BRITISH AIRWAYS

2nd QUARTER & INTERIM RESULTS 2002/2003

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Lord Marshall: Good morning, ladies and gentlemen. Thank you very much for joining us today. The pre-tax profits of £310 million for the half-year, including £245 million in the second quarter, are higher than most forecasts and clearly reflect the success so far of our Future Size and Shape business recovery programme launched back in February. This performance was due largely to cost reduction and business restructure measures, and you will be hearing more about these shortly.

This morning's format is the usual one. First, you will hear from John Rishton, our Chief Financial Officer, and then Rod Eddington, our Group Chief Executive. After that we will take your questions.

While we reported that year-on-year gains are impressive, we recognise that this year compares with the exceptionally poor results we had to report in 2001. The Board have decided that there will be no interim dividend, which I am sure comes as no surprise to you – perhaps some relief – as we might otherwise have decided. I shall leave John and Rod to take you through the numbers.

Our business restructure is fundamentally focused on re-establishing Heathrow as our sole global network hub, on recasting Gatwick as an origin and destination airport, serving its natural catchment areas and, on further consolidating UK regional activities. As you will hear, good progress has been made in these areas.

In the current period of consolidation on the Government's proposed new aviation policy, we have made it clear that our preferred option for London and the Southeast is the construction of another runway at Heathrow. Building on the success of Heathrow as a world-class gateway will sustain the United Kingdom air transport industry as a whole including the benefits for the regional airports.

A changing market and evolving customer demands have been met by us, I believe, with competitive response. On the shorthaul network, the full service BA product is now available at widely promoted low fares. Network-wide bargain fares can be sourced quickly and easily through the new Fare Explorer internet service. Our intercontinental premium products, including the new World Traveller Plus, are increasingly well received. There is always cause to recognise our people but, over the past difficult months, their fortitude and professionalism have been outstanding, and we are especially encouraged by their ready acceptance of the Future Size and Shape strategy and their intelligent response to its challenging requirements.

The global political and economic outlook remains uncertain but British Airways is now in better shape and, barring the effects of war in the Middle East or further terrorist incidents, we expect to be profitable for the full year. I shall hand over to John Rishton to take you through the results in detail.

John Rishton (Chief Financial Officer): Good morning. Let us start with the headline numbers.

Headline numbers

In the three months to 30 September, our second quarter pre-tax profits were £245 million, up £240 million on the previous year despite turnover being down 6.5%. For the half-year, our profit before tax was £310 million on turnover down 8.6%. At an operating level, the profit was £248 million in the quarter, up £176 million from last year. The operating margin was 11.8%, up 8.6 points and the best for six years. Operating profit for the half-year was £406 million, giving an operating margin of 9.8%, up 7.1 points compared with last year.

Cost savings exceed revenue decline …

The operating profit improvement from £176 million has, again, been driven by cost efficiencies. Cost reduction in the quarter was £323 million, reflecting actions in all major cost categories.

… and driven best margin for 6 years

In total, costs were down by more than 14% in the quarter, and this resulted in the best operating margin for six years.

Revenue stable

Turning now to revenue, this slide shows the percentage change in revenue compared with the prior year. As you can see, revenue in the last three quarters is down about 9% on capacity down 12% in terms of ASKs. This is in line with our forecast at Q1 and our revenue outlook for the year remains unchanged, that is revenue in the financial year will be down slightly compared with last year.

Yield per RPK

Looking at the yield side of the equation, this slide shows that the yield per RPK remains positive, up 1.2% although down from the Easter impacted growth in the first quarter.

Seat factor improving

Seat factors of 76.7% in the quarter were up 2.8% compared with last year, the third quarter of improving loads.

And yield per ASK steady

The increased load and yields combined to give a stable yield per ASK picture over the last three quarters, with growth at around 5.5%.

Q2 costs

In the second quarter, capacity was 8.7% lower than the year ago but costs were even lower, over 14% down. Despite capacity reduction, therefore, unit costs improved by 6.1%.

Net costs down 14%

The aggressive cost reduction actions reported in the last few quarters continued, with reductions again being achieved in all major cost categories. Employee costs were down 15% reflecting the ongoing manpower reductions. Rod will take you through more detail shortly. Substantial savings were also achieved in operational areas, selling and engineering. Fuel costs were down 32%, reflecting not only pricing and hedging savings but also volume reductions due to newer fleet and less flying. Even if I exclude the full fuel benefit costs, we are still down over 11% in the quarter.

