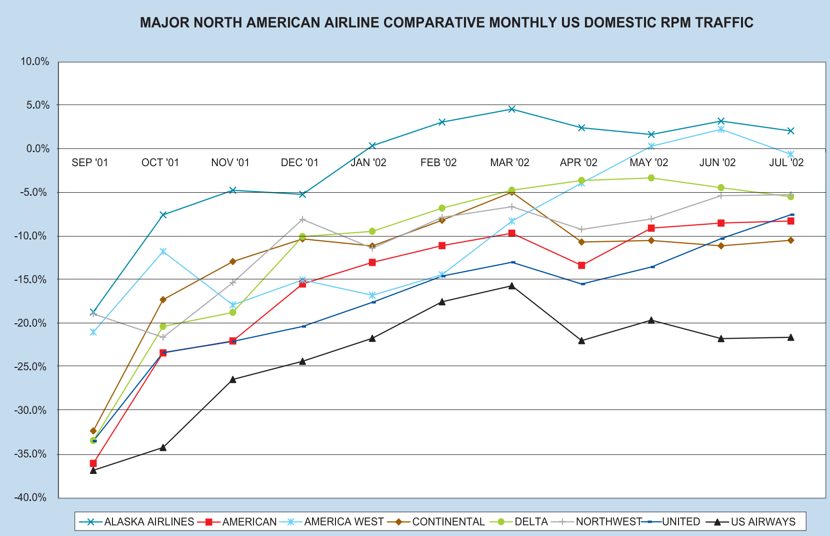
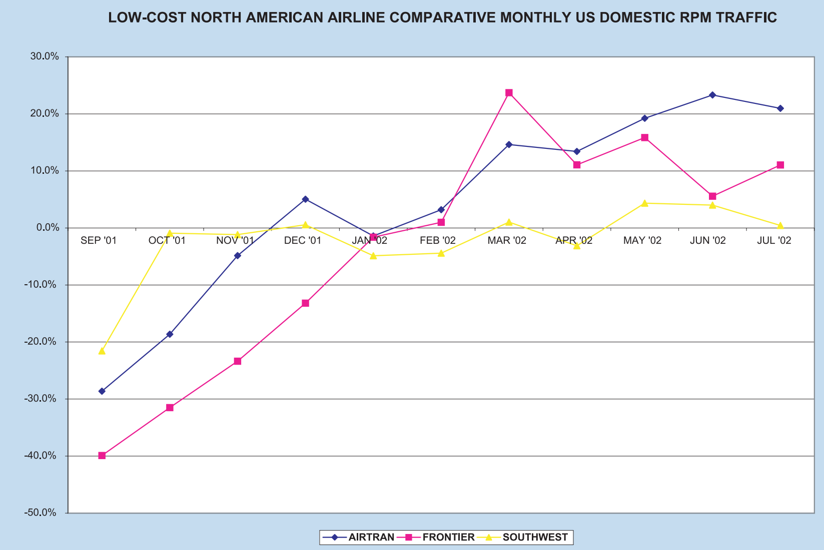
US carriers still struggling with traffic, but revenues show improvement

Domestic traffic has recovered slowly in the second quarter after a faster recovery in the first. Low-cost airline traffic continues to grow at the expense of the majors. Recovery is hampered by problems in the US economy and a failure of business passengers to return.





US domestic traffic, in terms of revenue passenger miles (RPMs), continues to recover sluggishly to pre-September 11th levels for most majors, but has increased for low-cost carriers and Alaska Airlines and America West *(see charts, this page)*.

These charts show the monthly RPM traffic for the top 12 US airlines compared to the same month a year ago, thus illustrating their traffic relative to pre-September 11th levels.

The general trend among most US majors is that their traffic recoveries have faltered in the second quarter and into the first month of the third. The exceptions are America West, which implemented a low-fare structure to win back passengers, and Alaska which made a quick recovery.

Major carriers showing small but steady traffic improvements each month are American, Northwest and United. These airlines are still hampered system-wide, however, because recovery in international traffic is just as slow as domestic traffic.

Despite highly publicised problems with its financial circumstances, and the increasing probability of a filing for Chapter 11 bankruptcy protection, United is making a steady recovery in its US domestic traffic at the rate of two of three percentage points per month *(see first chart, this page)*. American's recovery is far slower, but still improving. Northwest has also slowed down.

Delta's domestic traffic recovery has fallen back somewhat, and Continental's has ground to a halt for the past four months.

Despite the busy late spring and summer season, the US market has been plagued by financial scandals, a problematic economy and the failure of business passengers to return to the skies.

The slow recovery by the majors is in contrast to the low-cost carriers. Since the start of 2002, these have enjoyed traffic growth on the same month a year before *(see second chart, this page)*. Frontier, AirTran and JetBlue are all big winners. Southwest has made small gains.

The majors' faltering recovery is skewed by traffic being transferred to their regional affiliates. The majority of the traffic gains is still with low-cost airlines, however.

