs and why Southwest and JetBlue can even charge slightly higher fares than competitors. Traditionally, the legacies have used complicated fare structures to squeeze revenues from business passengers. The differentials between full and discount fares grew so large that business travelers began voting with their feet in early 2001. That caused a domestic revenue slump even before September 11 and the subsequent economic downturn, which led to a further tightening of corporate travel cost control policies. The bottom line is that customers do not trust the legacies to give them good value for money.

How significant a change?

Delta's new fares, introduced in the contiguous 48 states from January 5, slashed walk-up fares by up to 50% and capped fares at $499 (one-way) in economy and $599 in first class. The largest fare reductions were in key business travel markets such as New York-Dallas, which previously had walk-up fares in the $1,000 range.

However, Delta's fare reductions were much smaller in markets where it already competed with LCCs - a significant 70% of its domestic routes. Also, the new fares remain higher than those offered by LCCs - both AirTran and Southwest issued statements saying that they would have to raise their fares to match Delta's.

As the *Wall Street Journal* noted, it was "a subtle but clear admission that most domestic first class isn't worth much more than $100". By comparison, AirTran charges $35-$75, depending on the length of the flight, to move passengers to the front cabin.

Delta's new fare structure is much simpler than the old one. There are now only six fare categories for economy and two for first class. Passengers can choose between refundable or non-refundable tickets and obtain further savings by booking three, seven or 14 days in advance.

Significantly, Delta has totally abolished the unpopular Saturday night stay requirement. However, a roundtrip purchase and one-night stay are still required on all other than walk-up fares. And the new fares are available only on delta.com or from travel agents - Delta has imposed $5 and $10 fees for telephone and ticket office bookings. Therefore the fare structure is not as simple as the offerings of LCCs.

Criticising the Delta fares for what it called "a litany of convoluted rules", AirTran pointed out that it does not "nickel and dime customers with junk fees based on how a customer makes a reservation". It remains to be seen if that matters to travelers. Delta is only following legacy sector practice with the new booking fees - part of a trend of "unbundling" airline service, namely separating food, reservations and suchlike from the ticket price.

Fare analyses will continue to show a large number of Delta fares available in a given market, because the new pricing structure does not apply to Delta-marketed codeshare flights or pro-rated flights that connect to international services. In addition, there are "sale fares" in response to competitors' fare sales - so much for simplification.

In addition to the fare reform, Delta has simplified its FFP and is redesigning its aircraft interiors (brighter, with leather seats). Later this year it will unveil improvements to delta.com, a new food product and new employee uniforms. At the end of January, it began dehubbing Dallas Fort Worth in favour of boosting service at its three main hubs.

Interestingly, despite the obvious attempt to move domestic mainline operations in the direction of Song, Delta is expanding, rather than merging with, its low-fare unit. Song will grow by one third in May, with the addition of 12 757s and new transcontinental and Caribbean services. Rather than causing confusion, Song has gained a strong identity separate from Delta's and is highly regarded by passengers. Delta regards it as "a successful test bed for new and innovative ideas".

The other legacy carriers were expected to fully match the fare structure in markets where they compete with Delta. Although it is too early to reach a final verdict, by late January two things had happened. First, the airlines had not matched the fare structure entirely in competitive markets - they typically left out hub markets and did not introduced fare caps. Second, American had broadly matched Delta's fare structure nationwide, including hubs, with modifications such as fare caps at slightly higher levels.

However, now that American has embraced the concept, it may only be a matter of time before everyone joins in. The latest reports from travel analysts indicate that business fares have declined sharply all around the country. A survey by Harrell Associates, quoted in the *Wall Street Journal*, found that business fares in the top 40 markets were down by one-third from a year ago.

Short-term pain, long-term gain?

Even though seats sold at full fares account for only a few percent of legacy carriers' total domestic seats these days, those tickets still account for a fair chunk of revenues. Consequently, the industry is bracing for a significant negative revenue impact in the next 6-12 months. Merrill Lynch's Michael Linenberg has estimated the potential 2005 industry revenue dilution at $2-3bn, or a 3-4% decline from 2004's $70bn.

The impact is likely to be felt throughout the legacy sector, depending on competitive overlap and the extent of LCC competition already present. Some analysts believe that Northwest could take the largest unit revenue hit this year because it has historically been less exposed to LCCs in its core markets.

Of course, the Delta-imposed fare changes are only one of a string of serious problems that the industry faces in 2005. In addition to the dismal revenue environment, the challenges include a severe capacity glut (particularly on the East Coast) and continued high fuel prices.

However, the good news for the airlines that make it through 2005 is that the negative effects of the fare changes are expected to diminish and revert to positive over time. The legacy carriers are counting on the following:

• Traffic stimulation

The simplified lower fares are expected to stimulate price-sensitive business travel demand, leading to more trips. Business travel is more inelastic than leisure travel, but perhaps because the fares were previously exorbitantly high, Delta has reported an enormous passenger response to the initiative.

• Market share improvement

Some price-sensitive travelers are expected to shift from connecting flights (typically operated by AWA and LCCs) to nonstop flights. Others will shift from secondary, less convenient airports (served by some LCCs) to primary airports. Some customers will return because of the FFPs and larger networks offered by the legacy airlines.

• Better traffic mix

There is potential to offset some of the yield decline resulting from the fare reductions through an increase in the business and full fare content of traffic. In addition to existing business passengers making more trips and new business customers pulled from LCCs, some existing discount fare travelers may upgrade to full fare to get the flexibility, now that the fare differential is relatively small.

• Productivity and efficiency benefits

The shift to web bookings will produce significant cost savings - Delta's aim is to move half of its customer transactions to its web site (currently

20%). Also, the new lower fares will reduce or even eliminate the need for group or corporate discount programmes, which are time-consuming and expensive to negotiate and administer. Delta apparently has 6,000 such programmes. However, the downside is that all of those corporate customers will be free to switch to LCCs if they so choose.

