CONSOLIDATION IN THE MARKETPLACE

The airline industry is consolidating at an accelerating pace. We are determined to be a leader in the restructuring of our industry. Our proposed merger with Iberia, and our planned joint business with American Airlines and Iberia are examples of how we are shaping our own destiny in a new era for international commercial aviation. These deals are not about getting bigger. They are about getting better, for the benefit of our customers.
Chief Executive’s statement
WILLIE WALSH

Chief Executive Officer (CEO), Willie Walsh, answers some of the questions most frequently asked by shareholders about our performance in 2009/10. He explains why we need radical change to create a secure and sustainable future for our business and why consolidation is so high on our agenda.
The economic downturn presented you with significant challenges to overcome and meant you obviously needed to cut costs. What actions did British Airways take?

The airline industry is facing three powerful challenges. The first is recession. What we have been living through in the last two years is the deepest downturn this industry has ever faced. The International Air Transport Association (IATA) is forecasting revenues for the industry as a whole will fall by 15 per cent or $85 billion in 2009 and it expects total losses to amount to $9.4 billion. Our own revenues have declined by 11 per cent or £1 billion and we have recorded losses for the second year running.

Traditionally, airlines have been quite good at cutting costs to counteract economic recession. But they tend to lose discipline when markets improve. That’s why our industry has lived through repeated cycles of boom and bust. In fact, in the last decade, airlines have enjoyed only two years of profitability. This in itself is not sustainable for a business like British Airways and we must change if we are to achieve the sort of returns our shareholders deserve.

The industry is now facing structural as well as cyclical change and this has increased the jeopardy we face.

The oil price has risen from an average of $48 to $83 a barrel. The fact that it’s done that during a recession tells you one thing and one thing alone – high oil prices are now a fact of life.

Secondly, we’ve seen what we think is a permanent shift in business travel, with corporations now no longer willing to pay premium prices for their staff to make short trips of under three hours.

Thirdly, access to financing – readily and cheaply available two years ago – has got much tighter in the wake of the banking crisis. We think it will stay that way for some time to come.

This adds up to the deepest crisis our industry has ever faced. We saw no option but to take swift action to counteract the downturn and to make long-term structural changes to match the permanent structural changes imposed on us. Our approach will not just equip us to deal with cyclical economic changes but will give us a more efficient base from which to achieve much higher levels of profitability when conditions improve.

You were very quick to call the downturn and to begin your cost drive. Some believe you were over pessimistic? Have you been over zealous?

We did call the recession before most people. And yes some people accused us of over-egg ing the pudding and, even, of talking down British Airways. The truth is we called it exactly as we saw it.

We began our cost drive in October 2008 with our decision to reduce our management staff by a third. Some people thought we were mad to move so fast and so far. But history has taught us that, because of our reliance on premium traffic, we would be among the first to feel the effect of recession and that we’d feel it very hard. We had to move quickly with our plans – making savings, raising over £700 million of new finance last summer, including £350 million through the convertible bond and £540 million (approximately £330 million) of bank guarantees released back to us from our pension Trustees – and matching our capacity to rapidly declining demand to make sure we survived.

It’s clear that we made the right judgement. I’m proud that we have demonstrated that we can face up to a crisis. But the fact that we’ve done it in a way that will bring long-term, permanent benefits to the business, is the real satisfaction.

Yet the results are still pretty bleak aren’t they?

Yes they are, despite a positive trend in the second half of the year. As Keith explains in the next chapter, these results are so much better than they would have been if we had just sat back and tried to ride the economic storm.

It’s a hard message to get across to our customers? running you are not able to pay a dividend, but our reduction in unit costs this year has actually been outstanding.

Achieving these results has been down to some fantastic work by people across the airline who have worked very hard and in much smarter ways. They’ve also made personal sacrifices – with nearly 7,000 applying to work part-time, take unpaid leave, or work without pay. It’s been a really fantastic effort.

You talk about British Airways making a cost driven recovery. What does this mean?

In the short term and with our revenues in such sharp decline, we’ve relied on the deep cuts we’ve made in our costs with savings of some £390 million, and a £597 million reduction in our fuel bill, to begin to turn round our performance.

You saw our underlying profitability improve in the third and fourth quarter because we moved extremely quickly to take cost out of the business – far faster in fact than most commentators thought possible. This is the first phase of our recovery and it has been down to costs.

But this is not just about one-off, emergency cost reductions. The changes we have made are long term. They are about improving the underlying efficiency of the business on a permanent basis. When our revenues recover – and they will – we will be in a position to access growth in a much more profitable way and that makes us very well placed for recovery.

There must be a limit to the cuts you can make without hurting customer service. Have you reached that limit?

The search for further efficiency has to continue and it will. Of course, it becomes harder as time goes on. But we are trying to instil a discipline into this business and it is all about looking for and building on our efficiency gains continuously, in good times as well as bad. We need to keep examining all the costs we control and asking if it is a cost that is genuinely bringing value to our customers?
Chief Executive's statement continued

When you look at cutting cost in this way it is a positive thing, because it is all about eliminating waste.

