AIR CARGO SECURITY POLICY NEWSLETTER

Aviation Updates

May 10, 2012

Just three weeks before Berlin's shiny new international airport was scheduled to open, officials have called it off, citing problems with fire safety equipment. No new date has been set but the German capital's mayor has said it could be as late as the second half of August.

Der Spiegel international also reports that Lufthansa CEO Christoph Franz has surprised employees in recent days with radical plans for cost-cutting at the German national airline. He wants to combine the airline's low-cost subsidiary Germanwings and large portions of its European flights. The move is intended to reduce costs, but not necessarily fares.

Boeing and Airbus suffered major order cancellations last month, with airlines dropping 25 787 Dreamliners and seven A350s, according to data released by the aircraft manufacturers.

The Center for Aviation[1] (CAPA) an organisation delivering market analysis, data and information services to support strategic planning recently produced a report entitled "*Etihad Airways gets*

[1] http://www.centreforaviation.com/

springboard into Northern Europe with 2.9% stake in Aer Lingus"

The United Kingdom is emerging as an end-game country for the Middle East triumvirate: **Emirates** has firmly planted itself across the country, **Qatar** Airways is cosying up to British Airways and **Etihad** Airways' 2.9% stake in Aer Lingus has the potential to give it a springboard into the UK, codesharing on Aer Lingus' wide Ireland-UK network..

Air Scoop[2] , a consultancy reporting on low cost Eu airlines, has updated its initial 2011 report on Ryanair's business model. The goal was to establish a comprehensive report on the most disruptive low-cost airline on the market to serve as reference for future years. It provides a brief, compelling, overview of Ryanair's business model, as well as highlight new elements and evolution in the carrier's development.

DELTA AIR LINES is getting into the oil-refining business. On April 30th, the company announced that a subsidiary, Monroe Energy LLC, would acquire the Trainer refinery complex near Philadelphia. The state of Pennsylvania is providing $30m in assistance (basically in exchange for saving the jobs at the refinery), and Monroe plans to pour some $100m into retooling the complex to "maximise jet fuel production", according to a Delta press release. The newsletter provides a link to an *Economist* blog article

[2] http://www.air-scoop.com/

Opening of Berlin's new airport delayed

As reported in Der Spiegel International

For months, Berlin has been looking forward to the opening of the German capital's new airport on June 3. Finally, the city was going to have the kind of efficient, modern airport it deserved.

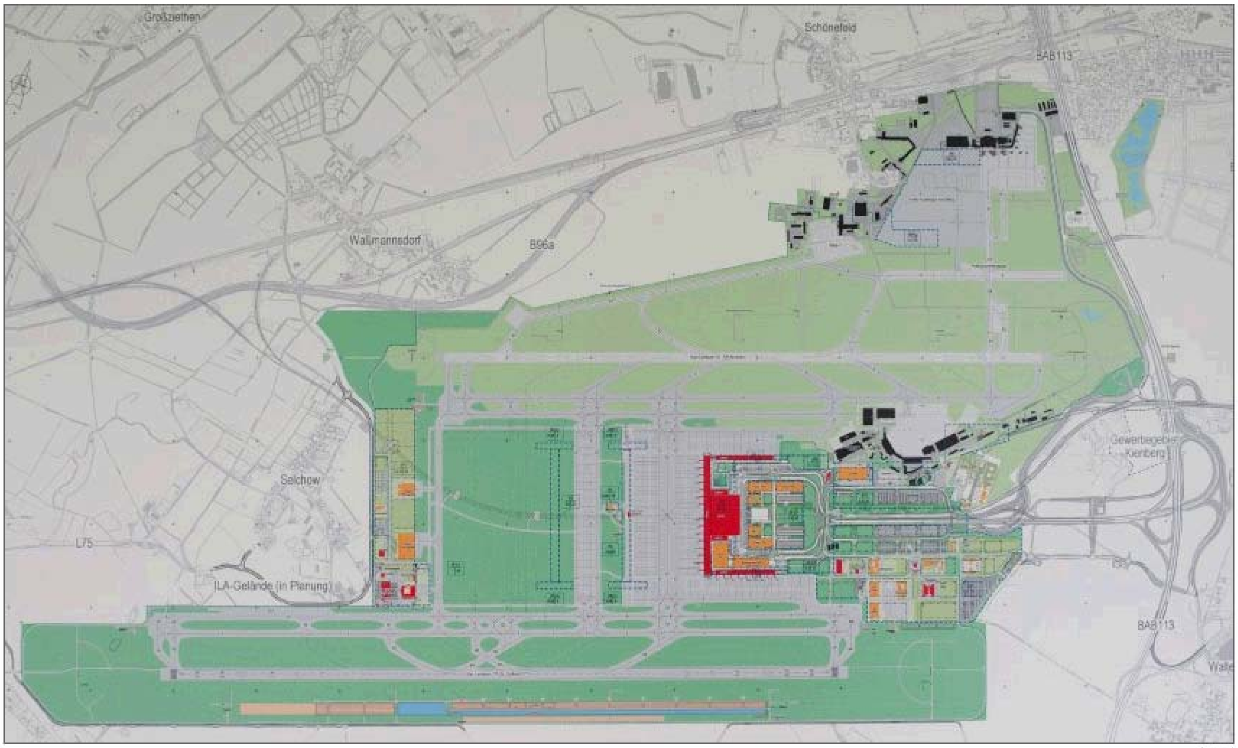
Just three weeks before the first planes were scheduled to take off, airport operators announced that the opening would be delayed due to fire safety problems. Airport head Rainer Schwarz said that a new opening date would be identified "after the summer break."

