A COST DRIVEN RECOVERY LEADING TO LONG-TERM PROFITABLE GROWTH

With the recession and structural market change leading to a sharp decline in our revenues, we have responded quickly by making significant and permanent reductions in our cost base. We have gone further and faster than predicted. So far our recovery has been cost driven, but crucially, we now have a more efficient base from which to achieve higher levels of profitability in the future.
Chief Financial Officer’s statement

The financial performance of our business is linked to the general strength of the economies in the UK and across the world. We have had to cope with the deepest downturn in the global economy in 60 years.

With the recession and structural market change leading to a sharp decline in our revenues, we have responded quickly by making significant and permanent reductions in our cost base. We have gone further and faster than predicted. The result is that although still loss making, we have been able to stabilise the financial performance of the Company and have been able to beat most analyst expectations for the business.

So far, our recovery has been cost driven, but crucially, we now have a more efficient base from which to bring the business back to profitability as the economic recovery gathers pace.

The impact of the recession is being compounded by important structural changes to our business. The first is the impact of high oil prices which have increased our fuel cost to the point of being our single largest cost and, secondly, changes in shorthaul business travel have had some impact on our revenues.

The impact of the recession is being compounded by important structural changes to our business. The first is the impact of high oil prices which have increased our fuel cost to the point of being our single largest cost and, secondly, changes in shorthaul business travel have had some impact on our revenues.

The impact of the recession has been to reduce our revenue by 11.1 per cent to £7,994 million.

We anticipated the sharp decline in revenue and adapted our costs accordingly. As a consequence, we reported an operating loss which was almost flat year on year – a loss of £231 million including £85 million for restructuring the business.

As a result of increased interest and pension costs, our pre-tax loss increased from £401 million to £531 million.

Revenue decline

Passenger revenue for the year was down by £856 million, a decline of 10.9 per cent. The first half of the year saw the most dramatic decline in revenue, as premium revenues were affected by the sudden and severe drop in demand as a result of the changing economic outlook. Revenue started to recover in the second half of the year, as capacity was better matched to demand and yields started to recover.

We were quick to manage capacity to this greatly reduced demand, cutting overall flying by 4.9 per cent.

In responding to the extent of the downturn, particularly in the UK, we were quick to take advantage of the stronger euro to offer more seats for sale in European markets than was previously the case for this typically lower yielding traffic. As a result, our transfer volumes grew in the first half of the year, and then eased off again as the point-to-point business started to recover. This contributed to the strong seat factors reported all year.

Seat load factor – the percentage of seats actually filled – rose by 1.5 points, to 78.5 per cent. This compares very well with some of our main competitors who have reported significant declines in load factors.

Geographically, we saw the steepest decline in traffic on our Asian routes, while on the North Atlantic, a major part of our business, traffic held up remarkably well and showed promising signs of improvement towards the end of the year, which bodes well for our recovery.

Our cargo business, like our passenger business, experienced a sharp decline in the first half of the year but began to recover quite strongly as the year closed.

Global freight markets were impacted materially by the economic downturn, reaching a low point in early 2009, more than 20 per cent lower than the previous year. British Airways World Cargo (BAWC) volumes, measured in cargo tonne kilometres (CTKs), were down 8.1 per cent for the first half of the year. Since November 2009, both the market and British Airways have
seen a return to positive year on year growth, with overall volumes for the year down only 2.2 per cent against capacity, down 4.6 per cent.

Market reductions in capacity lagged and were lower than the demand reduction, impacting market yields by more than 20 per cent. Our cargo yield (revenue per CTK) averaged 16.5 per cent lower than the previous year, including the impact of lower fuel surcharges.

The overall load factor for the year was 73.3 per cent, up 1.3 points on last year.

Creating a competitive cost base
I want to be very clear about the action we have taken on costs during the year and assure you that we are very serious about identifying further efficiencies. We remain completely focused on creating a competitive cost base that will underpin our future performance, in good economic times and bad.

We benefited from two areas of radically reduced costs during the year. With oil prices still high but at lower levels than we saw the year before, our fuel bill was £597 million lower at £2.4 billion. At the same time, we were able to reduce our non-fuel costs by £390 million. A large proportion of that reduction was down to much lower employee costs which were down by 8.9 per cent or £195 million on the year at £1,998 million.

This reduction was achieved through a number of factors including improved productivity through permanent changes to working practices across the business and the imposition of a two year pay freeze for all our staff. Many of the changes in working practices were introduced in the second half of the year. For example, our decision to deploy one fewer cabin crew on our longhaul flights was only introduced in November 2009. These permanent structural changes are required to return our business to profitability.