Implications for LCCs

In the short term, LCCs generally are not likely to experience revenue dilution as a result of the Delta-led fare cuts. They have not had to reduce their own fares and are unlikely to lose customers in the near term. As Southwest's CEO Gary Kelly noted in the company's fourth-quarter conference call, "so far it looks like a non-event".

The market share shifts that Delta and the other legacies are counting on would only affect the LCC sector in the longer run and in a gradual fashion. However, the consensus among analysts is that only certain types of LCCs are in danger of being severely affected.

The worst-positioned LCCs are those that depend heavily on connecting traffic that has been attracted by undercutting legacy carriers' nonstop fares - particularly AWA and ATA, but also AirTran. According to JP Morgan, AWA, ATA and AirTran generate 24%, 23% and 18% (respectively) of their revenues in connecting markets where non-stop alternatives are available. For Southwest and JetBlue, those percentages are only 4% and 3%.

UBS analyst Robert Ashcroft aptly described the at-risk airlines as "hybrid LCCs/secondary network carriers". He also pointed out the irony that AWA's early embrace of value pricing was instrumental in its turnaround three years ago, and now "it may be in danger of having those clothes stolen by bigger, more comprehensive primary networks." While AWA has only reported minimal impact so far, in late January it decided to withdraw from most transcontinental markets by the summer, in favour of developing more international services.

While AirTran is more of a true LCC, it is vulnerable also because of its extensive route overlap with Delta, as both have their main hubs at Atlanta, and a heavy East Coast presence. Analysts are concerned about its plans to grow ASMs by as much as 25% this year (19 aircraft deliveries). AirTran may have to come up with some new strategies, but it is worth bearing in mind that it has survived a constant barrage of extremely aggressive competitive moves from Delta over many years, with little adverse impact on its bottom line.

The consensus opinion is that Southwest and JetBlue will not feel much impact from the Delta-led pricing moves. They are really in a category of their own, in terms of financial strength, culture and efficiency. They have strong brands and enjoy a loyal following of customers. JetBlue also has a product that many view as superior to the legacies' offerings.

Another strength enjoyed by Southwest and JetBlue that may prove particularly important is that they dominate their key markets, just like the legacy carriers do. An analysis by UBS shows that Southwest accounts for over 70% of the total traffic in its top 100 markets, while JetBlue has a 55% share in its top 50 markets. Legacy carriers' shares are in the 45-63% range, but AWA's and AirTran's are only about 20%.

But the new pricing developments may force Southwest, in particular, to re-examine some of its strategies. First, relying on secondary airports may make less sense if fares decline at primary airports (though Southwest has pointed out that secondary airports do have some advantages - for example, they are easier to get to and have less congestion). Second, the traditional strategy of going for "overpriced and underserved" markets is at risk, because the legacies' fare cuts may have eliminated many overpriced markets.

Kelly indicated that Southwest did not really see any new threats here - that it was already mindful of the fact that, as time goes by, it will face more and more low-fare competition. In other words, it would have to adjust its strategies over time anyway.

Because of the reduction in overpriced market opportunity, some analysts are predicting that LCCs will see reduced profit margins and slower growth, potentially meaning aircraft order deferrals or cancellations. However, while such scenarios may materialise for the weakest companies, there are two further reasons why the LCC sector overall may not suffer. First, the legacy carriers may be too financially distressed to offer effective competition. Second, the strongest LCCs, led by Southwest, are likely to be the main beneficiaries of industry restructuring.

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The German emergents: Germanwings, HLX, Gexx and dba

Aviation Strategy looked at Air Berlin in its last issue (December 2004), and here we examine prospects for the other emergent airlines in Germany - Germanwings, Hapag-Lloyd Express, Germania Express and dba - against the background of a stagnant German economy and intense competition from Ryanair and easyJet.

Germanwings

Germanwings is a fully owned subsidiary of German charter airline Eurowings (49% of which is owned by Lufthansa) based at Cologne/Bonn airport. It was created from the A319 charter business of Eurowings in October 2002, and adopted a low fare, low cost business model from launch.

The airline soon became embroiled in a fare war with the other fledgling German LCCs, particularly Hapag-Lloyd Express - which is also based at Cologne/Bonn - and dba, which offered fares as low as €10 on the key Berlin Tegel-Cologne route. However, as an indirect subsidiary of Lufthansa, Germanwings has deeper pockets than most other LCCs, and though it operated at a loss though 2003 it kept expanding its route network.

Germanwings recorded turnover of €245m for 2004, 60% up on 2003, and the airline is aiming to reach €300m in revenue during 2005. The airline made a small operating profit in 2004 (estimated to be between €1m-€3m), but that is a solid achievement given the increasing competition in the LCC market as well as the rise in fuel prices last year. Increased fuel prices cost Germanwings the relatively small amount of €0.8m per month in 2004 as the airline managed to hedge 90% of its fuel costs during the year.

The airline also faced the challenge of potential industrial unrest last year when the pilots union - Vereinigung Cockpit (VC) - lobbied Lufthansa to include Germanwings pilots in the Lufthansa group pay agreement. In December Lufthansa agreed a pay freeze with pilots at the main airline until March 2006, in return for pension improvements and the inclusion of Germanwings' pilots into the collective Lufthansa deal, which in effect raises pay levels for the LCC staff. As with all of the German LCCs, there are question marks as to whether Germanwings is a true low cost airline in the mould of a Ryanair or easyJet. For example, Germanwings targets primary rather than secondary airports, which inevitably raises costs. On the other hand, a considerable amount of Germanwings' revenue comes through its web site; unlike some of its LCC rivals, Germanwings does not distribute via travel agents. The airline is also exploring other ways of low cost distribution, and now offers flight booking via mobile phones in partnership with T-Mobile.