Cost performance improving

This slide shows the history of total and unit costs compared with the previous year. As you can see, total net costs in blue have improved for the last six quarters. Unit costs in yellow have improved for the last three quarters despite substantial capacity reductions. I expect to see continued improvement in unit costs through the year but absolute reductions were slow as we start a cycle against last year’s strong performance.

Productivity improving

Productivity measured in terms of ATK per manpower equivalent has also improved, up 4.9% in the quarter despite the reduced capacity.

Liquidity increasing

Let me turn now to cash. Liquidity continues to improve. We have a near record cash balance of over £1.5 billion and committed undrawn facilities of a further £0.5 billion. Also, despite disposals, we still have realisable assets of about £2 billion, bringing our total liquidity position to about £4 billion.

Operating cash flow strong

Operating cash flow has been positive since 11 September 2001. In the second quarter, the business generated £364 million of cash and we were cash flow positive at the bottom line after taking into account interest, capital spend disposals and debt repayment. Total cash inflow before financing for the six months was £738 million, up £684 million on last year.

Capital expenditure down

Capital spend this year will be no more than £450 million, about half of last year's spend and about £1 billion less than two years ago. Next year's spend will be lower as we continue to benefit from a partial capex holiday. Remember, we have no wide-bodied deliveries, in fact no wide-bodied orders.

£426 million of disposals done

We said we would make £0.5 billion of disposals this year. To date we have achieved £426 million, including £218 million in the last few weeks of last year. I am confident that we will comfortably beat this year's £0.5 billion target.

Net debt £1 billion lower

Debt is down over £1 billion or 16% from its December peak. It is now at its lowest level for three years.

Debt characteristics

As you all know, our debt has no financial covenants. There are no repayment spikes. It is long term with over 90% attached to aircraft and property and 55% is now fixed at historically low rates. I can reconfirm that we have no plans for a rights issue.

BA delivers

In summary, we are delivering on our financial commitments. Operating profit for the quarter was £248 million and the operating margin at 11.8% was our best for six years. Net debt is down over £1 billion from the peak and we have over £2 billion in cash and committed facilities. We are delivering on Future Size and Shape as we said we would. Thank you and now I hand over to Rod.

Rod Eddington (Chief Executive): Thank you, John, and good morning everyone.

Future Size and Shape

In February this year, we said our priority was to deliver our two-year business programme Future Size and Shape. Today's results are proof that we are doing exactly that. Revenues remain depressed and the market continues to be very challenging. Nevertheless, I am pleased to be able to tell you that we are ahead of plan. Let me take you through some of the detail.

Future Size and Shape is about returning the airline to sustained profitability. We are aiming for a 10% operating margin through the cycle. The key elements to the programme are to reduce costs, restructure the shorthaul operations and remove complexity from the business.

Shorthaul update

We have delivered cost savings, which means we have achieved the highest quarterly operating margin in six years at 11.8%, and that is no mean achievement in the current climate. In February, we said we would deliver £450 million of annualised savings by March 2003 and by September our annualised run rate was over £350 million.

Back in April, we started the roll-out of the new shorthaul pricing model. We adopted a phased approach and started with the domestic market. By the end of August, we had the new fares available on almost 6,500 flights every week to 176 routes in Europe. In August and September, we sold over 200,000 seats each month on line at the lowest fares, and that is up to 20% of capacity on some routes.

Shorthaul yield

Our customers like what we are doing and they coming back to British Airways. While it is still early days, the business trends are very encouraging. To maximise revenues, we have to make the right trade-offs between yield and seat factor. Yield per ASK is the best measure of success. Since June we have seen a steady rise in yield per ASK driven by much higher seat factors and yield per RPK has not materially changed. There is hardly any impact on our highest yield in premium traffic and we have gained considerably at the mid and low fare level. Put simply, the trend in shorthaul revenue is improving. It is still early days, as some routes have only had the new fares in place since September.

Online usage increasing

Our customers tell us that the new booking engine is great. It is reliable, transparent and suits their needs. Bookings on BA.com have risen sharply. We were at 6,000 bookings a week online a year ago; we are now doing more than 30,000 bookings a week online. With the new look BA.com, our look to book ratio has risen from 43:1 to 10:1 in the last six months.

