



Changing Economics

How are fuel costs and environmental imperatives changing industry dynamics?

Presented by:

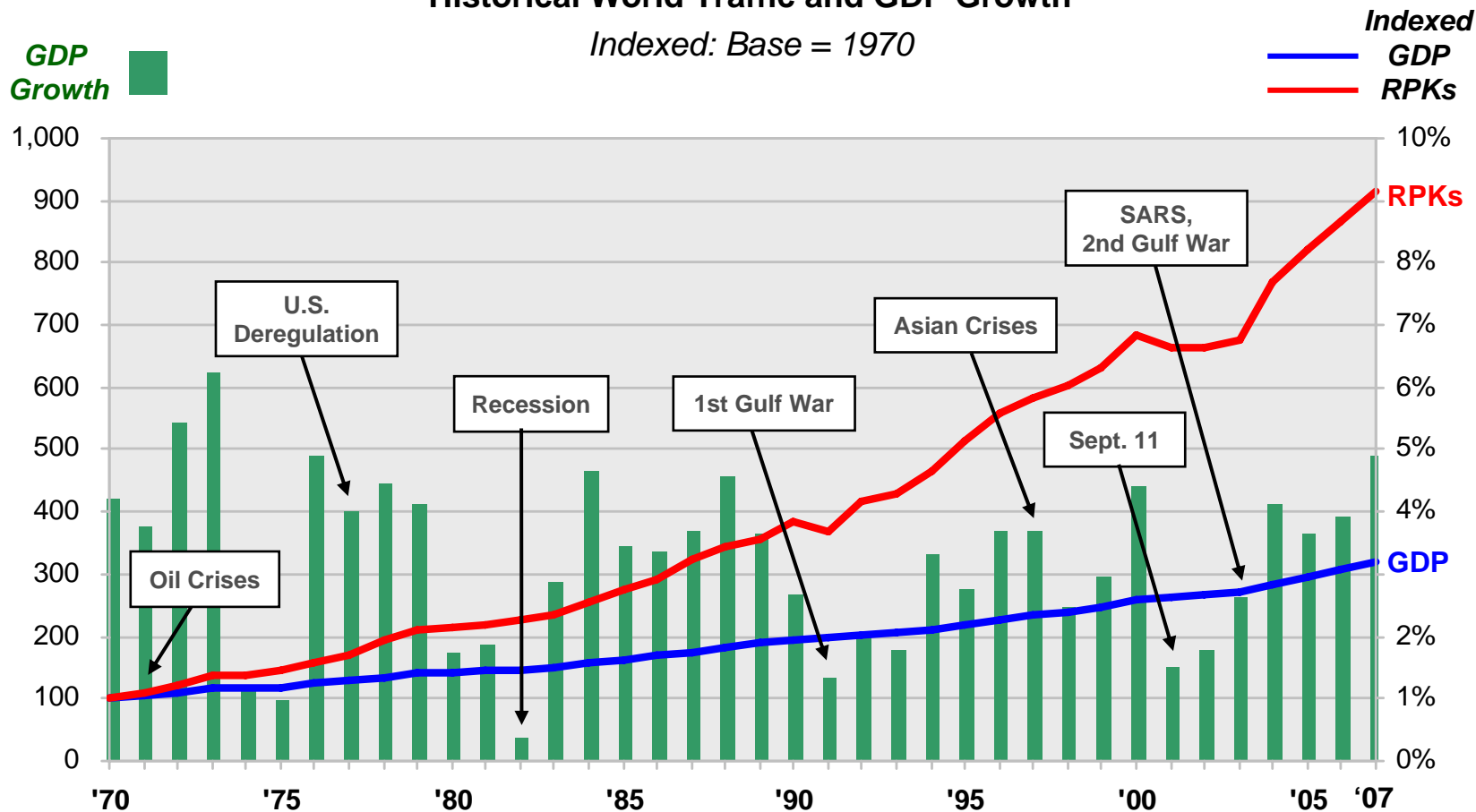
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Over the longer term, history illustrates that the airline industry will adapt to cost and demand shocks...but