Between 40% and 50% of Germanwings' passengers are business customers and the airline is keen to attract more, having corporate travel deals with more than 300 German companies. On the leisure side, as well as selling direct to the German public, Germanwings provides capacity to German tour operators such as Neckermann.

Germanwings operates a fleet of 14 A319 and A320 aircraft, 10 of which are based in Cologne/Bonn and four at Stuttgart. Lufthansa owns part of the fleet and some of these aircraft have to return to the German parent shortly, so Germanwings has to find replacements for these as well as for the planned substantial expansion of its route network in 2005.

Germanwings has recently leased nine former US Airways' A319s through GECAS. The new aircraft are needed for planned routes to Birmingham, Catania, Dubrovnik, Leipzig, Lyon, Moscow, St Petersburg and Toulouse. The target is to carry between 5m and 6m passengers in 2005, compared with 3.5m in 2004 (when load factor was 82%) and 2.4m in 2003. Germanwings currently serves 34 different destinations - 31 out of Cologne and 16 from Stuttgart.

Germanwings accounts for 30% of flights at Cologne/Bonn, making it the most important airline at the airport, and is second only to Lufthansa at Stuttgart, where it started operations in August 2003. Germanwings is making a big push to become the leading airline at Stuttgart and recently doubled its routes out of the airport through the addition of services to London Stansted, Madrid, Zagreb, Hamburg and Dresden as part of the 04/05 winter timetable. Germanwings plans to add another German hub this year. As Cologne/Bonn becomes more congested, Germanwings is looking at nearby Dusseldorf airport, where it has applied for slots. That would be a direct challenge to charter airline LTU, which is based at Dusseldorf, but - problematically from Germanwings' point of view - also for Cityline, a Lufthansa regional subsidiary.

The search for a third German hub is partly necessary because Germanwings is vulnerable to easyJet or Ryanair starting base operations at Cologne or Stuttgart. Publicly, Germanwings' management maintains an aggressive stance towards the encroachment of easyJet in Germany, and the airline says it will fight the UK LCCs "route by route". Indeed, when easyJet started a Cologne-London Gatwick service for £40 return, Germanwings reacted by cutting its fare on the route to £26. However, Germanwings' main strategy in dealing with the threat of the non-German LCCs is to avoid confrontation wherever possible. Germanwings has stayed away from easyJet's Berlin hub, stating that "they can keep Berlin …. there is not a good enough market there for a low cost airline". Germanwings argues that Berlin's catchment population of 6m shrinks to 1m when the income profile for the area is taken into account.

But Germanwings is also under attack closer to home, with continuing vigorous competition by German LCCs. Another key rival is the German railway company Deutsche Bahn, which in November 2004 offered 1.2m seats on German routes for a flat € 29 one-way fare.

Though the immediate priority for Germanwings is another German hub (along with Dusseldorf, likely candidates are Hamburg, Nuremberg or Munich), the airline is also looking at potential hubs outside of its home country. Zurich is one airport believed to be under consideration - although how Zurich's very high landing fees fit in with the LCC business model is hard to see. Eastern Europe is a more promising area, and Germanwings added Zagreb and Split to its route network in the summer of 2004. And Germanwings is keen to expand into the Polish market, which with a population of 40m already has LCC services to/from Germany through Air Berlin, easyJet and Wizz Air. In the summer of 2004 Germanwings operated from Cologne and Stuttgart to Warsaw and Krakow, and in October it added routes from Stuttgart to Gdansk and Lodz. According to Dr Joachim Klein, Germanwings' managing director: "Poland is definitely among the interesting places, and we would also like to form a closer co-operation with an existing airline in central and eastern Europe". In early 2004 Germanwings considered a potential partnership with LOT (like Lufthansa, a member of Star) , but has recently agreed a comprehensive sales and marketing arrangement with a LOT subsidiary, the LCC Centralwings. This agreement is aimed at developing a stronghold on low-fare traffic between Germany and Poland.

Germanwings is also considering a partnership with Snowflake, SAS's LCC. In Scandinavia, Germanwings launched routes to Oslo, Helsinki and Stockholm in 2004, and it is analysing other potential destinations in the region. In October 2004 Germanwings signed a sales and marketing agreement with UK LCC bmibaby, in which each airline will promote the other's routes. The move is linked to Star membership of both LCC's respective parent airlines (and Lufthansa's ownership of a 30% stake in bmibaby parent BMI British Midland), but Germanwings is likely to sign more deals with Star alliance members in 2005.

Thanks to the strength of its Lufthansa parent, Germanwings is one of the more secure German LCCs, and it is expected to grow substantially over the next few years. Longer-term, Eurowings also has plans to start mirror airlines in other countries. Germanwings has registered naming rights for the "wings" brand in various European counties, which would allow the launch of airlines called Austriawings or Polishwings, for example.

Hapag-Lloyd Express (HLX)

Hannover-based Hapag-Lloyd Express (also known as HLX) started operations in December 2002 using four aircraft wet-leased from Germania, after an investment of € 100m from parent company TUI, the German tour operator giant. Today HLX operates a fleet of three 737-500s and eight 737-700s to 24 destinations in nine European countries from Cologne-Bonn, Hannover, Stuttgart, Hamburg, Munich and Berlin-Tegel.

The 737-700s are operated for HLX under wet leases by Hapag-Lloyd and Germania, and HLX is planning to add another four aircraft for summer 2005, two of which may be F100s leased from Germania Express. In January 2005 TUI placed an order for 10 737-800s, worth € 494m and scheduled for delivery in 2006 and 2007, and some of these may be operated by HLX.

90% of HLX's bookings come via its website, and 35%-40% of HLX's passengers are business travellers, some of this coming through a contract with the German government (held jointly with dba) to carry government employees between Berlin and Bonn, the new and old capitals of Germany. HLX has also been innovative through a deal with Buchclub, a German book club owned by media giant Bertelsmann. The club has contracted a block of 28,000 seats from HLX, which Buchclub has been selling from its retail outlets since December 2004.