Shorthaul distribution changing

The success of BA.com has driven a major channel shift for us. In the shorthaul non-premium point-to-point markets, which is where we compete with the no-frills carriers, 34% of our passenger sector journeys in September were booked on BA.com. That is up 14% from six months ago, and it is also ahead of what we expected to achieve by March 2003. This is another demonstration of how we are delivering.

In the UK domestic market, where the model has been running longest, BA.com accounts for 40% of those low fare bookings. The reason we have phased the new shorthaul business model over six months was to ensure that all the booking and revenue management systems could cope with the large volume of business. Advertising has been phased, first, to establish in people's minds that we offered genuinely low fares and then in phase two to reinforce the value-added benefits of flying with a value for money, full service airline. Let us look at those commercials. [*commercials shown*] The campaign to reinforce our messages and support the new pricing model will continue in the months ahead.

Distribution

We are also simplifying our distribution model. Our new booking engine is also supporting the £100 million in annual cost savings from distribution costs and is the platform for the channel shift through the whole business. In the US we have just added an upgrade that allows the booking of six freedom transfer journeys. In June we reduced UK travel agency booking payments for shorthaul and in October we reduced our US commissions to zero. The distribution cost savings this year are expected to be some £50 million.

E-ticket penetration continues to grow. On direct sales, 81% of bookings are able to use E-ticket and the take-up is 74%. On indirect, the numbers are 62% and 43% respectively.

Gatwick

Let us turn now to simplification and cost savings at Gatwick. We started reshaping Gatwick in early 2001 and we accelerated implementation under Future Size and Shape earlier this year. In 2001 we few to 41 longhaul and 54 shorthaul destinations. This summer we have reduced that network to 17 longhaul and 38 shorthaul routes. In total, by summer 2003, we will have moved 30 Gatwick destinations around the M25 to Heathrow.

On the Gatwick fleet side, the 747-400s, 767s, 757s and DC10s have all gone from Gatwick. The move of the RJ-100s will be completed by the end of the winter season. Gatwick will have just one longhaul fleet, Boeing 777s, and one shorthaul fleet, 737s. As we have reshaped the Gatwick network to more point-to-point services, transfer traffic is now less than 20% of the Gatwick passenger flow. By summer next year, the shorthaul capacity reduction will be complete and by winter next year the longhaul reduction will also be completed. To put the magnitude of the change into context, Gatwick's longhaul capacity reduced this summer by 46% and by next summer another 33%.

Sweating assets

Looking ahead, we expect that, in addition to simplification, Future Size and Shape will also produce asset utilisation opportunities. In the summer 2003 programme, capacity will rise by about 3% in ASK terms. This is the first increase since summer 1999. The growth will be achieved by higher aircraft utilisation and entirely resourced from the existing fleet; no new aircraft are required.

Some highlights of the capacity growth are as follows. Heathrow-Chicago will move to triple daily services; Heathrow-Newark will increase by five services per week; Toronto will increase by three flights a week; Melbourne via Singapore will increase from five flights a week to a daily service, and Gatwick-Rome will move to double-daily.

Another asset working harder for us is property. By March 2003 we will have reduced office space at Heathrow by some 42%. In January occupancy at Waterside will rise by 1,000 to 4,200. Since the middle of last year, we will have released some 94,000 square metres of floor space from operational and office facilities, and anticipate more disposal over the next 18 months. We have also closed engineering bases in Manchester and Belfast. Gatwick has seen the closure of five hangar bays. Engineering inventory has also delivered with decreases of over £100 million.

Manpower – down 8,180

Let us look now at manpower. Manpower under Future Size and Shape is reduced by 8,180 since August 2001. We will deliver our 10,000 target by March 2003. Natural wastage is the largest part of the reduction. The Business Response Scheme (BRS), under which staff can take voluntary unpaid leave for up to two years, is proving successful and is developing into an ongoing programme that has people coming into and out of the business.

Voluntary severance and early retirement are smaller than anticipated as a result and we expect that we will need only £150 million of the £200 million we set aside for restructuring.

Pay talks 2002

There are five core groups of pay round discussions and, to date, we have successfully concluded three groups: cabin crew, ground staff and engineers.

Outlook

These results demonstrate that we are delivering on our Future Size and Shape targets. Our balance sheet has been strengthened. We are generating cash and our debt is down by about £1 billion. The business environment continues to be tough but we are adapting our airline to cope with these realities. We are delivering on all aspects of Future Size and Shape, and we expect the business to deliver a pre-tax profit for the full year. Thank you. Chairman, over to you.