"This was more than a nasty surprise," said Matthias Platzeck, governor of the state of Brandenburg which surrounds Berlin. "I am not concealing that I am livid. Such a surprise is simply unacceptable so close to the opening." Platzeck has demanded that airport operators set a new date by next Monday, with Berlin Mayor Klaus Wowereit saying that the airport wouldn't be ready until August.

The €2.5 billion airport, known as Berlin-Brandenburg Airport Willy Brandt (BER), was originally set to open last November near the site of the much smaller Berlin Schönefeld airport.

It will replace Schönefeld and Tegel, which are due to close the night before it starts operations. Berlin's third airport, Tempelhof, was closed in 2008. Tempelhof and Tegel were integral to the success of the Berlin Airlift, which broke the Soviet blockade of Berlin in the late 1940s.

Both Schönefeld and Tegel are to remain open until the new airport is ready and the effects of the delay on air passengers are expected to be minimal.



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The Berlin-Brandenburg Airport, which if formally named after former German Chancellor Willy Brandt, will replace the German capital's two smaller airports, Tegel and Schönefeld. A third airport, Templehof, closed in 2008. This map shows the plans for the new international airport.

Tuesday's announcement is particularly surprising after the airport said just two weeks ago that the fire safety equipment was on track to secure approval. But Schwarz said on Tuesday that the facilities had not yet been able to pass the necessary tests. Airlines that fly out of Berlin now face a logistical nightmare. Air Berlin head Hartmut Mehdorn said that the delay would result in "incalculable extra costs" for his airline.

"It is not a good day for airport Berlin-Brandenburg and not a good day for our citizens and the many visitors to our region," Wowereit told a press conference. The Berlin mayor added that the delay would push airport financing "to its limits."

The airport ultimately aims to compete with the country's two largest international hubs in Frankfurt and Munich. Berlin-Brandenburg hopes to ultimately handle some 45 million passengers a year. At the moment, 24 million people pass through the two smaller airports.

The full article can be accessed at:

http://www.spiegel.de/international/germany/opening-of-new-berlin-international-airport-delayed-a-832104.html

Europe's Largest Airline Flies the Budget Route

Reported by Dinah Deckstein, Der Spiegel

Last week's issue of the Lufthansa employee newsletter will likely be spared the usual … fate. Under the headline "Good news - bad news," Lufthansa Chairman and CEO Christoph Franz explains in detail, for the first time, why he intends to save €1.5 billion ($1.95 billion) in the next two years and cut one in five administrative jobs.

"Our sales have doubled in the last 10 years," Franz informs his employees. But unfortunately, he adds, profits "have not kept abreast." This has to change, Franz explains, so that the company can pay for 170 aircraft it has ordered without having to take on more debt.