HLX depends heavily on tourist traffic to destinations such as Majorca and Olbia (Sardinia). The airline also carries substantial leisure traffic to the Italian market - six of the 16 international routes out of Cologne/Bonn and seven of the 15 from Hannover operate to Italy - and it is expanding its network there all the time: for example, a Cologne-London route has been dropped in favour of a service to Palermo.

HLX's main hubs are Cologne/Bonn, Hannover and Stuttgart. Cologne/Bonn was its first base, followed by Hannover Langenhagen from March 2003. Routes out of Stuttgart started in July 2003 with services to four Italian destinations making HLX the first German LCC to operate out of southern Germany. In association with Air Berlin and Germania Express, HLX fended off entry from easyJet into its hub at Hannover (see *Aviation Strategy*, December 2004), much to the irritation of the UK LCC, which said that the defence of the airport from other operators was detrimental to passengers. Like Germanwings, HLX has applied for slots at Dusseldorf airport, though this will not affect its long-term commitment to nearby Cologne/Bonn.

HLX, like Germanwings, has adopted a strategy of partnering with other LCCs across Europe, but unfortunately HLX uncannily manages to pick alliances with airlines that subsequently go under. In February 2004 HLX partnered with Italian LCC Volareweb, followed in June by an alliance with Air Polonia. Codesharing and marketing links between the airlines led to a so-called "three-way" alliance - an alliance that is pretty singular now that both Air Polonia and Volareweb have gone bankrupt (see *Aviation Strategy*, December 2004).

HLX reported a quarterly profit for the first time in July-September 2004, ahead of schedule according to its parent, TUI. However, as TUI now combines HLX's results with its other subsidiary, Thomsonfly, HLX's figures are not available. Combined, HLX and Thomsonfly recorded revenue of €64m in the third quarter of 2004, 64% up on 3Q 2003, with 1Q-3Q turnover for 2004 totalling €142m. The combined net profit for 3Q 2004 was €1m, compared with a €10m net loss in the third quarter of 2004. HLX alone achieved a turnover of approximately €100m in 2003. On its own, HLX is unlikely to record a profit for the full year 2004, though it expects to do so in 2005. HLX is likely to report 2.7m passengers carried in 2004, 38% up on 2003, and is apparently targeting a 40% increase, to 3.8m passengers, in 2005.

Despite this growth, there has been speculation over the long-term commitment of TUI to HLX, given the growing relationship between Air Berlin and Hapag-Lloyd (see *Aviation Strategy*, December 2004). The original intention of HLX was to help reduce costs at TUI and Hapag-Lloyd, with HLX taking over routes to destinations within a few hours' flying time of Germany. Indeed, in early 2004 HLX did take responsibility for some of Hapag-Lloyd's airlift to Palma de Mallorca, which served TUI's charter passengers. This was part of TUI's attempt to cut annual costs at Hapag-Lloyd by €70m in 2004, as well as longer-term plans for an IPO at Hapag-Lloyd, once all airline operations have been stripped away, leaving the subsidiary as a shipping-only business. Already a collective labour agreement enables TUI pilots to fly both HLX and Hapag-Lloyd aircraft, and as a next step TUI wants to standardise working conditions and salaries of pilots at both Hapag-Lloyd and HLX.

But doubt about the future of HLX as a separate brand was encouraged by TUI's announcement in September 2004 that from January 2005 HLX and the main Hapag-Lloyd airline would be integrated into TUI's "Central European division". At the same time HLX and Hapag-Lloyd's operations would become closer via joint route planning, marketing and use of IT - although TUI insists that each airline's distinctive branding will remain. This appears an attempt to bring Hapag-Lloyd's cost structure more in line with HLX's, although how low HLX's cost base is, is open to debate (particularly given Hapag Lloyd's apparent preference to ally itself with Air Berlin).

But, crucially, it was announced that HLX CEO Wolfgang Kurth would have to report "every month" to Wolfgang John, the CEO of Hapag-Lloyd who would be given responsibility for all TUI's airline businesses in Germany. Shortly after this reorganisation Kurth - who had been CEO since the launch of HLX - resigned, and was replaced by another HLX executive, Roland Keppler, in January.

The distinction between Hapag-Lloyd (which operates a fleet of 34 aircraft) and HLX is even smaller now that the former has started selling flights to all its European destinations from as little as €29. Approximately 25% of seat sold at Hapag-Lloyd are "low-fare" tickets, but TUI wants to increase this to 40% within the next three years. TUI claims that this will not have a negative effect on the business of the two airlines, but at the very least it's likely to sow confusion among German travellers.

HLX was one of the airlines rumoured to be interested in acquiring dba before it was sold by BA, but the agenda for HLX now appears to be as to whether or not it merges with Hapag-Lloyd's aviation assets, and if/when that happens, whether the HLX brand will remain. At some point TUI will have to make a strategic decision over the future of HLX, and that decision may be related to TUI's strategy for all the airlines in its group, which include not only Hapag-Lloyd and HLX, but also Britannia, Corsair, TUI Airlines Belgium, Britannia Nordic and Thomsonfly. In the UK, Britannia sells packages with Thomsonfly (a LCC) flights, so one possibility is that HLX becomes the main airlift provider for TUI instead of Hapag Lloyd.

Another possibility is a merger between Hapag Lloyd's aviation assets (i.e. both Hapag Lloyd and HLX) and Air Berlin, given that their relationship is closer than ever through codesharing on more than 300 flights a week and via selling each other's tickets. However, Air Berlin's cost base is likely to be lower than HLX's, and the Berlin LCC may prefer continuing the existing relationship rather than pursue an equity tie-up.

Germania Express (Gexx)

Germania Express (also known as Gexx) started operations in June 2003 as the LCC subsidiary of charter airline Germania.