Lord Marshall: Well done. Thank you very much, Rod and John. We now move into question time.

Question & Answer Session

Chris Avery (JP Morgan): I have two quick questions to get us rolling. First, on capacity increase for next summer, Rod, you are talking of increased utilisation. Presumably, that with a few more economy seats on some of the longhaul planes will get you through next winter as well but, at some point, aren't you going to have to think of the group increasing capacity by increasing the fleet? Secondly, it rather appears that the European Court will deliver its judgment today about government jurisdiction. What do you expect happens in the period immediately after that? Does Brussels get power or are we stuck in a quagmire for a long period of time before Brussels establishes competence?

Rod Eddington: Let me start with the second one first. Clearly, the devil will be in the detail of what is said by the European Court. We anticipate that in the broad Europe will claim competence but whether or not we find ourselves in some sort of Never Never Land in the middle in the interim I do not know. I hope not, I hope it will be clear-cut but it is difficult to be absolutely sure what Europe will say. As you know, we are broadly supportive of the view that Europe should have competence in this area for two reasons.

First, we believe the only way you really get a balanced agreement with the Americans, in the medium and longer term, is if Europe can negotiate as an entity. Secondly, we would also like to see the ownership and control provisions change from nation state to European, because we do not believe that you will see genuine consolidation in Europe until the ownership of control provision is European rather than French, British, Dutch, Italian or whatever.

On the issue of fleet, there are a couple of points to make here. The first is that we committed, as part of Future Size and Shape, to improve utilisation. There is a particular focus on shorthaul here, and we are about half-way down that journey. We said we would increase shorthaul utilisation by 10% and we will do so, and we are about half-way there.

There is a piece around longhaul utilisation as well, because that is important to us too. We can increase longhaul utilisation. We can get more capacity, particularly to the key profitable destinations, and I spoke about some of these a few moments ago. We are taking the opportunity on the North Atlantic, as some of our competitors step back, to put more capacity into profitable markets. This is not just on the North Atlantic and I talked about some examples from other parts of our longhaul network, in this instance Sydney-Melbourne.

I also talked about shorthaul and gave you an example there of Rome from Gatwick. Therefore, just as we are cutting capacity in some areas, we are growing it to others.

We are also doing more flying out of Heathrow. We have been able to swap some slots and this has given us the opportunity to do more flying out of Heathrow, which is critical to us. As our Chairman said, it is our only true hub and the opportunity to bring more services into Heathrow and to increase capacity to current destinations from Heathrow is very important to us. It was announced that we gained some slots as part of the deal we have done with ??SN Brussels but there have been some other slot-swap opportunities which we have taken. That means we will be doing something like 5% more flying out of Heathrow next summer than this summer, which is important to us as we build the critical mass we need in our hub, and we can do that without any more aeroplanes.

As you know, we released two 777s back to Boeing Aircraft Trading. We have slightly more capacity than we need in aircraft terms at the moment, which will come in handy for us through the next 12 months because the phase two cockpit door installation is a huge programme for us. At any one point in time, we may have as many as 10 aircraft on the ground if we are going to get them all done in time, as we must, so having a handful more airframes than we need in the short term is probably, in the circumstances, no bad thing. In the medium term, it gives us some growth opportunities without having to go back to the market.

Lord Marshall: We have, of course, added another flight already on JFK.

Rod Eddington: That is quite right, Chairman. We have moved from six to seven subsonic services a day from London Heathrow to JFK this winter period.

Peter Hide (Credit Suisse): Can you take that slightly further? You have obviously set an EBIT margin target for the business. The other side of that is asset utilisation. Could you say any more from a group level as to what kind of capital turns or asset utilisation you might be looking for for the whole business?

On a completely separate point, could you go back to the shorthaul slide where you showed a very strong increase in yield per ASK. If I am reading that correctly, it suggests your load factor on shorthaul has gone up dramatically. I suppose I am most interested in the fact that September seems to have increased dramatically vis-à-vis the few months previously. Is there something particular in terms of rolling it out further, or have you rolled it out? Do you think that that gap will stay where it is or will it increase even more?