The 'Scare' Program

Whether Franz's explanation will be enough to reassure Lufthansa's anxious employees remains to be seen. New details about the "SCORE" efficiency enhancement program, introduced at the beginning of the year, have been leaked to the public every week. Some rumors, like the elimination of 2,500 jobs in Germany, have already been confirmed. Others, such as speculation over the establishment of a new discount carrier, have turned out to be wrong. In internal Internet forums, the efficiency program is already being referred to as the "Scare" program.

Although this may be somewhat exaggerated, Lufthansa employees do have reason to be concerned.

Until several days ago, it almost seemed as if the company had cleverly concocted the uproar over the cost-cutting program to adopt a threatening position ahead of wage negotiations for cabin employees and pilots. But since last week, when Lufthansa released its financial figures for the quarter ending in March and was forced to announce a loss of almost €400 million, it has been clear to even the last skeptics that Europe's largest airline is in serious trouble.

Under Franz's predecessor Wolfgang Mayrhuber, who was supposed to assume the chairmanship of the supervisory board in about a year, the company had sought to enhance its appeal to premium customers in First and Business Class, and had even built new, exclusive luxury lounges for them -- albeit without much success. In fact, frequent fliers have given the German airline low marks for service and comfort on board its aircraft.

A Decade of Mistakes

At the same time, Lufthansa also acquired substantial interests in Brussels Airlines, the successor to defunct Belgian flag carrier Sabena, AUA, the parent company to ailing Austrian Airlines, and the traditional British carrier BMI. After the Alitalia bankruptcy, Lufthansa also tried to gain a foothold in Italy. But most of the airline's new investments proved to be mistakes.

The upgrades to its services and the investments abroad cost the company a great deal of money -- money that would probably have been better spent to buy new, more fuel-efficient aircraft. "The fact that we have not modernized our fleet in a timely manner is an obvious mistake on the part of management," says Stefan Ziegler, the chairman of the group that represents all flight personnel.

Now everything has to happen very quickly -- too quickly, in fact, for many labor *representatives. "Mistakes that were made in the last 10 years," says Ziegler, also a member of the Lufthansa supervisory board, "can't be fixed within two to three years."*

Still, Franz and his team want to try. The plans to combine decentralized European flights with low-cost subsidiary Germanwings are apparently relatively far along, according to a confidential 12-page presentation.

The presentation, titled "Further Development of Decentralized Traffic," sounds harmless enough. Nevertheless, employee representatives see the document, studded with abbreviations and insider terminology, as a declaration of war.

Restructuring of Business Outside Frankfurt and Munich

The concept, which was presented to the representatives of flight personnel for the first time last Friday, explains in detail how the company intends to make its business beyond the Frankfurt and Munich hubs profitable, which appears to be urgently necessary. According to one set of figures in the presentation, subsidiary Germanwings has only turned a profit once since 2005 -- all of €18 million in the 2009 fiscal year.

The situation is apparently even more serious for Lufthansa's decentralized European business, which hasn't been in the black since 2005. Instead, both 2009 and 2010 saw losses totaling more than €200 million, attributable in part to the regional subsidiary Eurowings.

Lufthansa management now wants to rename Germanwings and call it Direct4U. In addition to its existing fleet, the airline would add several dozen short- and medium-range Lufthansa aircraft from other units.

In the future, the new company's planes would only bounce back and forth, like ping pong balls, between their respective origin and destination cities -- a model demonstrated by discount icon Ryanair for years -- and would divide up flights to cities like Berlin, Stuttgart and Hamburg. The refurbished Lufthansa subsidiary would be allowed to purchase services such as ground handling on the open market in the future, a sacrilege in the company's 57-year history. It is still unclear how many jobs could be eliminated as a result.

Other proposals in the detailed plan seem similarly sacrilegious. The new, internally developed low-cost platform is also expected to assume responsibility for long-haul flights in Düsseldorf in the future. Lufthansa has already had to cancel a planned route from that city to Tokyo until further notice, due to a lack of demand.

The goal of this and other measures is to reduce losses by €50 million a year starting in 2012 and, as of 2015, to finally generate a profit on domestic routes in Germany and on decentralized European routes. However, this is premised on the price of crude oil falling by almost 16 percent by then, a highly optimistic assumption.