Our manpower (MPE) has fallen by nearly 3,800 since March 2009 to 36,832. This reduction comes from productivity improvements and natural attrition combined with voluntary redundancy, decreased overtime, an increase in part-time working and unpaid leave.

In the short term, these savings – coupled with a near £600 million reduction in our fuel bill compared with 2008/09, when oil prices spiked to $146 a barrel – meant we could offset the sharp reduction in our revenues.

It’s been a cost driven recovery so far with some signs of revenue improvement towards the end of the year. This gives us some optimism for a return to profitability.

I hope you can see from the action we have taken how seriously we saw the need to reduce costs both in the short term and on a permanent basis. But the work must continue and the search for further cost savings will go on, as Willie has already made clear. Controllable costs are being put under the microscope continuously and pared back wherever we can be sure that our actions will not jeopardise efforts to provide outstanding customer service.

We also expect to see long-term cost benefits from consolidation. Our planned merger with Iberia and our proposed venture with American Airlines and Iberia to operate a joint business on North Atlantic routes should provide significant synergies, both in terms of savings and improved revenue.

We expect total synergies from the merger with Iberia to be in the region of €400 million annually by the fifth year.

Returning our business to profitability requires permanent structural change in our cost base. So far our recovery has been cost driven, but crucially, we now have a more efficient base from which to achieve higher levels of profitability in the future as economic improvement continues.

<table>
<thead>
<tr>
<th>Total revenue (£ million)</th>
<th>Fuel costs (£ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009/10: 7,994</td>
<td>2,372</td>
</tr>
<tr>
<td>2008/09: 8,992</td>
<td>2,969</td>
</tr>
<tr>
<td>2007/08*: 8,758</td>
<td>2,055</td>
</tr>
<tr>
<td>2006/07: 8,492</td>
<td>1,931</td>
</tr>
<tr>
<td>2005/06: 8,213</td>
<td>1,581</td>
</tr>
</tbody>
</table>

*Restated for the adoption of IFRIC 13 & 14
Chief Financial Officer’s statement continued

Operating expenditure

<table>
<thead>
<tr>
<th>£ million</th>
<th>2009/10</th>
<th>2008/09</th>
<th>Better / (worse)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee costs</td>
<td>1,998</td>
<td>2,193</td>
<td>8.9%</td>
</tr>
<tr>
<td>Restructuring</td>
<td>85</td>
<td>78</td>
<td>(9.0)%</td>
</tr>
<tr>
<td>Depreciation, amortisation and impairment</td>
<td>732</td>
<td>694</td>
<td>(5.5)%</td>
</tr>
<tr>
<td>Aircraft operating lease costs</td>
<td>69</td>
<td>73</td>
<td>5.5%</td>
</tr>
<tr>
<td>Fuel and oil costs</td>
<td>2,372</td>
<td>2,969</td>
<td>20.1%</td>
</tr>
<tr>
<td>Engineering and other aircraft costs</td>
<td>505</td>
<td>510</td>
<td>1.0%</td>
</tr>
<tr>
<td>Landing fees and en route charges</td>
<td>608</td>
<td>603</td>
<td>(0.8)%</td>
</tr>
<tr>
<td>Handling charges, catering and other operating costs</td>
<td>997</td>
<td>1,021</td>
<td>2.4%</td>
</tr>
<tr>
<td>Selling costs</td>
<td>290</td>
<td>369</td>
<td>21.4%</td>
</tr>
<tr>
<td>Currency differences</td>
<td>(2)</td>
<td>117</td>
<td>nm</td>
</tr>
<tr>
<td>Accommodation, ground equipment and IT costs</td>
<td>571</td>
<td>585</td>
<td>2.4%</td>
</tr>
<tr>
<td>Total Group expenditure on operations</td>
<td>8,225</td>
<td>9,212</td>
<td>10.7%</td>
</tr>
<tr>
<td>Total Group expenditure excluding fuel</td>
<td>5,853</td>
<td>6,243</td>
<td>6.2%</td>
</tr>
</tbody>
</table>

nm = not meaningful.

Pensions financing expense and retranslation expenses

Pensions financing expense was £116 million compared to £17 million in the prior year. This was mainly due to the fact that we saw a £160 million decrease in the return on assets and a £37 million charge for the amortisation of actuarial losses (mainly associated with the New Airways Pension Scheme (NAPS)). This is partially offset by lower interest costs of £30 million and an immediate recognition of an £85 million gain on the Airways Pension Scheme (APS) due to the effect of the asset ceiling.

The retranslation of currency borrowings generated a charge of £14 million, compared with a charge of £59 million the previous year, due to the weakening of sterling, offset by the de-designation of a portion of our yen debt.

Taxation

The analysis and explanation of tax on the result for the year is set out in note 11 to the financial statements.