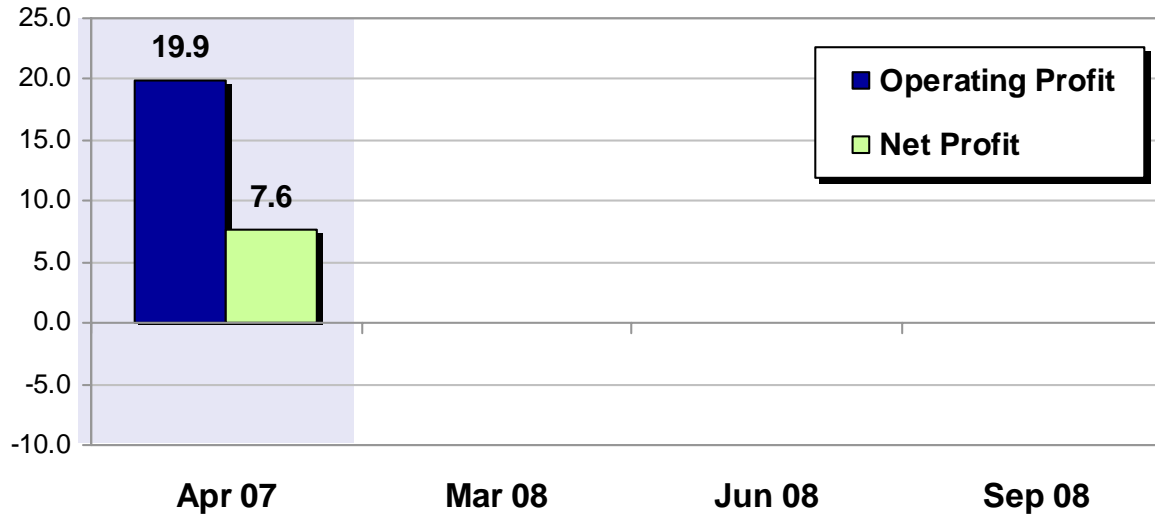
Historical World Traffic and GDP Growth

Indexed: Base = 1970



Since mid-2007, the trading environment facing the airline industry has been highly volatile and continues to deteriorate

IATA All-Airline Profit Forecast for 2008 (US\$ billion)

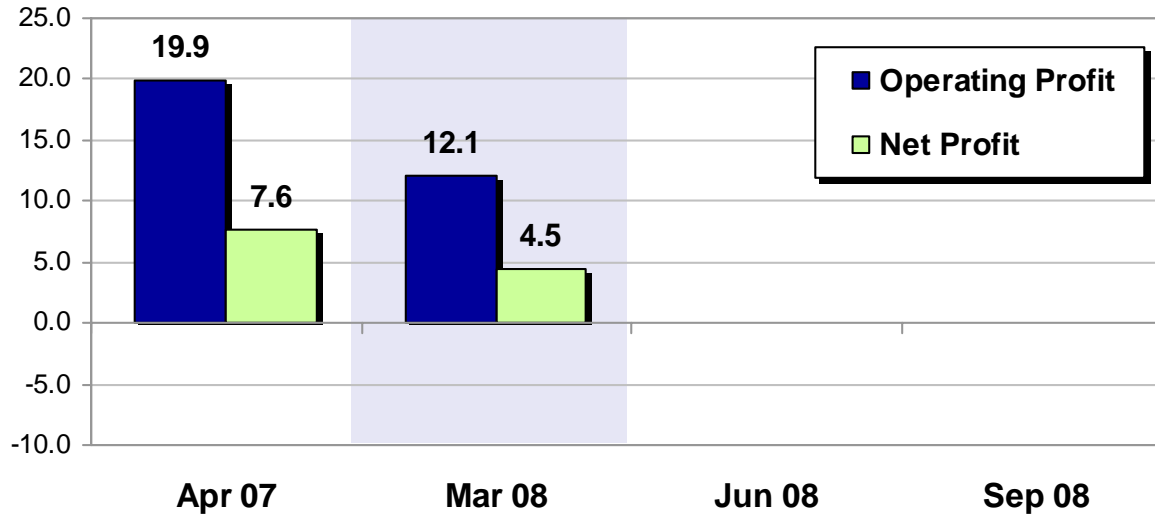


early
2007

- ◆ Discussions of the super-cycle remain in mind and industry embarking on another year of record orders
- ◆ Significant optimism in emerging markets, particularly Asia, and oil economies
- ◆ Another two years of strong North American performance is widely expected

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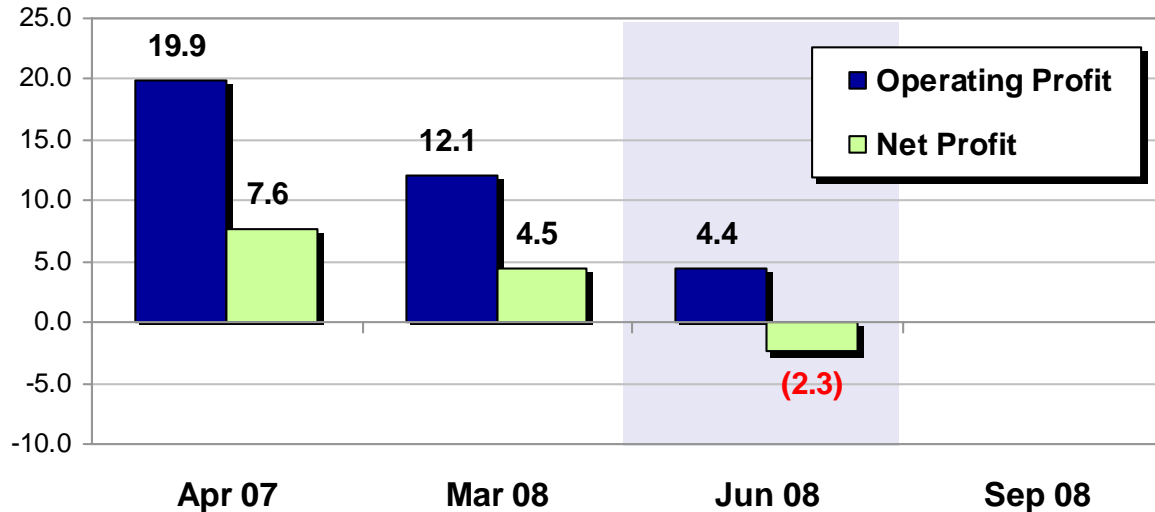


