

US carriers continue with cost reduction struggle

Major airlines are all fighting to reduce costs and regain profitability. While fuel prices have fallen slightly following the end of the Iraq war, traffic volumes and yields are still weak. Most carriers are seeking to reduce costs through labour concessions.

The US aviation industry continues to suffer with airlines posting large first-quarter operating losses. Northwest Airlines reported a net loss of \$396 million, Continental lost \$221 million, Delta Air Lines responded to its \$470 million loss by furloughing a further 200 pilots. American Airlines lost \$880 million, and has struggled to avoid bankruptcy. United Airlines, already in bankruptcy, posted a \$1.34 billion net loss.

Reflecting this poor economic performance, Merrill Lynch adjusted its overall industry forecast from a previous forecast of \$7.4 billion to \$8.2 billion for 2003. In response to these losses most airlines have tried to cut costs further.

With stability in the Middle East, oil prices have begun to drop; providing some relief on fuel costs. While oil traded as high as \$40 per barrel, it has recently dropped to around \$28. This is still a high price, and analysts expect it to remain at this level for some period. Any significant saving will be provided by each airline's hedging policy. Prices

returning to normal would cut several \$100 million off US airline costs.

Of the major US carriers, fuel accounts for between 12% and 14% of total expenses, while salaries account for between 33% and 42%. Staff expense is a significant cost area, and is the focus of much of the cost saving attempts.

Without the agreement of the unionised workforce to take salary reductions, airlines will seek Chapter 11 protection to enable the reorganisation of their cost structure towards more competitive levels.

United Airlines, still reorganising under Chapter 11 protection, has now been joined by Hawaiian Airlines; which filed for protection in March, and Air Canada; which filed for protection in April.

Industry analysts are still unsure whether Delta will also file for Chapter 11 to secure the required labour and cost concessions to remain competitive.

American is now close to finalising the concessions it secured from workers; these concessions enable American to remove \$1.8 billion in cost per annum.

Under the proposal, \$660 million would come from pilots, \$340 million from flight attendants, \$620 million from maintenance employees, \$80 million from agents, and \$100 million from management. Despite these concessions, which have already been threatened by stiff resistance, American may still have to file for bankruptcy to enable debt renegotiation and lease restructuring.

Chapter 11 protection allows carriers to reorganise their cost structures under court directives; providing airline management with greater power over their unionised workforce. This benefited US Airways, traditionally hamstrung by union constraints. US Airways emerged from Chapter 11 in March; five months after it filed for protection.

US Airways was able to lower its labour contracts, debt levels, and aircraft lease rates; allowing it to become more efficient. Under restructuring US Airways removed 128 aircraft, 17,000 employees, and \$2.1 billion of debt.

The airline emerged from Chapter 11 after less than eight months as a smaller carrier expected to focus more on regional jet operations. It has cut annual operating costs by \$1.9 billion and schedules fewer flights than before 11th September 2001. US Airways still expects to make a loss in 2003 and 2004.

It is now seeking an immediate order for 100 RJs, with options for a further 80. Embraer is favoured to win the order. This increase is possible due to the relaxation of its RJ scope clause.

In the recent Airline Industry Update, Merrill Lynch analyst Michael Linenberg has forecast the US airlines to lose \$8.2 billion in 2003, reducing to \$2.5 billion in 2004.

Merrill Lynch believes the worst of the problems are now over, with the impact of the Iraqi war, SARS, and the industry recession all beginning to recede. However, with airline losses predicted to continue for at least another two years, airlines need to reduce their cost structure to survive and cash burn levels must be reduced. Reduced labour costs, combined with the existing cost savings that airlines have secured, may provide partial relief to their burdened balance sheet until the industry's economic performance improves.

US Airways emerged from Chapter 11 with its cost base reduced by \$1.9 billion. It is also, however, a smaller carrier and reduced its fleet by 128. It has also reduced debt by \$2.1 billion. It still expects to generate losses in 2003 and 2004.





Profits in Russia

After a dismal decade in the 1990s, Russian airlines turned the corner in the last quarter of 2000, and revenues and passenger numbers have grown steadily since.

At the same time, a new generation of business managers is joining the larger airlines, with noticeable attention to improving transparency, passenger services and thus the bottom line.