Gexx uses a fleet of 19 F100s, all of which were acquired from US Airways at prices believed to be deeply discounted. The LCC has three hubs - Berlin Tegel, Munich and Hamburg - and operates domestically to 10 German airports and to 13 destinations across Europe. After launching routes out of Berlin Tegel, a Munich hub was started in August 2003 with routes to Palma, de Mallorca, Ibiza, Alicante, Hamburg, Lisbon, Zurich and Thessaloniki. Flights to Russia were added from Munich (and from Berlin Tegel) the following month. Incidentally Gexx and its parent, Germania, offered to buy Berlin Templehof airport last year, which is closer to the city centre than the other Berlin airports, and its move was backed by rival airlines, including dba and Air Berlin.

Gexx's strategy differs from the classic LCC business model in that it sells tickets through travel agents. Traditionally, German air passengers (at least in the leisure sector, if not the business sector) have preferred to book flights through travel agencies rather than direct using credit cards - although other LCCs argue that this has changed. Gexx also operates largely to major cities, rather than secondary airports. Altogether, around 60% of its passengers are business customers; most of these using Gexx for their daily commute to and from work in other cities.

Despite increasing capacity by 30% in the winter of 2003/04 and with ambitious plans to expand its F100 fleet to 40 aircraft, last year saw a strategic about-turn for Germania Express. In March 2004 Gexx withdrew from five routes - from Hamburg, Dusseldorf and Berlin to Vienna and Zurich, and on Munich-Vienna - and instead signed a contract under which Air Berlin took responsibility for the routes to Vienna and Zurich using three wet-leased Gexx F100s. The aircraft are painted with Air Berlin livery. This appears to be consistent with the policy of parent airline Germania, which leases aircraft to rival LCC Hapag-Lloyd Express. Interestingly, at the time of HLX's launch (in December 2002), TUI claimed that Germania's operation outside of the HLX contract would be "very, very limited", so perhaps the contracting out of aircraft has always been the goal of the Germania management.

In the summer of 2003 Gexx was in negotiations with Zurich-based charter carrier Odette Airways over the launch of a new LCC for the Swiss market, then in November 2004 Swiss sources suggested Gexx would become a joint shareholder with Air Berlin in launching a new airline, to be called Air Zurich. The airline is aiming to start operations in 2005, it is believed, once the Swiss federal aviation authority gives approval.

With the available fleet decreasing rather than increasing, route expansion has been slow. In autumn 2004 only Berlin-Karlsruhe/Baden-Baden and Hamburg-Dusseldorf services were launched, bringing the number of domestic routes to seven, although there are plans to commence routes from

Cologne and Stuttgart to Moscow and St. Petersburg sometime in 2005, building on existing services from Berlin, Munich, Hamburg and Dusseldorf to Moscow Domodedovo. The Russian routes have been a success for Gexx, with its lower fares forcing Aeroflot to halve its own fares between Moscow and both Berlin and Munich. Gexx flights operate to Russia with reported load factors of more than 90%.

Despite a small profit and a forecast 30% increase in turnover in the 2003/04 financial year ending October 31, to around €130m, in October 2004 Jurgen Branse - the CEO of Germania Express since it was launched - resigned unexpectedly. According to German sources this was because Branse wanted the airline to expand in order to beat off the challenge of rival LCCs, whereas parent company Germania - headed by Hinrich Bischoff - wanted German Express to lease out more of its fleet to LCC rivals in order to lock-in guaranteed revenues. That strategy is a long way away from the extra aircraft every three weeks that Bischoff said (back in 2003) that Gexx would be growing by. Added to this is the fact that although the airline carried 1.4m passengers during the 2003/04 financial year, its load factor was 72%, which is 10% less than at rivals Air Berlin and Germanwings.

Branse was replaced by Wolfgang Vieweg, the managing director of Germania, who says Germania Express will continue as a standalone LCC. But that seems unlikely, and at the end of 2004 talks were held with dba over a possible merger. That would be an interesting combination, given that the two airlines' route networks overlap. Last year also saw a fare war between Gexx and dba on Dusseldorf-Munich, believed to be one of dba's profitable routes. But Gexx would benefit more from a merger than dba, as dba has more strategic options available (see below).

Another possibility is a merger into Air Berlin, building on the existing wet lease and sales & marketing agreements between the two, as well as the unofficial alliance Gexx made with the Berlin-based LCC in seeing off the threat of entry by easyJet at Hannover airport.

dba

Munich-based dba started operations as full-service Deutsche BA back in 1992, though its origins go back to 1978. However, after struggling against the might of Lufthansa in the German market and racking up years of losses, its owners - British Airways - decided to sell the company.

In 2002 easyJet paid BA more than €10m for an option to purchase Deutsche BA, but although the German airline's route network appeared to link well with easyJet's European routes, after a year-long close examination easyJet decided to proceed no further. BA looked elsewhere for a buyer, and in July 2003 Deutsche BA was sold to Intro Verwaltungsgesellshaft - a German consulting/investment firm owned by entrepreneur Hans Rudolf Wohrl - for €1. A month later, 10% stakes in the airline were acquired by new joint CEOs Martin Gauss and Peter Wojahn.

Wohrl is experienced in the airline sector - he was on the Deutsche BA board from 1994-2001 and previously founded Nurnberger Flugdienst, a charter airline that subsequently merged into Eurowings. Wohrl's plan for the renamed dba was clear: in the first year of operations he aimed to improve productivity by 20% and boost revenues by at least 10%.

The former Deutsche BA had tried to become a LCC in 1Q 2002 in an attempt by the BA-appointed management to take out around €80m in annual costs and achieve break-even by 2003, but execution was poor, and labour constraints were tight.

Under Wohrl, however, the drive to become a true LCC is more focussed and substantial. Fleet utilisation has been improved and 737 lease rates have been renegotiated, as have contracts with virtually every other major supplier to the airline.