early
2008

- ◆ Increasing concern over rising fuel prices and other airline cost pressures beginning to bite
- ◆ Credit crunch clearly impacting the US economy
- ◆ Decoupling theory still widely believed

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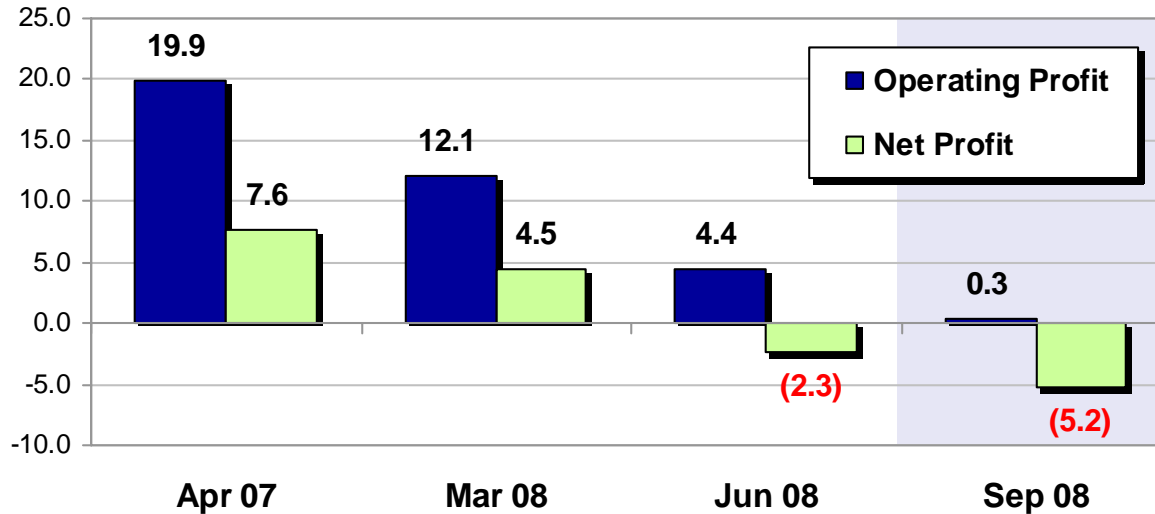


mid 2008

- ◆ Dramatic oil price increases threaten to alter the shape of the airline industry
- ◆ Europe and Asia economies no longer viewed as insulated
- ◆ Generally, air travel demand is holding but signs of business traffic weakening spark concern