Skodas at Volkswagen Prices

Although the costs of the new shared company are to remain at the current, lower level of costs at Germanwings, management hopes to continue charging passengers the same prices they have paid for classic Lufthansa services until now. "It's as if you were to sell a customer a VW at the price of a VW, but with the interior of a Skoda," employee representative Ziegler, who is also a Lufthansa pilot, said when contacted by

SPIEGEL, referring to vehicles made by VW's lower-cost Czech subsidiary.

A company spokesman says that the plans are "nothing but a concept at this point," and that the executive and supervisory boards have not reached any concrete decisions on the matter yet.

Stiill, that is unlikely to allay the fears of employees, especially after it was leaked late last week that several hundred jobs could also be lost at Lufthansa Technik, the company's engineering division.

Nevertheless, the Lufthansa CEO tried to reassure his employees in the newsletter. Lufthansa, Franz wrote, is still "in a position of strength" and has a solid "financial foundation." For this reason, he added, Lufthansa has not had to take any action out of necessity so far.

Many employees will likely have gained a different impression in recent weeks.

Translated from the German by Christopher Sultan and downloadable from:

http://www.spiegel.de/international/europe/restructuring-plans-further-along-than-thought-for-german-airline-lufthansa-a-832089.html

Boeing and Airbus suffer cancellations

PARIS (AFP) – Boeing and Airbus suffered major order cancellations last month, with airlines dropping 25 787 Dreamliners and seven A350s, according to data released by the aircraft manufacturers.

With 25 cancellations of 787 Dreamliners, against 19 orders so far this year, Boeing is in negative territory for its flagship aircraft built with composite materials that it says will use 20 percent less fuel than similarly sized aircraft.

A Boeing spokeswoman said China Eastern Airlines had Shanghai Airlines switched orders of 24 787 Dreamliners for 45 737-88 aircraft. The switch means $800 million less for Boeing at list prices.

A VIP client also canceled an order for a 787 Dreamliner, said Boeing spokeswoman Jennifer Cram, leaving total orders for the aircraft at 854.

For its European counterpart, the cancellation of seven A350-1000 aircraft by Abu Dhabi-based Etihad Airways represented a loss of $2.2 billion at catalogue prices.

The Emirati airline canceled six other A350-1000 aircraft late last year. Airbus said the airline was going through with 12 of the 25 planes it ordered in 2008.

Airbus also declined to comment on the order figures for the A350- 1000, a new aircraft it began assembling last month which also includes many composite materials.

The first A350s are due to be delivered in 2014.

Boeing retained a large advance over Airbus in terms of orders received this year. Boeing's orders stood at 415 on May 1 against 95 for Airbus on April 31

Etihad Airways gets springboard into Northern Europe with 2.9% stake in Aer Lingus

”For some months reports, subsequently denied, indicated Etihad was interested in Aer Lingus. But over the past few months Bank of America and Merrill Lynch, on behalf of Etihad, bought 2.987% of Aer Lingus, according to the Irish Times. That specific amount was just below the 3% holding that would necessitate a stock disclosure. The 2.987% stake represents 11 million shares, which based on recent market prices gives Etihad’s investment a price tag of approximately EUR11 million.

While Etihad is coy about increasing its stake – both the Irish government, holding 25%, and Ryanair, holding 30%, say their stakes are up for sale – it was also coy after its initial stake in airberlin, which it increased in Dec-2011.

Etihad CEO James Hogan stated early in the year that the carrier is interested in the Irish Government’s stake, which the government intends to sell “at the right price and at the right time” according to Transport Minister, Leo Varadkar. The government has set a minimum price of EUR1 per share for the 134 million shares it controls.

Ryanair has accumulated its Aer Lingus stake in the hope of taking control of the carrier, but has been stymied twice by the European authorities on competition grounds. Ryanair CEO Micheal O’Leary has ruled out making a third bid for the carrier or acquiring the government’s share. Following Etihad’s stake Mr O’Leary gave an initial typical caustic response, saying an Etihad purchase of Aer Lingus would see it be broken up. Mr O’Leary then got down to business and said Ryanair would “welcome” the buyer of the government’s stake to also acquire Ryanair’s stake.

Etihad and Aer Lingus are now discussing codeshares. Etihad does not intend to increase its stake in the airline until such talks are completed. The carriers may look at opportunities to further increase revenue or control costs; Etihad and airberlin will conduct joint 787 pilot training and leverage their scale for joint-procurement – a potential boon to the struggling Aer Lingus, which is pursuing a cost reduction plan.