In spite of a weak traffic recovery, unit revenue is steadily improving each month. Passenger revenue per available seat-mile (PRASM) fell almost 31% in September 2001 compared a year before. In June it had increased again to 9.6% lower than a year ago. In July it was 8.7% lower than a year ago.

The biggest factor behind this improvement is tight capacity control by airlines and constantly improving load factors. The trend in improving PRASM is expected to continue.

The faltering traffic recovery, and long-term losses as a result, have forced airlines to take action to ensure long-term survivability. American has announced plans to retire all of its 74 Fokker 100s, and improve utilisation and increase seat numbers of its remaining aircraft. American is also bringing forward the retirement of eight ex-TWA 767-300s.

Continental is also rationalising its fleet, and has made further capacity cuts and will retire a sub-fleet of MD-80s. America West will its remaining 737-200s.

US Airways has attracted the most

Volga Dnepr is the first Russian airline to gain western debt financing for a Russian aircraft. International Finance Corporation provided a $30 million at an interest rate of 4.75% over LIBOR.

attention. It will retire up to 80 of its mainline fleet, including 40 Fokker 100s. Its main development will come from concessions by its pilots to relax its scope clause and develop its RJ operation to compete better with Delta and Continental. The focus of this operation will be at Pittsburgh with the newly-formed MidAtlantic Airways.

Finance for An-124

When Volga Dnepr Airlines signed an agreement with International Finance Corporation (IFC), a member of the World Bank Group, for a $29.9 million loan in July 7th 2002, it achieved a notable first.

This is the first time an international bank has provided sizeable funds for an airline to purchase a Russian-built large commercial aircraft.

The funds are required to complete the construction of what will be Volga Dnepr's tenth Antonov An-124-100, the world's largest production freighter aircraft. It is capable of carrying a 120 tonne payload. The aircraft is expected to be approved to increase to a 150 tonne payload in the near future.

The airframe is substantially completed on the Aviastar production line at Ulyanovsk in Russia, but engines and other components remain to be installed. At the signing ceremony, held in Moscow, Aviastar's chief executive officer, Viktor Mikhailov, said the aircraft should be delivered in early 2003.

IFC's director of Infrastructure Department, Declan Duff, said that IFC had increased its presence significantly on the Russian market. This is its first loan to the Russian aviation sector, but it looked forward to further opportunities. He described IFC's principal security as "The quality of Volga Dnepr's management and staff", although it later transpired that IFC also took a hold over 51% of the airline's issued capital, five An-124s, an insurance policy on the aircraft being funded. It also has guarantees from other associate companies of the airline. Interest rate is 4.75% over LIBOR.

Because this is the first western funding for a Russian-manufactured airliner, the loan conditions are understandably onerous. From the airline's view, the interest rate is considerably lower than the 30 to 50% normal in Russia, although it is exposed to currency fluctuations.

Volga Dnepr has been working to improve both the market understanding and market values of Russian aircraft. It has been actively seeking western funding and investment, and has made progress on having the An-124-100 approved and certified in the west. It is working to achieve certification of the aircraft by the United Kingdom's Civil Aviation Authority by late 2003 or early 2004. If successful, it plans to place two new aircraft on the UK register.

Volga Dnepr believes this will help to establish residual values for the aircraft, and enable further funding opportunities for Russian-manufactured aircraft. A major element of UK certification would be the installation of an English language avionics package on the aircraft.

Russians seek aircraft

With production of new generation aircraft from Russian factories running at just a trickle and difficulties in financing, growing traffic plus an expected reduction in import and value added taxes (which add a total of 44% to imported aircraft prices) are resulting in at least a dozen Russian airlines looking at the possibility of adding western aircraft to their fleets in the coming year.

Aeroflot already has approval to "roll over" the 27 western passenger airliners in its fleet. An announcement is expected shortly, with GECAS placing 18 A320s and nine 767-300ERs with the airline. This will be in exchange for the termination of Aeroflot's existing leases on 777s and 737-400s.

Sibir, the country's second largest airline, is "close" to finalising a deal for an initial two A320s, while Kras Air, another of the country's leading five airlines, is expected to sign for two 767-200s before the end of summer.

Transaero has already received two 737 classics, both –300s, and a third plus two 767s are expected to follow.

Another of the big five airlines, St. Petersburg's Pulkovo, has purchased four ex-Chinese Tupolev Tu-154Ms, which have been converted to meet the new European noise and equipment requirements. Russian state airline Rossiya will receive its first (of two) Tu-214s in August, and KMV airlines will take its third Tu-204.

Several other carriers are looking for regional and freighter aircraft.

The US Federal Aviation Administration (FAA) issued FAR-25 approval for the first time to a transport aircraft built in Russia, or the former Soviet Union, on June 2nd 2002. The aircraft approved was the Ilyushin Il-96T.

The approval was issued even a though a small number of software tests have not yet been completed. They were scheduled to be carried out in June and July. Until this has been done, the Il-96T is not acceptable for FAA registration. The actual certification document is expected to be handed over to the Ilyushin Design Bureau, the Il-96T's designer, in a ceremony to be held in Moscow on July 7th. AC