John Rishton: As you know, Peter, our financial target is that we will be cash valued added positive, and we have been using 10% as a proxy for that if for no other reason than it is much easier to explain than cash value added. Our asset sales turn ratio that we are shooting for at one, consistent with the 10%, is something that will drive us to cash value positive. That is our bottom line target.

Rod Eddington: On the shorthaul proposition, Peter, the short answer to your question is yes. British Airways shorthaul route network load factor was around 60% and historically it has been around that figure. Given that we have completely recast the pricing and distribution model for shorthaul, one of the opportunities for us was significantly to increase that load factor. If you look at the way in which Fare Explorer works and what it has done for us in real terms, and the best example is probably to take a route like London Heathrow-Edinburgh where we have of the order of a dozen services per day, if you go onto Fare Explorer you will not find many cheap seats available on the seven and eight o'clock services in the morning; they are peak business flights. Not only have we skewed the pricing and distribution piece away from flights that are already full, for obvious reasons, but what we have seen as a result is that the incremental load factors on London-Edinburgh at peak times in the morning and late afternoon have not changed much as the aircraft are pretty close to full anyway.

Mid-morning, early afternoon and the last flight in the evening, which is at a time beyond when most business men and women would want to travel back from a day's business in Edinburgh, we have seen material increases in load factors of 20% to 30% in some instances. The increase in system-wide shorthaul load factor, and there was plenty of opportunity for us to do this, has been driven primarily by improving load factors in the off-peak flights. That is the greatest opportunity we have to sell into the gaps and we are taking it.

Peter Hide: [*follow-up comment off microphone – inaudible*]

Rod Eddington: What has driven it, Peter, is that the pricing and distribution policy completely changed and it is the new pricing distribution model that has done it much more than anything else.

Lord Marshall: You will see the October figures at 2.15 this afternoon.

Rod Eddington: Some of the new fares and routes were only put on line at the end of August so that is to your point about September, and I am sure you will see a continuation of that through the rest of the year.

Chris ?? (Commerzbank): I have two quick questions. The first one concerns some of your travel agents, some of whom are very high profile, not appreciating what they see as cost transfer. If you could update us on that, it would be most helpful and whether there are any other than American Express who are making a lot of noise about it?

My second question concerns Gatwick. You show that you have re-oriented the structure of the business there. What in terms of slots does this mean for you? Are you going to build your slot position at Gatwick and, overall, how do you see new entrant airlines gaining more slots there, if at all?

Rod Eddington: Let me take the one on travel agents. The ABTA conference this year was in Cairo a couple of weeks ago, and I went down to give the keynote speech. I took that decision in an environment where I do not expect too many Christmas cards from travel agents. The interesting issue for me, within these four walls, was that, to be frank, it is old news. What do I mean by that? As you know, Chris, we announced some changes some time ago to our full fare pricing structure, moving away from commissions to service payments and then more recently the substantial changes to the shorthaul agency commission levels as a result of the new booking engine.

One of our fiercest critics said, sharing a platform with me, that with the gift of hindsight BA has probably done the industry a favour, because it forced them to look at service fees to customers rather than relying on airline commissions and - surprise! surprise! - that worked pretty well. I had better be careful here because there are two major trade publications – *Travel Trade Gazette* and *Travel Weekly* – but the issue of one of those two publications that coincided with the ABTA convention in Cairo said on the front page that some travel agents are doing much better now that they have moved to service fees rather than commissions. On the back page, there was a survey of travel agents which said the majority – and it was just the majority – of travel agents believed it was best for the airlines to move to zero commissions and for them to exist in a world where they just charged service fees to their customers. Therefore, the mindset of the travel agency community has changed in the broad. We would not have introduced the changes we did if we were not confident that the major business travel agents, in particular, were with us, and the team did a lot of work to ensure that that was true before we rolled them out.

What was clear to me from Cairo was that, broadly within the travel agency community, there is an acceptance that the days where they can automatically charge a 9% commission on any ticket they sell are long gone and that, increasingly, some airlines are moving to zero percent commissions and that travel agents, if they are going to survive and prosper as businesses, have to move to service fees.

As far as Gatwick is concerned, when we announce our summer programme for next year at Gatwick, you will see that there are no further reductions to our Gatwick operations. We are comfortable with the progress we are making at Gatwick on the longhaul and the shorthaul side, and we are still far and away the major operator from Gatwick, so we see no further changes to Gatwick. In fact, we are looking now at how we can best use the Gatwick slot portfolio. We will always be interested in looking at growing the parts of our route network that make money and being tough on the parts that do not, and that applies to Gatwick as well as to Heathrow. You could well see some shifting in how we deploy our shorthaul operations at Gatwick but, in the broad, we still operate well over a third of the services ex-Gatwick.