Etihad said that the share purchase "reflected its desire to forge a commercial partnership with the Irish national carrier", which could produce "significant commercial benefits for both airlines". Etihad recently ended its three-year codeshare relationship with Aer Arann, after the carrier moved its network to be under the Aer Lingus regional franchise operation.

Aer Lingus network gives access to Ireland, UK

Whereas the Etihad-airberlin deal gave Etihad access to the German domestic market – one of the largest in Europe – in face of bilateral restrictions, Ireland is open and does not have a large local market to offer Etihad. Etihad can gain significant and short-term benefits without acquiring a majority share of the carrier. First Etihad and Aer Lingus can initiate codeshares with Etihad placing its code on Aer Lingus’ short-haul network and Aer Lingus’ code on Etihad’s long-haul services. While Aer Lingus *is on the periphery of western Europe and any European connections would require backtracking over Dublin, this is not unfamiliar territory to Etihad.*

The Etihad-airberlin partnership sees Etihad codeshare on a number of airberlin destinations, some geographically convenient with minimum extra travelling distance – like Hamburg – while others involve backtracking. Active airberlin codeshares include Rome, which when served from Abu Dhabi via Dusseldorf has a 42% longer journey distance than a direct service from Abu Dhabi to Rome. Yet a Birmingham-Abu Dhabi routing via Aer Lingus' Dublin hub would only be 11% longer than flying direct from Birmingham to Abu Dhabi. Scottish destinations become more geographically convenient to route through Dublin; Edinburgh to Abu Dhabi via Dublin is only 8% longer than a direct service".

This CAPA article can be accessed at:

http://www.centreforaviation.com/analysis/etihad-airways-gets-springboard-into-northern-europe-with-29-stake-in-aer-lingus-72899

Ryanair's Business Strategy

The base price of a Ryanair ticket obeys a quite simple structure, although it may evolve through complex price-optimisation processes in order to maximise plane filling and passenger revenues. Contrary to traditional carriers and major legacy airlines, the Irish low-cost company has opted for a rather simple fare system.

The traditional pricing system means that "fundamentally, each flight must be paid for by exactly one fare, but a single fare may pay for more than one flight. Multiple fares may be combined to pay for all the flights in a journey. The airline industry uses the term fare component (FC) to refer to a fare and the flights it pays for (covers)"[1]. Fare components can be combined in six different geometric figures (ranging from direct trip to elaborate circle trip), any combination of one to four fare components qualifies as a "Priceable Unit" (PU). A ticket can be built from any number of priceable units to form a coherent sellable trip. Some more restrictions may apply such as rules indicating that there "must be a Saturday night between departure of first flight in first fare component of priceable unit and departure of first flight and last fare component"

This results in an incredibly complex faring system in the traditional airline industry and low transparency for customers.

Many low-cost carriers use a different pricing system. Because companies such as Ryanair rely on a point-to-point rather than a hub-and-spoke system, they cannot offer similarly connected flights. Ryanair has decided to turn this into an advantage and offer simply-priced "point A to point B" tickets, avoiding the hassle of elaborating complex ticket structures and allowing the company to deny any responsibility in a missed connection while having the opportunity to intensively utilise aircraft and crews.

In fact, low-cost carriers' pricing policies stand in stark contrast against that of legacy carriers' for many more reasons:

- They offer only a single-class and no free "bonus" amenities to regular passengers, letting price be the sole decision-making factor for customers
- They usually sell one-way trip tickets, forcing their customers to buy the return ticket separately (allowing for maximisation of fees paid)
- They do not offer last-minute deal but rather coerce their customers into buying a long time in advance to get the cheapest deals

Inflating prices through taxes and fees

Because of these differences in philosophy, low-cost carriers have a fare-breakdown completely antagonistic to that of legacy carriers. Ryanair in particular seems to be striving for the most barebone ticket construction possible. Looking at this, it is actually not so surprising that many refer to the company as the "bus of the sky"[3]; Ryanair actually wants to become the airborne equivalent of a bus.

But anything rare comes with a price – even when that something is purportedly cheap – and for Ryanair to cover up for what it is not making in revenue, the company has to generate the maximum expenses from its customers. It manages to do it by two main means: miscellaneous fees and charges on tickets and ancillary services.