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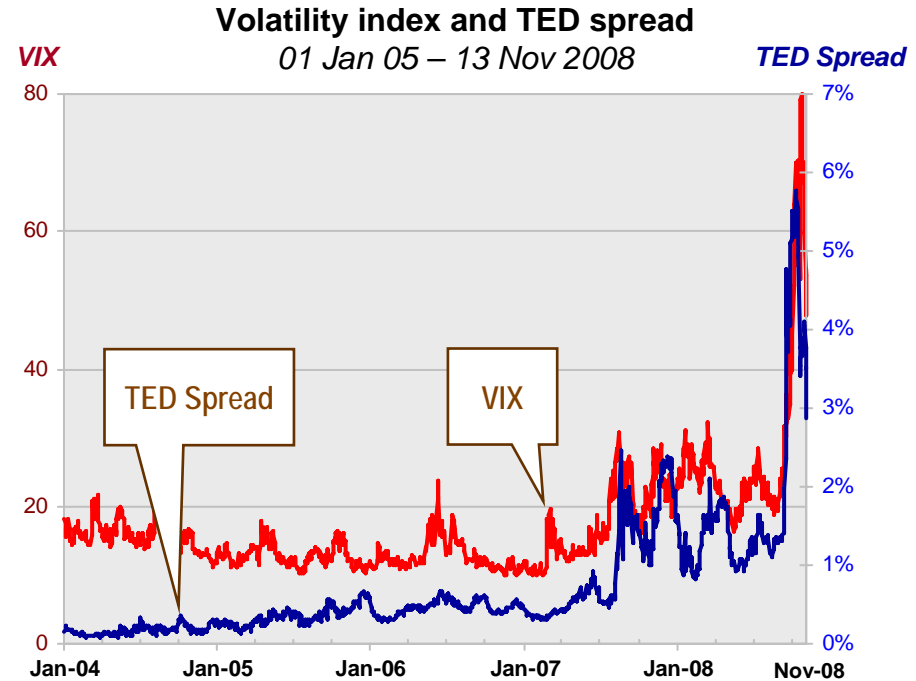
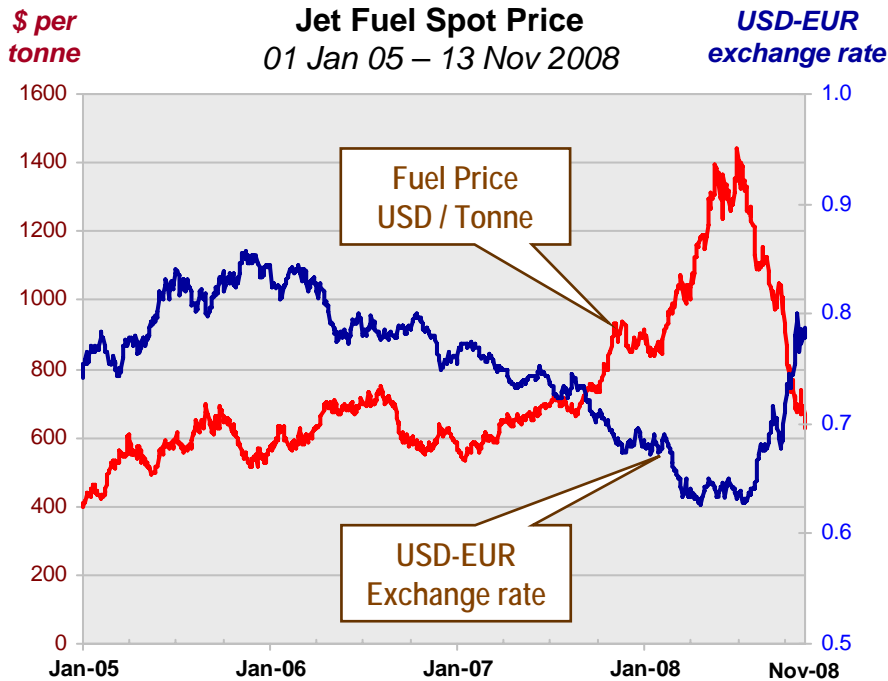
IATA All-Airline Profit Forecast for 2008 (US\$ billion)



Today

- ◆ Despite falling oil prices, industry dynamics continue to worsen
- ◆ The US credit crunch has evolved into a global credit crisis and general economic conditions are worsening
- ◆ Passenger and freight demand falling rapidly and 2009 traffic growth estimates are being slashed

Airline inputs are increasingly volatile and dispersed



Fuel: 95% higher in Jul-08 than a year earlier;
Since fallen to early-07 levels

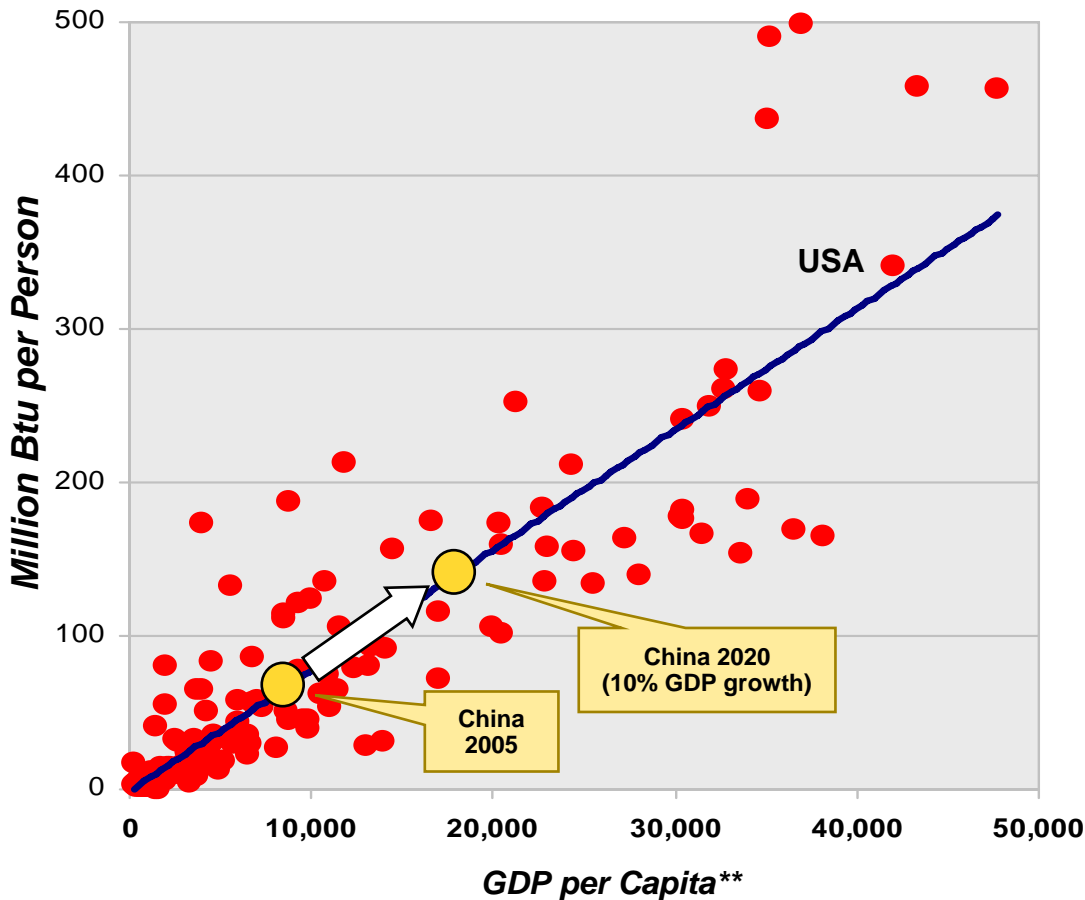
Currency: USD up 25% against Euro in
3 months