It’s not about cutting service. We have to keep delivering outstanding service at the same time to meet our customers’ rising expectations. Efficiency and outstanding service are the two main foundations of the global premium airline we are trying to build.

Q

So operationally, service remains a real focus for you?

A

Absolutely and I’m delighted that our punctuality performance scores continued to rise throughout the year and our customer service scores remained robust, despite the severe challenges we faced. Terminal 5 is playing a big role in that. It’s allowing us to provide customers with a completely new level of service in a highly efficient way. Those important gains have fed through elsewhere at Heathrow, Gatwick and across the entire network.

We’ve also continued with important strategic investments in our fleet. The £100 million programme to modernise our First cabin is now under way and feedback is excellent. Customers like the fact that we have given them what they wanted most – a more comfortable bed, more space, greater privacy and understated British style, rather than gadgets and gimmicks.

Our longhaul fleet replacement programme is fully financed up to 2013. The new Boeing 787 and Airbus A380 aircraft joining our fleet from 2012/13 will give us the scope to improve the in-flight experience for all our customers as well as offering important environmental benefits. On the ground we continue to invest in our terminals and lounges, drawing on the many lessons we have learnt at Terminal 5, which is a fantastic asset.

And we are continuing to come up with new ideas. It was a brave decision to launch a premium-only direct service from London City to New York in current market conditions. But this is a real piece of innovation, offering customers incredible comfort and convenience, and truly is one of the most exciting ventures we have done. Introduced in September, it’s been one of those quiet successes. Seat factors in the first three months averaged 70 per cent, hit 74 per cent in December, and 60 per cent for the six months to the end of March. Customers are urging us to expand. We may well add new destinations when the time is right.

At the beginning of the year we launched our BAcking Britain campaign to help British businesses beat the recession. Working with the UK Trade and Investment and British American Business, we offered £15 million of free flights to stimulate business travel and economic recovery. Across the North Atlantic, the Harvard Business Review found that face-to-face meetings are key to building long-term relationships. So, we created a Business Opportunities Grant which hundreds of US businessmen have benefited from to kick-start business.

We have also focused on a new premium leisure strategy and launched five new routes during the year, including Punta Cana in the Dominican Republic, the Maldives and Las Vegas, which has been a star performing route. We increased capacity to the Caribbean by 40 per cent and are now the biggest operator in the region.

In its first year of operation our OpenSkies subsidiary serving New York from Paris has also proved successful, for example establishing a 28 per cent share of the Paris/New York market and achieving good load factors and strengthening passenger yields. Services from Amsterdam to New York proved less successful and were ended during the year, but, given its otherwise robust performance, we’ve decided OpenSkies should remain a wholly-owned part of our business. A new service from Paris to Washington was launched on 3 May 2010.

Q

How do your plans for a merger with Iberia and to run a joint business with American Airlines and Iberia on North Atlantic routes fit with the strategy of permanent structural change?

A

Our planned merger with Iberia is a good deal both for customers and for the long-term sustainability of the business. By bringing together two complementary networks – one strongest on the North Atlantic and Asia, the other strongest in Latin America – we will be better placed to cover the globe from our respective hubs in London and Madrid. That means far greater choice and convenience for our customers. Together we believe we can also realise some €400 million in synergies from the fifth year.

We believe our approach leaves the door open for extending the venture in future. Bringing the two airlines together is not the end game. It’s the beginning of what we hope will be an exciting journey on the road to further consolidation.

We’ve waited a long time to win approval to operate a joint business across the North Atlantic with American Airlines and Iberia. We’ve had to be patient because we believe the synergies we can realise by pooling our resources on this highly competitive route will be good for customers, shareholders and the industry.
**Q** What happens to the British Airways brand if you merge with Iberia?

**A** We’ve structured the deal carefully to protect both the British Airways and Iberia brands. Both are very strong and have a particular resonance in the market. We saw our own brand rise up the Superbrands league last year from 30th to fourth place. That tells you how valuable our brand now is and we would be foolish to put that value at risk.

That’s why we’ve concentrated in our merger plans, on building one overarching economic entity known as International Airlines Group, sitting above two operating companies with their own distinct brands remaining in place, just as they are today.

A simple analogy for what we are proposing can be found in the hotel industry. Take the InterContinental Hotels Group (IHG), for example. IHG owns brands as diverse as Holiday Inn, Crown Plaza and InterContinental. People know exactly what to expect from each of these distinct brands. They know they are not the same hotels, yet they are owned, managed and operated by the same company.

You’ll see us take a similar path in our merger with Iberia and stay on that path if, at a later stage, we look to bring other brands into the venture. As the pace of consolidation picks up in the industry, we will need to become increasingly expert at the business of managing brands across the globe.