Though the distinction may seem purely artificial – as the many fees and charges can be understood as "ancillary" – the company relies on it in its accounting. Looking at a Ryanair ticket, it quickly appears that, beyond the advertised fare, lay a large number of miscellaneous charges and fees, often added at the last minute, sometimes avoidable (for a small number of customers) or just representing what customers would expect to see included in a traditional carrier fare. These additional charges and fees can be represented as a succession of circles surrounding the advertised fare, each one further from the centre as the expenses it covers become more avoidable.

These four strata of charges form a complex web of rules destined to maximise passenger expenses by exposing them to numerous rules and taxes very hard to avoid. They can be understood according to different characteristics:

- **1° Variable amount fare:** corresponds to the base fare Ryanair charges, and advertises, for a single trip
- **2° Additional compulsory charges:** are charges related directly to the ticket or the act of travel that cannot be avoided by travellers except in the case of an exceptional rebate or promotional offer
- **3° Non-compulsory ticket related services:** are charges and expenses that most passengers will not avoid, because they are directly linked with and often part of the process of buying the ticket
- **4° Ticket-related fees:** are the penalties that passengers expose themselves to when failing to abide exactly to the – complex – rules of ticket buying with Ryanair.

The full Air Scoop report can be accessed at:

http://www.air-scoop.com/pdf/Ryanair-business-model_Air-Scoop_2011.pdf

Delta Buys an Oil Refinery

The Economist Gulliver Travel blog reports:

> "DELTA AIR LINES is getting into the oil-refining business. On April 30th, the company announced that a subsidiary, Monroe Energy LLC, would acquire the Trainer refinery complex near Philadelphia. The state of Pennsylvania is providing $30m in assistance (basically in exchange for saving the jobs at the refinery), and Monroe plans to pour some $100m into retooling the complex to "maximise jet fuel production", according to a Delta press release.[3] Here's more from the airline:
>
> *"Acquiring the Trainer refinery is an innovative approach to managing our largest expense," said Richard Anderson, Delta's chief executive officer. "This modest investment, the equivalent of the list price of a new widebody aircraft, will allow Delta to reduce its fuel expense by $300 million annually and ensure jet fuel availability in the Northeast. This strategy is aligned with the moves we have made to build a stronger airline for our shareholders, employees and customers."*
>
> Most of the coverage of this move has accepted Mr Anderson's pitch that this is a smart way for Delta to manage its fuel expenses. But if that's true, it's a "damning indictment of an American financial sector that... is supposed to be in the business of creating more elegant solutions to these kind of problems," argues S*late*'s Matthew Yglesias[4]. When you see the presumably sophisticated CEO of a huge public company claiming on conference calls with reporters that certain risks (in this case, the "jet crack spread", the difference between the cost of an unrefined barrel of crude and a barrel of jet fuel) are essentially impossible to hedge on the financial markets, something is wrong. Has Mr Anderson been poorly advised, or are the financial markets really not doing their job? Others are still confused:
>
> *What on earth makes Delta think that it can run a refinery more efficiently than someone who's fighting tooth and nail for business in the free market? If they can really do that, it's not a failure of Wall Street, it's a failure of capitalism. This whole deal sounds crazy.*
>
> Virginia Postrel[5], a libertarian-ish columnist for Bloomberg, agrees. "Vertical integration fools a lot of people," she says:
>
> *You might think that owning a refinery would at least protect the airline from price fluctuations. But, [Craig Pirrong, a finance professor and energy expert at the University of Houston] notes, crude oil prices affect the profits of airlines and oil refineries exactly the same way. When oil prices go up, their profits go down. Owning a refinery would simply magnify the effect. "If anything," he says, "it increases the risk exposure that has bedevilled the airline industry for years."*

The Economist post can be accessed at:

http://www.economist.com/blogs/gulliver/2012/05/delta-air-lines?fsrc=nlw|newe|5-9-2012|1697594|37835986|

[3] http://news.delta.com/index.php?s=43&item=1601

[4] http://www.slate.com/blogs/moneybox/2012/05/01/delta_buys_oil_refinery.html

[5] http://www.bloomberg.com/news/2012-04-19/delta-s-oil-refinery-plan-flies-against-economic-sense.html