There was concern by analysts as to whether employees would accept the LCC changes introduced by Wohrl and his team, particularly as easyJet's non-exercise of its option was partly due to unions' refusal to adopt the pay scales prevalent at the UK LCC without a guarantee that jobs would not be lost. In addition, British Airways annulled existing contracts with the Deutsche BA workforce in 2003, just before the airline was sold to Intro. But after tough words from Wohrl - including a warning he might shut the airline down if he was blackmailed - matched by a warning strike by unions in November 2003, the two sides came together and held substantive negotiations. Finally, the pilots' union - Vereinigung Cockpit - agreed a pay structure in the summer of 2004, and although details of the settlement are secret, it is believed that salary cuts of up to 20% were agreed, saving dba up to €10m a year in costs. The workforce also shrank from 800 at acquisition to 610, though this increased back to

710 by the end of 2004 as the route network expanded, and 50 more flight attendants are being employed in the first quarter of 2005.

Wohrl is also targeting dba more at business customers, although here the airline is up against not just the might of Lufthansa, but also Deutsche Bahn, the Germany railway company. dba now allows greater flexibility in changing reservations and, unlike most LCCs, dba offers some frills, such as free onboard snacks and allocated seating. Originally, after the change to a LCC model, these extras weren't offered, but apparently dba faced complaints from existing customers, and selected frills were reintroduced. A FFP is being introduced, and in June 2004 the new managing directors also said that dba would no longer compete against its fellow LCCs in destructive fare wars.

In October 2004 dba launched two more domestic routes, from Munich to Hannover and Dresden, and in December 2004 dba signed a contract to provide feed for Delta flights out of Berlin Munich and Stuttgart from Cologne-Bonn, Dresden, Dusseldorf, Hamburg and Hannover. This follows similar dba feed contracts for five other international airlines operating out of Germany.

dba now operates between eight destinations in Germany, while internationally it has routes to Ibiza and Nice. With 95% of dba's flights being domestic, the airline plans to reduce this exposure by expanding its international network, particularly to major business centres. However, choosing the right routes isn't easy - a Berlin Tegel-London Gatwick route was axed in March 2004, just four months after it was relaunched after being previously dropped by the BA-owned Deutsche BA in 2002.

In the year to March 31, 2004, dba made a loss of €63m on revenues of €265m, although €25m of the losses occurred in the period when the airline was owned by British Airways, and there was an extra €15m of costs in the financial year due to one-off restructuring charges. The loss is higher than forecast by Wohrl after he acquired dba, but is still lower than the forecast for 2003/04 made under BA ownership, when a loss of up to €80m was anticipated.

For the first time ever, dba broke even on a monthly basis in September 2004, and the LCC is on target to make a small profit in the financial year to end of March 2004 - exactly as Wohrl targeted when he acquired the airline, and based largely on reducing annual costs by €40m - the first profit in 12 years. A significant profit is forecast for 2005/06. Current load factors are low for a LCC, at around the 70% mark, but dba says it breaks even at a load factor of 65%.

dba's turnaround should allow Wohrl and Intro to make a successful exit at some point. Earlier in 2004 dba's management said it was planning for an IPO in 2006 or 2007, when Intro's stake would be reduced to 25%, but the exit strategy now appears to be via a merger or trade sale, possibly with a fellow German LCC. In November 2004 talks on a potential merger were held with Germania Express. There is overlap between dba and Germania Express domestically, with four of dba's 14 aircraft currently on wet-lease from Germania, Gexx's parent company. However, Germania Express is also close to Air Berlin, with which it co-operates, and a Gexx/dba merger now appears unlikely.

Though it would be tricky politically, a revived dba could be an interesting acquisition for foreign network carriers looking to secure a foothold in a domestic market with 25m passengers a year. The British Airways' experience may put off many candidates, but as long as potential acquirers understand where BA went wrong and where Wohrl is going right, then acquiring dba would secure a vital share of one of the biggest domestic markets in Europe, as well as securing feed into international routes.

An IPO or trade sale will help fund fleet renewal at dba. It currently uses 14 leased 737s, but Wohrl prefers owned aircraft to leased equipment, and extra capacity is needed for route expansion, particularly internationally. An order for up to 30 aircraft is expected, dba is believed to be choosing either the A319 or the 737-700, and an order is likely to be placed in February or March, with the first aircraft arriving in the first quarter of 2006. With Airbus keen to grab yet another short-haul aircraft order away from the clutches of Boeing, the A319 is the favourite.

If - or when - Wohrl makes a profit on his investment in dba, he can partly thank BA for his good fortune. Although Intro bought a loss-making airline, its risk was lessened by an agreement with British Airways whereby the UK airline paid £25m to Intro as well as agreeing to finance dba's entire fleet for 12 months, at a cost of another £24m. In return, BA receives 25% of dba's profits up until June 2006. While analysts praised the deal as getting rid of a major headache for BA, the deal looks remarkably good for Intro, having in effect been paid €75m to take an airline that today is starting to pump out profits.

