The longest and deepest recession in living memory has meant we have had to move quickly to match our capacity to a rapid decline in demand. In February 2010 we saw the first upturn in demand for premium travel in 18 months. With recovery likely to be slow, we will continue to match our flying schedule to demand and to general economic activity as it picks up.
The markets we operate in

Whilst a number of major developed economies started to emerge from recession during the first half of our financial year, the UK lagged behind. It eventually endured six consecutive quarters of negative growth, amounting to the longest and deepest recession in living memory, before finally emerging from recession in the final three months of 2009. Momentum appears to have been maintained in early 2010, discounting the impact of the severe winter weather we suffered in January.

MARKET OVERVIEW

The global economic and financial crisis coupled with continued high fuel prices has accelerated consolidation in the airline industry. Many passenger and cargo carriers have either gone bust or have been absorbed into other airlines and, overall, the global aviation market remains weak.

2009 saw the collapse of SkyEurope, Flyglobespan and the merger of Alitalia with Air One, for example. In Asia, JAL filed for bankruptcy protection.

In Europe, we have announced plans to merge with Iberia. Austrian Airlines, Brussels Airlines and bmi have all been taken over by Lufthansa. In the US, Northwest has merged with Delta and United Airlines and Continental Airlines have announced a merger to create the world’s largest airline.
Global premium air travel demand in key markets, calendar year 2009

<table>
<thead>
<tr>
<th>Premium demand</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>North Atlantic</td>
<td>-12.2%</td>
</tr>
<tr>
<td>Within Europe</td>
<td>-25.1%</td>
</tr>
<tr>
<td>Within Far East</td>
<td>-19.8%</td>
</tr>
<tr>
<td>Europe – Far East</td>
<td>-15.6%</td>
</tr>
<tr>
<td>Europe – Middle East</td>
<td>-5.9%</td>
</tr>
<tr>
<td>Total market</td>
<td>-15.8%</td>
</tr>
</tbody>
</table>

Source: IATA

The economic landscape

Whilst there are now clear causes for optimism for the UK economy, a number of persistent concerns remain and these may still delay a rebound in consumer confidence. Recovery in 2010 is, therefore, likely to be slow, although momentum may build in 2011.

The US returned to positive growth one quarter earlier than the UK, and we saw economic activity grow at an unprecedented rate in the final three months of 2009 — far faster and stronger than the rebound seen after the downturns of 1991 and 2001.

Emerging economies, and particularly those in East Asia, have also bounced back strongly on the back of a recovery in world trade, and massive government support for the Chinese economy. Improving domestic demand in these countries, driven by both consumer spending and business investment, should ensure the strong growth witnessed in China in recent years continues.

Rising sovereign debt levels, however, pose a new threat to global economic security. There are risks that the global financial crisis, from which we are now emerging, will evolve into a global fiscal crisis and that national deficits, which have ballooned during recession, may curtail future growth.

We are already seeing the start of the fiscal claw back in the UK, and growth has become sufficiently strong in a number of economies for monetary policy to begin returning to normal. But worries about national debt have been exacerbated by recent developments in Dubai and Greece. The latter’s problems have exposed the fiscal frailties of some other European countries, depressing the outlook for the Eurozone despite its encouraging exit from recession in the second half of 2009.

Impact on our industry

Demand for global premium travel finally returned to year on year growth in December 2009, some three months behind an upturn in general global economic activity. It was the first such increase in 18 months.

Regionally, demand is picking up at very different rates, however, reflecting the differing pace of economic recovery in major economies. Emerging markets have seen the strongest rebound in growth. The Far East and Middle East markets are now performing well, whilst the North Atlantic market has come very close to recording growth. But premium demand within Europe remains depressed, thanks both to recession and significant structural changes in the airline sector.

Corporate responsibility

While recession is the overriding concern for most customers, the environment and corporate responsibility remain very important issues to them. It is clear from research that those companies with a clear and open commitment to behave responsibly and to manage their environmental impact have a far greater chance of building a trusted relationship with their customers.

Competition

In response to the worsening economic conditions, the airline industry is in the process of change in a number of areas.

Consolidation

The global economic and financial crisis coupled with continued high fuel prices, has accelerated consolidation in the airline industry. Many passenger and cargo carriers have either gone bust or have been absorbed into other airlines and, overall, the global aviation market remains weak.

2009 saw the collapse of SkyEurope, Flyglobespan and the merger of Alitalia with Air One, for example. In Asia, JAL filed for bankruptcy protection.

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Increased competition

Most of the markets in which we operate are highly competitive. Levels of competition vary, route by route.
The markets we operate in continued

In April 2009 we completed our third application to EU and US competition authorities to operate a joint business on North Atlantic routes with our one world alliance partners, American Airlines and Iberia.

We are seeking the same anti-trust immunity to run this business as is already enjoyed by our major competitors. Their respective alliances, Star and Skyteam, are already allowed to coordinate schedules and offer customers a wide range of benefits and valuable services. Other recent regulatory changes have made these routes, and Heathrow in particular, far more competitive than in the past and we have argued that the move would bring real benefits and choice to customers.

We received tentative approval for our joint business agreement from the US Department of Transportation (DOT) in February 2010 and we hope to receive final approval shortly. We have tabled commitments to the European Commission to address competition concerns expressed in its Statement of Objections of September 2009. The commitments include making daily take-off and landing slot pairs available at Heathrow, Gatwick and/or New York JFK to allow other operators to compete with us on transatlantic routes.