**Q** What is the latest position on the alleged price fixing between British Airways and Virgin Atlantic?

**A** In 2007, the Office of Fair Trading (OFT) had agreed that it would be prepared to resolve its investigations into alleged price fixing between British Airways and Virgin Atlantic under the Competition Act 1998 if certain conditions were met. Given the collapse of the criminal trial on 10 May 2010, the acquittal of the four defendants and in light of potential new evidence, we are considering whether the settlement offer made by the OFT, including the as yet unpaid fine of £121.5 million, remain appropriate.

**Q** The dispute with the Unite union over changes you have made to cabin crew working practices caused huge disruption for your customers. Why is it so hard to find a resolution?

**A** Firstly, we regret the disruption and uncertainty this dispute has caused to our customers. We did everything in our power to negotiate a settlement with Unite over the course of a year. Three times we successfully argued our case through the courts, first to stop a planned 12 day strike over Christmas and when our decision to introduce changes to cabin crew work arrangements in November was challenged.

When strikes were eventually called in March we drew up very thorough contingency plans. For the seven days of strikes, the airline operated 79 per cent of longhaul flights and 58 per cent shorthaul. Though some customers were understandably unhappy to face unnecessary disruption, many let me know that they understood our position and many urged us to see our planned changes through.

Secondly, I regret that we found ourselves at loggerheads with very valued members of staff at a critical time. When we have had the chance to explain our proposals directly, many...
understand what our agenda is really about: to secure jobs in the airline and put the business on a footing where it can achieve the growth it needs to survive long term. They understand that, without change, British Airways will just shrink and shrink and shrink. Because of the legacy structures we have in this business, we are increasingly unable to serve some popular destinations in our network, such as Sydney, profitably. We need profitable growth to make this business sustainable.

Q Some observers believe both sides were set on confrontation over this issue. Is that fair?

A I genuinely believe it is unfair to say we looked for confrontation. We negotiated these changes over the course of a year and tried repeatedly to answer concerns raised by our staff. There are very few, if any, FTSE CEOs who have spent as much time at the Trades Union Congress (TUC). I would not do that if I did not believe we could find a solution.

Our position is clear. We’ve done some excellent work with the unions over the years and we’re happy to work with them. But we can’t let them stand in the way of the progress that’s needed to make our airline’s future more secure.

Q You saw no merit in Unite’s own cost saving proposals?

A Their proposals – which included a substantial pay cut for our crews – would not have resulted in the savings they were claiming. The numbers didn’t add up. In fact, their plans would have sought pay cuts from Gatwick crew – who already work with reduced crew numbers – to pay for extra crew at Heathrow. That is wrong. Our own proposals – which involve no reduction in pay for existing staff and no compulsory redundancies – would save £62.5 million a year. They are fully and carefully costed. They do mean that people will have to work harder. But we know just how hard people are prepared to work to secure our future – they’ve shown it in every part of the business, in the air and on the ground, in the current downturn.

This is the true culture and spirit of British Airways. We want to make sure we use that spirit externally not internally – to compete against other airlines rather than amongst ourselves.

Q Have the difficulties of the last year forced you to rethink your commitments on corporate responsibility (CR)?

A Our commitment on these issues is all part of our long-term strategy to create a sustainable global business, as I hope this report and our separate CR report demonstrate. But the real test is in what we are doing, not just what we are saying.

This year our main priority has been managing change and making sure wherever possible we support our staff through that change. We’ve had to push through a very big redundancy programme – achieved entirely on a voluntary basis. By and large I think we have communicated the need for change well and responsibly and the majority of our staff have supported us in unbelievable ways. Of course, the dispute with Unite shows that we still have lessons to learn.

Q And on the environment?

A As Martin has made clear in his introductory remarks, we have continued to argue for an effective global emissions trading scheme that includes our industry. We have established an industry lead in emissions trading by taking part in the UK scheme and we know that it works. We are also pushing our industry to adopt a coherent set of carbon reduction targets, not least a commitment to halve (2005) carbon emissions by 2050 – a target we set ourselves in 2008.

We’re ready to invest in new ways to meet our targets. That’s why we are so excited about our venture with the US Energy group, Solena, to turn London’s rubbish into bio-kerosene at a new plant in East London, set to go on stream in 2014.

The process sounds like alchemy but in fact uses existing technology that is being combined for the first time. The projections are that this more environmentally friendly ‘drop in fuel’ which we can use without modifying our aircraft and engines, will be certified for use in an unblended form by the time it is produced in 2014. We have committed to buying the complete output of the plant, which, once at full tilt, will produce enough fuel to power more than twice our entire London City operation.

We’re delighted the project will also create 1,000 jobs during construction and 200 permanent posts at the new plant.

Q So is the business well set for the future?

A We think our market will recover, but recovery is likely to be gradual. The important thing is that we are ready for it.

We’ve genuinely changed the cost base of our business in a structural way. It’s not perfect yet and there’s more to do. I’m delighted we’ve been able to do that important work while maintaining a strong operational performance and delivering outstanding customer service.

The fact that we’ve done that should give all our stakeholders confidence that we can continue to do so in the future.

Willie Walsh Chief Executive