		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 2003**	**2,445**	**2,456**	**-11**	**13**	**-0.4%**	**0.5%**	**37,614**	**26,061**	**69.3%**	**19,981**	**13,401**
	Jan-Mar 04	598	657	-59	-43	-9.9%	-7.2%	8,333	5,761	69.1%	3,592	9,984
	Apr-Jun 04	699	719	-20	-2	-2.9%	-0.3%	9,068	6,605	72.8%	4,116	10,255
	Jul-Sep 04	702	626	76	41	10.8%	5.8%	9,675	7,356	76.0%	4,589	10,201
	Oct-Dec 04	656	714	-58	-45	-8.8%	-6.9%	8,774	6,399	72.9%	3,998	9,433
	Year 2004	**2,724**	**2,804**	**-80**	**-15**	**-2.9%**	**-0.6%**	**35,849**	**26,121**	**72.9%**	**16,295**	**9,968**
American	**Year 2003**	**17,440**	**18,284**	**-844**	**-1,128**	**-4.8%**	**-6.5%**	**279,706**	**202,521**	**72.4%**		**96,400**
	Jan-Mar 04	4,512	4,470	42	-166	0.9%	-3.7%	68,551	48,746	71.1%		
	Apr-Jun 04	4,830	4,634	196	6	4.1%	0.1%	70,804	53,627	75.7%		92,500
	Jul-Sep 04	4,762	4,789	-27	-214	-0.6%	-4.5%	71,638	55,777	77.9%		93,300
	Oct-Dec 04	4,541	4,896	-355	-387	-7.8%	-8.5%	69,049	51,325	74.3%		90,700
	Year 2004	**18,645**	**18,789**	**-144**	**-761**	**-0.8%**	**-4.1%**	**280,042**	**209,473**	**74.8%**		**90,700**
America West	**Year 2003**	**2,255**	**2,222**	**33**	**57**	**1.5%**	**2.5%**	**44,880**	**34,270**	**76.4%**	**20,050**	**11,326**
	Jan-Mar 04	577	559	18	1	3.1%	0.2%	11,832	8,539	72.2%	4,897	11,827
	Apr-Jun 04	605	584	21	6	3.5%	1.0%	12,153	9,519	78.3%	5,343	11,936
	Jul-Sep 04	579	607	-28	-47	-4.8%	-8.1%	12,305	10,021	81.4%	5,556	11,936
	Oct-Dec 04	579	602	-24	-50	-4.1%	-8.6%	12,236	9,471	77.4%	5,336	11,845
	Year 2004	**2,339**	**2,357**	**-18**	**-90**	**-0.8%**	**-3.8%**	**48,525**	**37,550**	**77.4%**	**21,132**	**11,904**
Continental	**Year 2003**	**8,870**	**8,667**	**203**	**38**	**2.3%**	**0.4%**	**139,703**	**104,498**	**74.8%**	**39,861**	**37,680**
	Jan-Mar 04	2,269	2,404	-135	-124	-5.9%	-5.5%	32,621	23,678	71.7%	9,735	
	Apr-Jun 04	2,514	2,471	43	-17	1.7%	-0.7%	34,676	27,083	77.6%	10,809	
	Jul-Sep 04	2,564	2,540	24	-16	0.9%	-0.6%	35,371	28,843	81.5%	11,182	
	Oct-Dec 04	2,397	2,558	-161	-206	-6.7%	-8.6%	37,962	29,350	77.3%	14,253	
	Year 2004	**9,744**	**9,973**	**-229**	**-363**	**-2.4%**	**-3.7%**	**95,082**	**73,151**	**76.9%**	**56,482**	
Delta	**Year 2003**	**13,303**	**14,089**	**-786**	**-773**	**-5.9%**	**-5.8%**	**216,263**	**158,796**	**73.4%**	**104,452**	**70,600**
	Jan-Mar 04	3,292	3,680	-388	-383	-11.8%	-11.6%	55,300	39,027	70.6%	25,343	69,900
	Apr-Jun 04	3,961	4,202	-241	-1,963	-6.1%	-49.6%	62,151	47,610	76.6%	28,616	70,300
	Jul-Sep 04	3,871	4,294	-423	-646	-10.9%	-16.7%	63,031	48,952	77.7%	28,247	69,700
	Oct-Dec 04	3,641	5,897	-2,256	-2,206	-62.0%	-60.6%	61,384	45,237	73.7%	27,794	69,150
	Year 2004	**15,002**	**18,310**	**3,308**	**5,198**	**22.1%**	**34.6%**	**244,097**	**182,351**	**74.7%**	**110,000**	**69,150**
Northwest	**Year 2003**	**9,510**	**9,775**	**-265**	**248**	**-2.8%**	**2.6%**	**142,573**	**110,198**	**77.3%**	**51,900**	**39,100**
	Jan-Mar 04	2,603	2,711	-108	-223	-4.1%	-8.6%	35,133	26,883	76.5%	12,500	39,230
	Apr-Jun 04	2,871	2,923	-52	-175	-1.8%	-6.1%	36,634	30,215	82.5%	14,289	39,154
	Jul-Sep 04	3,052	2,973	79	-38	2.6%	-1.2%	38,324	31,774	82.9%	14,800	38,178
	Oct-Dec 04	2,753	3,177	-424	-412	-15.4%	-15.0%	36,964	29,107	78.7%	13,775	
	Year 2004	**11,279**	**11,784**	**-505**	**-848**	**-4.5%**	**-7.5%**	**147,055**	**117,981**	**80.2%**	**55,374**	**39,342**
Southwest	**Year 2003**	**5,937**	**5,454**	**483**	**442**	**8.1%**	**7.4%**	**115,532**	**77,155**	**66.8%**	**65,674**	**32,847**
	Jan-Mar 04	1,484	1,438	46	26	3.1%	1.8%	29,582	18,977	64.2%	15,995	31,522
	Apr-Jun 04	1,716	1,519	197	113	11.5%	6.6%	30,212	23,054	76.3%	18,864	31,408
	Jul-Sep 04	1,674	1,483	191	119	11.4%	7.1%	31,359	22,794	72.7%	18,334	30,657
	Oct-Dec 04	1,655	1,535	120	56	7.3%	3.4%	32,540	21,140	65.0%	17,709	31,011
	Year 2004	**6,530**	**5,976**	**554**	**313**	**8.5%**	**4.8%**	**123,693**	**85,966**	**69.5%**	**70,903**	**31,011**
United	**Year 2003**	**13,274**	**15,084**	**-1,360**	**-2,808**	**-10.2%**	**-21.2%**	**219,878**	**168,114**	**76.5%**	**66,000**	**58,900**
	Jan-Mar 04	3,732	3,943	-211	-459	-5.7%	-12.3%	56,181	42,287	75.3%	15,923	
	Apr-Jun 04	4,041	4,034	7	-247	0.2%	-6.1%	58,313	47,840	82.0%	18,444	59,700
	Jul-Sep 04	4,305	4,385	-80	-274	-1.9%	-6.4%	61,403	50,439	82.1%	19,360	59,000
	Oct-Dec 04	3,988	4,481	-493	-664	-12.4%	-16.6%	58,033	44,824	77.2%	17,143	57,500
	Year 2004	**16,391**	**17,168**	**-777**	**-1,644**	**-4.7%**	**-10.0%**	**233,929**	**185,388**	**79.2%**	**70,914**	**58,900**
US Airways	**Year 2003***	**5,312**	**5,356**	**-44**	**-174**	**-0.8%**	**-3.3%**	**85,673**	**62,408**	**72.8%**	**44,373**	**26,797**
	Jan-Mar 04	1,701	1,844	-143	-177	-8.4%	-10.4%	23,771	16,220	68.2%	12,700	26,854
	Apr-Jun 04	1,957	1,874	83	34	4.2%	1.7%	24,991	19,336	77.4%	25,953	26,880
	Jul-Sep 04	1,799	1,976	-177	-232	-9.8%	-12.9%	25,462	19,382	76.1%	14,274	26,835
	Oct-Dec 04	1,660	1,802	-142	-236	-8.6%	-14.2%	24,514	17,622	71.9%	14,097	24,628
	Year 2004	**7,117**	**7,495**	**-378**	**-611**	**-5.3%**	**-8.6%**	**98,735**	**72,559**	**73.5%**	**55,954**	**24,628**
JetBlue	**Year 2003**	**998**	**830**	**168**	**104**	**16.8%**	**10.4%**	**21,950**	**18,550**	**84.5%**	**9,012**	**4,892**
	Jan-Mar 04	289	256	33	15	11.4%	5.2%	6,790	5,427	79.9%	2,650	5,292
	Apr-Jun 04	320	275	45	21	14.1%	6.6%	7,494	6,333	84.5%	2,921	5,718
	Jul-Sep 04	323	300	23	8	7.1%	2.5%	7,950	6,753	84.9%	3,033	6,127
	Oct-Dec 04	334	322	12	2	3.6%	0.6%	8,200	6,802	82.9%	3,179	6,413
	Year 2004	**1,266**	**1,153**	**113**	**47**	**8.9%**	**3.7%**	**30,434**	**25,315**	**83.2%**	**11,783**	**6,413**