Equities: Volatility Index (“VIX”) – “Fear
Gauge” – up nearly 3 times its
historical average

Credit: TED Spread rose from 104 to 576 bps
between mid-Sept. and mid-Oct.

While recent fuel prices are falling, there is little reason to believe that prices will remain low the longer term

Energy use vs. GDP per capita (2005)



- ◆ Worldwide petroleum consumption has grown twice as fast as refinery capacity over the last decade
 - ...and distillate usage is even higher, as Europe drives diesel
- ◆ While sufficient distillation capacity is expected to come online to keep up with projected demand in 2009-2013, new refinery capacity is uncertain thereafter
- ◆ Emissions Trading and other potential cap and trade or carbon taxation will increase input costs further

* 1 million Btu = 8 gallons of gas or 293 kWh

** GDP per Capita: US\$ on purchasing-power-parity (PPP)

Source: Energy Information Administration - World Economic Outlook, OPEC

Environmental imperatives point clearly to the fact that airlines will have to pay for growth in carbon dioxide emissions

◆ EU ETS is the first such scheme

- All EU arriving/departing flights from 2012

◆ Allowance Cap

- 2013 onwards: 95% of average 2004-2006

◆ Auctioning

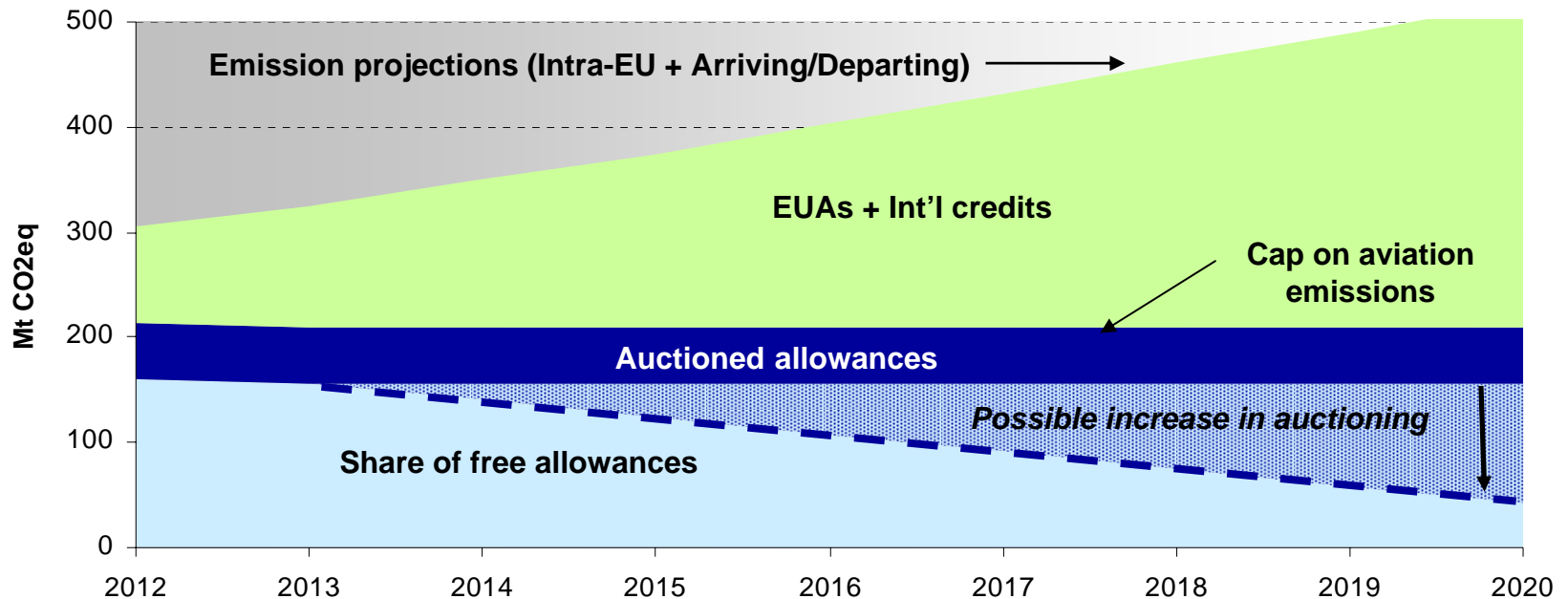
- 15% of allowances to be auctioned

◆ International carbon credits

- Up to 15% can be used to cover emissions

◆ Issues of Concern

- Cap, auctioning level, earmarking of auction revenues, limit on credit use... starting 2013

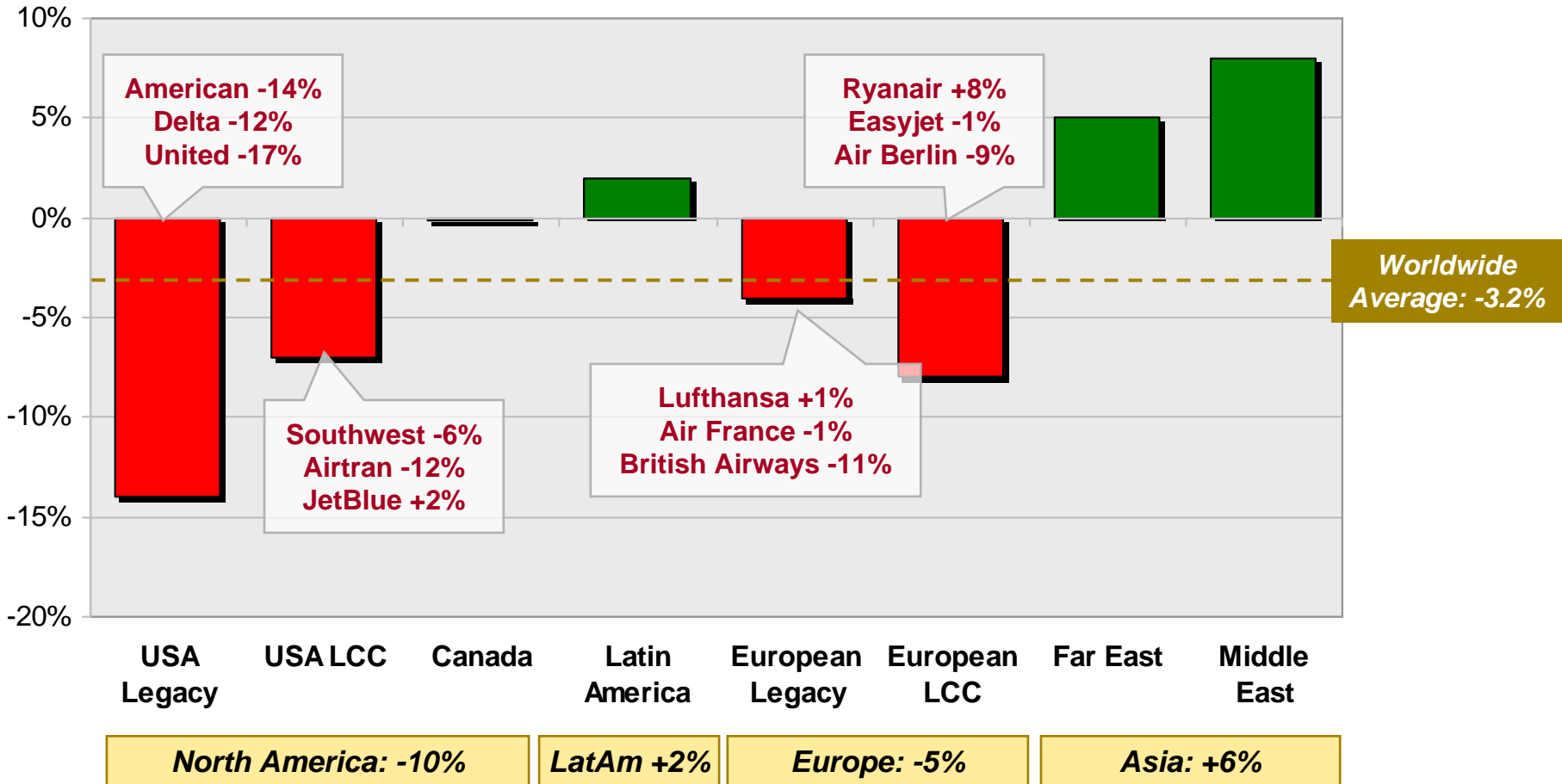


The continued volatility of input costs and long term expectations of high fuel and carbon prices have clear strategic implications