On a few international routes competition remains limited, with restrictions placed on the number of flights that can be operated and regulations governing the fares that can be charged. At the other extreme there is a free market for flights within Europe, allowing any European airline to operate any route it chooses and to set its own fares.

In an effort to protect their airlines from the effects of the financial crisis and global recession, some governments have regretfully resorted to bailout programmes. This has been particularly true in a number of major emerging markets, most notably in China and India.

Shorthaul market
On shorthaul routes, we face competition in the air and on the ground. Train operators in the UK are taking a bigger share of the air/rail travel markets now that infrastructure improvements have cut journey times on key lines such as the West Coast mainline. Eurostar, despite being severely disrupted by snow and freezing weather in January, continues to grow and carried 1.2 per cent more passengers in 2009, at a time when demand for flights from London to Brussels and to Paris fell by 14 per cent and 3 per cent, respectively.

‘No frills’ airlines are continuing to grow, but have switched their priorities to growth at continental airports. While seat capacity in London fell by 8 per cent for full service airlines during 2009, the ‘no frills’ carriers cut their seats on London routes by just 3 per cent. Competition among these ‘no frills’ carriers at Gatwick is also expected to intensify.

Longhaul market
Deregulation has had a significant impact on our longhaul business. The first phase of the EU-US Open Skies agreement, which took effect in summer 2008, has altered the competitive landscape on transatlantic routes, especially at Heathrow.

US carriers Delta, Continental and US Airways have all commenced new services from Heathrow and in 2009 offered a total of 102 services per week. New entrants and existing carriers from the Middle East, Africa and India have also added capacity at Heathrow. Our own OpenSkies subsidiary now operates direct services to the US from Paris.

Other important markets are also being liberalised. The EU recently signed an ‘open skies’ deal with Canada. Similar agreements are expected to follow with other like-minded countries such...
as Australia, New Zealand and Brazil in the coming years.

A new generation of wide-body aircraft is also changing the competitive landscape. The Airbus A380 is now well established at Heathrow, with three airlines offering a total of 28 departures a week during 2009 and additional services confirmed for 2010.

**Regulatory controls**

The airline industry is highly regulated. Almost everything we do – from the routes we fly, to the business partners we cooperate with, the airport slots we use, the fares we set, the infrastructure costs we pay, safety, security and the way we manage our environmental impact – governed or influenced by a web of tight regulations.

There were a number of important regulatory developments during the year that will have a major impact on the industry in general and on our own long-term strategy.

**Liberalisation**

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On 10 March 2010, the European Commission invited comments from interested parties on these proposals. If they confirm that these provide a suitable remedy for any competition concerns, the European Commission is expected to make the commitments legally binding on the parties and close its investigation into the alliance.

**EU-US second stage talks**

The EU and US reached agreement in Brussels in March on a draft second stage Air Transport Agreement. This will be taken to the EU Council of Ministers in June for final agreement. No progress was made on any immediate lifting of ownership and control restrictions (O&C) by the US. Instead, both sides have committed to continued negotiations aimed at removing market access barriers in the future. Both sides will be incentivised to change their laws in respect of Noise (in the case of the EU) and on O&C (in the case of the US), and will be granted additional rights when they do so. The suspension clause or ‘clawback’ that was due to trigger in November 2010 if there was no progress on O&C, has been replaced by a ‘freeze’ provision that will allow the EU to freeze growth if there is insufficient progress on O&C in the future. Some progress was made on ‘Fly America’, with the US agreeing to give EU carriers access to US government ‘contractor’ traffic, excluding defence/military traffic.

**UK airports**

The UK DOT and the Civil Aviation Authority (CAA) are conducting
consultations on a revised framework for the regulation of UK airports. It is too early to know what the ultimate shape of the new framework will be or the impact it will have on our business. We are contributing actively to the consultations, arguing that regulation should prevent abuse by monopoly airport service providers and offer incentives to airport operators that improve their performance and efficiency.

In October 2009, BAA sold Gatwick airport to Global Infrastructure Partners. The sale of Stansted airport is on hold, awaiting legal challenges to the Competition Commission’s report that called for the airport to be sold.

Capacity constraints at Heathrow mean it has fallen behind competing European airports in recent years, threatening its position as one of the world’s leading airports. The UK Government announced in 2009 that it was in favour of developing a third, short runway at Heathrow, subject to tight environmental conditions being met in terms of noise, emissions and air quality.

As expected, the new Conservative/Liberal Democrat coalition Government has confirmed that it will not support a planning application for a third Heathrow runway and has also ruled out approval of new runways at Gatwick or Stansted.

Environment
All airlines have to meet a comprehensive range of local, national and international environmental regulations. Our approach to these is to comply with all regulations as an absolute minimum, and to exceed them in a number of key areas. For example, our target to halve our 2005 net CO₂ emissions by 2050 leads the industry in commitment to reducing our carbon emissions.

Safety and security
Safety and security are key priorities for us. We have a formal safety management system in place to ensure that we comply with all relevant regulations. We operate a comprehensive monitoring system to ensure all incidents are reported and necessary action taken. From the start of 2009, all IATA member airlines have been required to pass an International Operational Safety Audit (IOSA). We have held IOSA accreditation since October 2007.

Governments across the world have introduced a range of security measures to combat the threat of terrorism and control illegal immigration. We continue to engage with the European Commission, the UK and other governments to make sure that these measures are effective while causing the minimum possible inconvenience to our customers.

Our security department works within the wider international security framework to ensure that any threats to our business are minimised and to protect our customers, worldwide assets, operations and staff.