***Note**: US Airways' financial results are for the 9 months up to Dec 31, 2003. Operating statistics are for the full year.

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

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 %
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
2003	210.7	136.7	64.9	215.0	171.3	79.7	131.7	101.2	76.8	497.2	390.8	78.6	742.6	551.3	74.2
Nov 04	17.6	10.3	58.7	16.7	12.8	77.0	12.9	10.1	77.8	42.9	33.5	78.1	63.8	45.9	72.0
Ann. chng	5.4%	4.1%	-0.8	0.4%	-1.7%	-1.6	13.0%	9.4%	-2.6	5.5%	3.8%	-1.3	5.9%	4.3%	-1.1
Jan-Nov 04	203.5	134.2	65.9	207.1	169.6	81.9	140.6	110.0	78.2	490.8	394.2	80.3	730.9	553.8	75.8
Ann. chng	5.1%	5.8%	0.4	4.8%	7.9%	2.3	17.4%	19.9%	1.6	8.1%	10.5%	1.8	7.9%	10.1%	1.5

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 %
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
2003	963.1	706.6	73.4	148.3	117.6	79.3	94.8	74.0	80.5	84.2	59.3	70.5	327.2	251.0	76.7
Dec - 04	85.6	63.0	73.6	13.1	10.6	80.4	9.5	7.3	79.7	9.1	6.5	71.0	31.7	24.6	77.5
Ann. chng	3.8%	4.6%	0.6	10.6%	7.9%	-2.0	14.3%	9.3%	-3.7	15.6%	13.6%	-1.3	13.1%	9.8%	-2.3
Jan-Dec 04	1014.5	763.6	75.3	164.2	134.4	81.8	105.1	87.6	83.4	96.4	68.0	70.5	365.6	289.8	79.3
Ann. chng	5.3%	8.1%	1.9	10.7%	14.2%	2.5	10.8%	18.3%	5.3	14.4%	14.4%	0.0	11.7%	15.5%	2.6

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	Delivery	Other information/engines
Boeing	17 Dec	KLM	2 x 777-200ER	1Q 2006	
	17 Dec	Etihad Airways	5 x 777-300ER	4Q 2005	
	22 Dec	JAL	30 x 7E7	2008 onwards	plus 20 options
	23 Dec	China Eastern	6 x 737-700	2006 onwards	
	28 Dec	Air Europa	3 x 737-800	1Q 2006	
	29 Dec	Blue Panorama	4 x 7E7-8		
	06 Jan	Hapag-Lloyd Flug	10 x 737-800	1Q 2006	
	12 Jan	Bavaria Leasing	6 x 737-700	2005 onwards	plus 6 options
	27 Jan	Icelandair	10 x 737-800	2006 onwards	plus 5 options
Airbus	14 Dec	TACA	14 x A320 family	2005/09	
	16 Dec	AirAsia	40 x A320	2006/11	plus 40 options
	17 Dec	Air Hong Kong	2 x A300-600F	06/2006	plus 2 options
	18 Dec	Kingfisher Airlines	10 x A320	4Q 2005	plus 20 options
	22 Dec	Jazeera Airways	4 x A320		plus 4 options
	11 Jan	UPS	10 x A380F	2009/12	plus 10 options
	27 Jan	Northwest A/L	6 x A330-300 2 x A330-200	2006 onwards	
	27 Jan	Air China	20 x A330-200		
Embraer	19 Jan	Republic Airways	16 x Emb 170	2005/06	plus 34 options

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