- ◆ **As fuel prices rise to ~40% of total costs, it becomes increasingly difficult to manage total costs downward**
 - Cost reductions in other areas are diluted
 - Costs that are controllable in the short-term wane in influence
 - Structural improvements become increasingly important
- ◆ **Volatility in fuel prices, interest rates, currencies and the general economy makes planning extremely complex**
 - Systematic risk management becomes increasingly important
 - Focus on liquidity is leading airlines to build larger cash reserves
- ◆ **A focus on revenue generation remains vital**

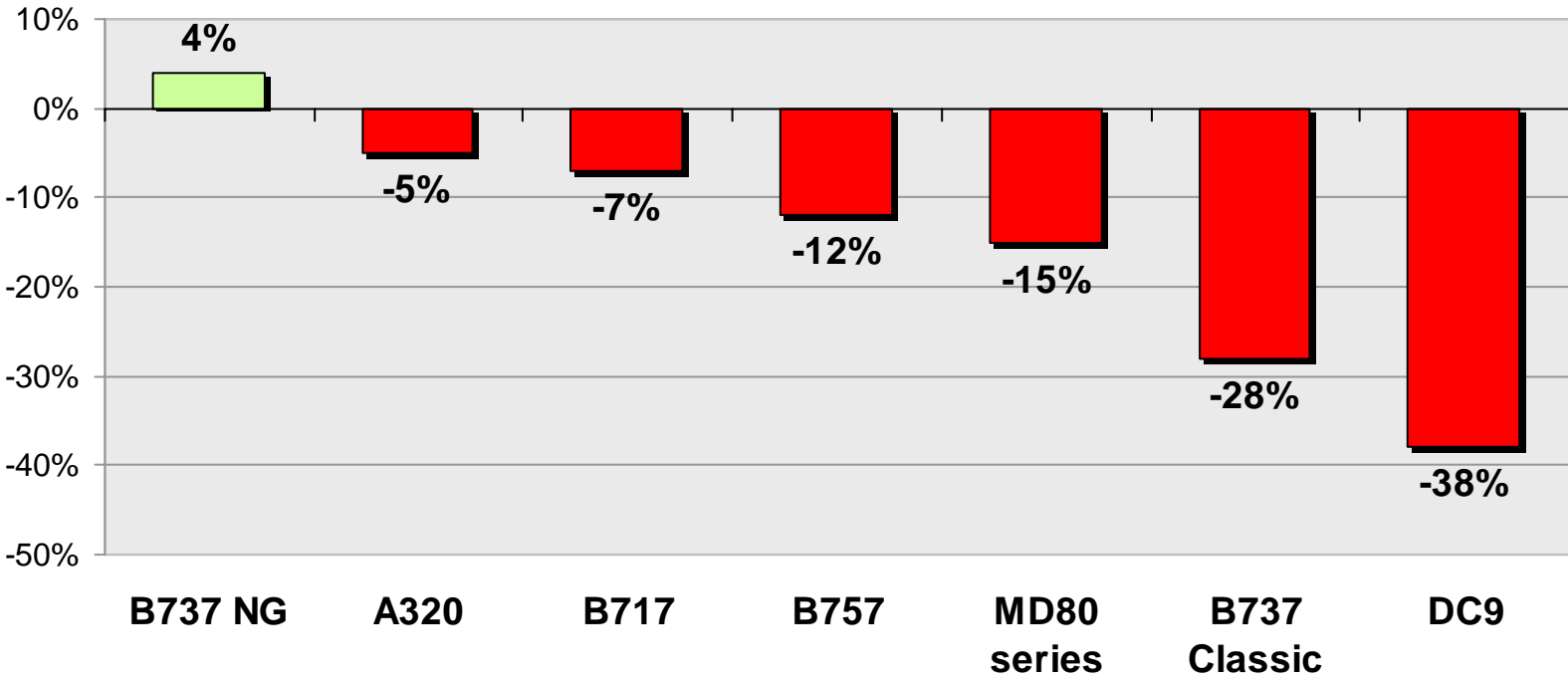
U.S. and European airlines reacted to high variable costs over the summer months by cutting capacity dramatically

Change in Seat Departures by Carrier Region
November 2008 vs. November 2007



Unsurprisingly, the schedule reductions have focused on older generation narrowbodies

Change in Scheduled Departures by Aircraft Type
November 2008 vs November 2007



| | | | | | | | |
|--------------------------------|-------|-------|-------|--------|--------|--------|--------|
| <u>Age of Fleet</u> | 6 yrs | 7 yrs | 6 yrs | 15 yrs | 19 yrs | 20 yrs | 37 yrs |
| <u>Change in Weekly Depts:</u> | +1006 | -984 | -370 | -1382 | -2030 | -6072 | -1128 |

There are a number of effective strategies for managing volatility, but short-term fixes are limited

◆ Cash Conservation

- Increased unrestricted cash holdings
- Manage contractual covenants and default triggers
- Manage credit card holdbacks
- Asset sales