With results for 2002 starting to come through, two of the largest airlines in the country are showing profits, although with differing circumstances in each case.

Aeroflot Russian Airlines

In 2000, a newly appointed first deputy General director (or deputy Chief Executive Officer), Alexander Zurabov took charge of the national carrier's finances and commercial affairs. He hired McKinseys to carry out a detailed analysis of every aspect of the airline, and to come up with recommendations on how to improve.

As a result of the recommendations, the airline changed its emphasis. The new policy saw it switch from attracting new passengers (mostly due to low fares) to seeking existing passengers to want to travel again (and again), by improving aircraft, cabin standards, the airline's reputation and offering suitable schedules and frequencies for the international business community.

It also decided to discontinue services on non-profitable routes, to upgrade the western 27 passenger aircraft it was allowed to bring in free of the high taxes,

currently totalling 44%. It sought and was granted permission to 'roll over' this relief to a new fleet, and has ordered 18 new Airbus A319/ 320s, plus five additional, although not new, Boeing 767-300ERs, while retaining the four it already operates. Its 10 737-400s, two 777s and 11 A310s will be returned to lessors as the new aircraft are delivered. The decision was taken for several reasons. The current climate offers better lease and finance terms. Passenger loads average 110 on European routes, and the A310s have excess capacity. The interiors and equipment on the new Airbus' are also well regarded by passengers.

The 5,100,896 passengers carried by Aeroflot in 2000 grew to 5,830,664 in 2001, the highest number ever carried by the airline, even in Soviet times, when it was the Central Department of International Air Services. But the change in route policy resulting from dropping non-profitable services saw this figure come back to 5,631,012.

Revenues, however, grew slightly in 2002 to just over \$1.43 billion (45 billion Roubles) from \$1.42 billion (41.52 billion Roubles) at the then average rate of exchange. Not a major growth, but the after tax net profit under Russian accounting standards is more related to cashflow and different to the west, came to \$101 million (3,198 million Roubles) roubles, well up from the \$45 million (1,315 million Roubles) of 2001.

One noticeable difference between Russian and western airlines is staff costs. The average monthly salary paid to Aeroflot's 14,802 staff during the year was \$621 (19,500 Roubles), well over twice the average salary paid to most Moscow workers.

Aeroflot still needs to improve its

Aeroflot's passenger traffic grew 14% from 2000 to 2001. The airline dropped non-profitable services in 2002, and while passenger numbers reduced by 4%, revenues remained unchanged. The carrier managed a post tax profit of \$101 million in 2002, a rise over \$45 million in 2001.

profitability further. As the aviation 'pocket' of the Soviet government, it received all overflight charges paid by foreign airlines to cross Russian airspace. The air navigation elements of these have been transferred to the country's Air Traffic Management authorities, but the airline still retains the commercial element. This came to revenues \$273 million in 2001. As the 2002 figure is included with other income in the Russian language report, it is not possible to give it, but total revenues come to just \$222 million (6,975 million Roubles), so it has reduced. It is likely that international pressure will erode it further in the medium term.

UTair

Formerly known as TyumenAviaTrans, UTair changed its name in October 2002 because foreign passengers were finding it difficult to pronounce.

With 1,238,516 passengers carried on its airline services in 2002, a growth of 22.4% on 2001, UTair now holds fourth position in passenger numbers of Russia's airlines. It also carried another 341,650 passengers in helicopters, mostly refugees on UN contract services.

Revenues from all operations rose by 17% in dollar terms to \$173 million, and an operating profit of \$6.42 million resulted, down from 2001 due to substantially increased costs. Airport charges, for example, rose by 81% in the year, fuel by 48% and salaries by 61.5%. The average monthly salary for this Surgut, western Siberia-based airline, is \$462 (14,500 Roubles), more than the average Moscow wage.

Net profit after taxes came to just \$1.4 million, but the airline's Chief Executive Officer says that this comes after including the purchase of an additional Tu-154M from an Estonian airline.

UTair's principal business continues to be helicopter operations, mostly for oil and gas companies, but since Andrei Martyrosov took command in 1999, he has grown revenues from international operations, mainly for the United Nations, from \$2 million in 1998 to \$40 million in 2002.

In the first quarter of 2003, UTair's traffic grew by 6.7%, and its load factor increased from 53.9% to 64.1%.