Our total tax credit for the year was £106 million (2009: credit £43 million). The tax credit included a one-off deferred tax movement of £13 million credit arising from a change in foreign profits tax legislation which was enacted during the year, and there were adjustments relating to prior years giving rise to a credit of £9 million (2009: £10 million credit) and the effect of pension fund accounting of £45 million (2009: £5 million credit). Excluding these one-off items, the effective tax rate for the Group would have been 24 per cent.

Our deferred tax balance at 31 March 2010 was £774 million (2009: £652 million). The year on year movement was primarily related to the tax effect of the retranslation of foreign debt and the marked-to-market movement on fuel and currency hedges and pension funding temporary differences, offset by the reversal of fixed asset temporary differences and further trading losses, which can be utilised against future taxable profits of the Company.

The Group also contributes tax revenues through payment of transaction and payroll related taxes. The total amount of such taxes paid during the year was £636 million (2009: £632 million).

Earnings per share

A basic loss per share of 38.5 pence (2009: loss 32.6 pence) is attributable to shareholders.

Other reserves

Other reserves at 31 March 2010 were £692 million, an increase of £262 million from March 2009. This increase is primarily driven by the marked-to-market movement on fuel and cash flow hedges of £587 million offset by the loss for the year. The equity portion of the convertible bond raised in August 2009 adds a further £84 million to reserves.

Dividend

The Board has decided not to recommend the payment of a dividend.

Capital expenditure

Total capital expenditure in the year amounted to £567 million, down £145 million on last year.

We reduced our projected capital spend from £725 million in our financial plan to a target of £575 million for the year, but in the end spent even less than projected by cancelling some non-essential programmes and delaying others.
Capital expenditure

<table>
<thead>
<tr>
<th></th>
<th>2009/10</th>
<th>2008/09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fleet – aircraft, spares, modifications and refurbishments (net of refund of progress payments)</td>
<td>518</td>
<td>584</td>
</tr>
<tr>
<td>Property and equipment</td>
<td>36</td>
<td>67</td>
</tr>
<tr>
<td>Landing rights and other intangible assets</td>
<td>13</td>
<td>61</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>567</strong></td>
<td><strong>712</strong></td>
</tr>
</tbody>
</table>

Liquidity

Our liquidity position remains strong with £1.7 billion of cash at the end of the year. We raised an additional £350 million through a convertible bond issue in August 2009 to boost our reserves and make sure we had sufficient cash and capital to invest in continuing improvements in our business. At the same time the Trustees of our defined benefit schemes released bank guarantees of $540 million (approximately £330 million) to the airline. These can be drawn in cash at any time until June 2012. Note 24 to the financial statements provides detailed analysis and explanation of our cash flow position. Our capital expenditure commitments are outlined in note 15 to the financial statements.

Financial risk management

We are exposed to a variety of financial risks, including market risk, credit risk, capital risk and liquidity risk. Our overall risk management programme focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on our financial performance. This is covered in more detail in note 30 to the financial statements.

Going concern

Our business activities, performance, strategy and risks are set out in this report. The financial position of the Group, including cash flows, liquidity position and available committed facilities are discussed in this section, and further information is provided in notes 24 to 31 of the financial statements.
After making enquiries, our Directors have a reasonable expectation that our Company and the Group has adequate resources to continue operating for the foreseeable future. For this reason, the going concern basis has been adopted in preparing the accounts.

Outlook

Airlines map GDP. When recession hits, premium services tend to fall first and fastest. As recovery begins they also tend to be quickest to pick up. With our dependence on premium travel, this means we should see our own performance pick up ahead of some of our main competitors.

That’s been the pattern in the past and it’s likely to be repeated. The difference this time is that we will be going into recovery in much better shape than in the past, having tackled many of the legacy cost structures that have traditionally held this business back.

But the pace of general recovery remains hard to predict. We expect it to be slow and we remain vulnerable to the threat of a double-dip recession. The oil price presents us with another difficult risk although we remain comfortably hedged to ride further volatility should it return to the market.

There are other uncertainties that we must contend with too. As you know, much of northern Europe’s airspace was shut down for six days in April following the eruption of the volcano in Iceland. It’s pretty remarkable to think that the disruption caused by this event was far greater than that seen in the aftermath of the 9/11 attacks on New York. We estimate it to have cost us around £100 million.

Although we were pleased to work with the authorities, aerospace manufacturers and other airlines to reassess the restrictions airlines operate under when volcanic ash is present in the atmosphere, we cannot rule out further disruption in the months ahead.

It has been a difficult two years for the airline as we faced economic recession. We should see some significant recovery this year as the economy improves. 

Keith Williams Chief Financial Officer