◆ Financial and Commodity Hedges

- Fuel: *Swaps, Collars, Caps*
- Currency: *Derivative & Options, Point of Sale Hedge*
- Interest rates: *Options, Swaps, etc*

◆ Commercial/Operational Strategy

- Network
- Point of Sale
- Consolidation and alliances
- Operational improvements

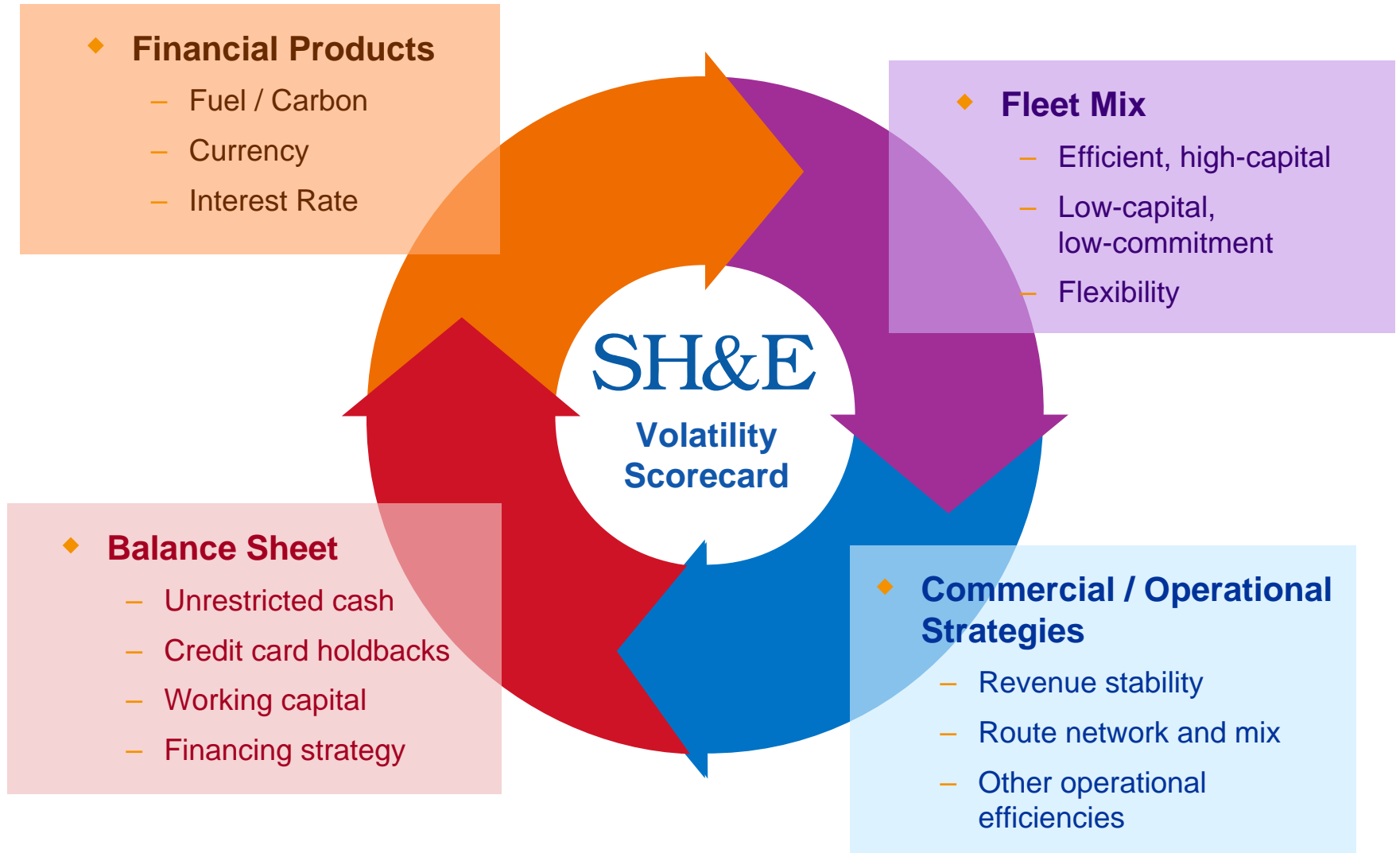
◆ Fleet Mix

- Lease vs. Own
- Old vs. New
- Adaptability & Flexibility

Airlines focused on maintaining unit revenue will be better positioned to withstand high variable costs and volatility

- ◆ **Importance of revenue management**
- ◆ **Sales and marketing strategies**
 - Dynamic market segment targeting
 - Point of sale strategy
- ◆ **Ancillary streams**
 - Charging for items that were historically free
 - Product enhancements
- ◆ **Fuel / Tax surcharges**
 - Mechanistic/Transparent or opportunistic?

Using a combination of operational and financial levers to manage volatility affords downside protection and upside benefits



Thank you for listening

For questions regarding this presentation, please contact:

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