7E7 details emerge

Initial details have emerged about the 7E7, Boeing's proposed new aircraft. The 7E7 has been conceived as an alternative to the Sonic Cruiser, which was scrapped because of a lack of interest. The 7E7 is a 200-250-seat conventional airliner family, which will have a similar ultra long-range performance to the Sonic Cruiser. This allows operators to open or operate city-pairs non-stop that are currently served by connections or services with technical stops. Boeing has responded to airline and passenger demand for such services. There are likely to be two models in the 7E7 family.

The 7E7's main features are a 200-250 seat capacity and 7,000-8,000nm range capability. This pitches the 7E7 as a direct replacement or substitute for the 767 family, while also offering operators a family of aircraft with a range of 7,000nm plus, and from 200 to 400 seats with the 7E7/777/747-400. The 7E7's size and range capability also put it in direct competition with the A330-200/-300.

Besides size and range, Boeing is aiming for a 10% improvement in efficiency and direct operating costs over current aircraft of a similar size. Boeing's objective is to offer an aircraft with the same cost per seat-mile as the 777, despite the 7E7 having the disadvantage

of smaller seat numbers.

With efficiencies being gained from reduced flight crews and engine numbers, extended range twin-engine operations (Etops), and maintenance improvements from past generations of aircraft, the 7E7 is looking at other areas of aircraft design to gain further reductions in operating costs.

All will be related to reductions in airframe and engine maintenance cost and fuel burn. Boeing claims, however, that the 7E7's ability to operate more routes non-stop, thereby reducing airlines' needs to make multiple-stop routes, will result in optimised crew costs, generating some cost savings.

Boeing is aiming for the 7E7 to have a 15% lower fuel burn than the 767-300 and A330-200. This will be achieved with all-new engines. There have been two generations of engine technology improvements since the introduction of the 767 in 1982, many of which were introduced in the engines powering the A330 and later 777. Examples of improvements in engine technology include composite and wide-chord fan blades.

Boeing predicts that the various gains in engine technology that can be incorporated into the 7E7's powerplants will generate an 8% improvement in efficiency over the 767's engines. One main benefit will be smaller and lighter engines compared to equivalent older

The 7E7 will be a 200-250 seat, ultra long-range aircraft. The targeted efficiencies will allow Boeing to offer an ultra long-range family from 200 to 400 seats with comparable comfort standards and unit costs.

generation powerplants delivering the same thrust.

This weight saving and smaller engine size will in turn lead to airframe design improvements.

Besides lower weight and fuel burn, technological gains should also translate into lower engine-related maintenance costs. One major contributor will be longer on-wing times between removals for shop visits.

The 7E7 will have an all-new fuselage that will have a standard 8-abreast seat configuration in economy class. This will be 226 inches wide at shoulder height, compared to the 222-inch wide cabin at ankle height on Airbus's widebody fuselage. This width will allow the 7E7 to have the same 18.5-inch width economy class seats as the 777, which are wider than Airbus' economy class seats. The 7E7's fuselage width will further allow aisles to be slightly wider than the 777's.

The fuselage width has also been selected to allow a 9-abreast economy class configuration for high-density operations using 737 standard seats.

The fuselage will be non-circular, and use a double-bubble type design. The upper section will have a wider diameter than the bottom section, which will be optimised to allow LD-3 containers to be carried. This is a change from the 767's fuselage design which is only wide enough to accommodate LD-2 freight containers and a 7-abreast seat configuration in the main cabin. The 7E7's cabin has been configured to provide high comfort levels required for ultra-long-range missions.

The aircraft's range capability will be complemented by Etops 'out of the box' capability, as introduced by the 777.

The 7E7 has been conceived so that Boeing can offer a long-range family that allows airlines to optimise capacity with varying demand, while offering similar levels of comfort, speed and range between the three aircraft types.

Boeing aims to start offering the 7E7 to airlines by the end of 2003 and to formally launch the programme with its first customer by the end of 2004, with entry into service in 2008. Boeing's 20-year forecast is for a market of 2,000-3,000 aircraft in the 7E7's size category, generated by a replacement of DC-10s, 767s, A300/310s and A330s, and aircraft to accommodate traffic growth. **AC**