Martin ?? (Morgan Stanley): I have two quick questions. First, on the alliance front, how are you getting on there, especially in your relationship with American? In the press release I believe you also mention Iberia and that relationship. In that context, KLM seem to be in talks, or they say the door is not shut for British Airways, so what is your view on that front? Now that you mention a third runway at Heathrow, do you need KLM, do you need a second hub in Europe?

My second question is on Deutsche BA: how is the restructuring getting on there and what progress are you making there to get that airline sold?

Rod Eddington: Alliances remain important to us but, as you know, the first, second and third most important thing to our business is our core business and that remains our major priority. Having said that, the major activity on the alliance front for us has been the application for ATI to work much more closely with Iberia and, in the context of Europe, once you have applied for ATI, you can act as if you have it, i.e. you can collude without my going to jail, which is always a relief. We have done that, we have announced some code share, as you know, with Iberia on London-Madrid and London-Barcelona, that has already begun. We are looking to work with them much more closely on a whole range of fronts. I see Iberia as a very important part of One World and I see the bilateral relationship with Iberia as important for BA. The networks are highly complementary, they are well-run and well-managed business and it is a good relationship that works well. There is very little competitive overlap with Iberia other than on the third and fourth freedom sectors between Spain and the UK. So that is the major focus in the context of One World.

We continue to look at options and opportunities for us in the broader context of Europe. This game still has a long way to go yet and we will only do what is right for our business and our shareholders. However, we have always recognised that, in network terms and in other ways, if we can find a sensible way to work with KLM, we would like to take it. KLM equally have some opportunities that they need to think about. Our interest in KLM in the broader sense remains but whether or not we can deliver something remains to be seen.

The team at Deutsche BA have done a lot of good work in terms of restructuring their business to run it much more on the low cost model. They have pushed many more of their bookings online. We believe that there is a good chance that easyJet will exercise the options they have. In the meantime, they continue to pay us a monthly fee to keep that option alive, and the Deutsche BA numbers are looking good.

Lord Marshall: We should not get too carried away about this third runway at Heathrow because, even if it is approved, it is not likely to be there for at least 10 years, which is a long way off into the future unfortunately.

Mike Stoddart (ING): Looking at the P&L there was about a 20% decline in the Other revenue figure. I wonder whether you could talk us through that decline and what effect it had elsewhere on the P&L, and whether you could give us a firming up of the view on the financial year basis for next year, what the ASK change will be and whether there is any preliminary view for the following year?

John Rishton: Let me talk about the Other revenue. It is down compared with the previous year and the reason for that reflects the tough environment the industry is in. Much of the Other revenue is engineering, third party work that we do for other airlines which, understandably, has slowed down substantially. Therefore, it is about the fact that business has slowed down substantially in that sector.

Rod Eddington: We will be looking for some modest increases in ASKs through next year. We will continue to look at the network restructuring, which is something which you never finish with in a sense but, as I said earlier in my set piece, Mike, we are looking to do more flying to some of the more profitable destinations. At the same time, we will continue to trim the unprofitable ones but net net, we assume a very small increase in ASKs next year of 3%.

Andrew ?Lodenberg (ABN): I have two questions. Can I ask about the profitability of the premium cabins on the North Atlantic: the is the new Club World continuing to deliver share gains or is it now stable, is the market growing or shrinking? Also I am hearing more positive noises from you about World Traveller Plus, can you elaborate on that please?

My second question relates to the pilots: can you give us some more colour on where negotiations are going with them please?

Lord Marshall: You obviously have not read the *Morning Star* today!

Rod Eddington: On the premium cabins on the North Atlantic, the market on the North Atlantic is still well down but we are still quite comfortable with our own performance on the North Atlantic. To be frank, we would not be putting more capacity onto New York, both JFK and Newark, Chicago and Toronto if we were not entirely comfortable with the way that is going. It is doing well not only in Club World but also in the World Traveller Plus. The World Traveller Plus loads are really beginning to deliver now and, remember, the World Traveller Plus piece in advertising terms for us took a back seat to the Club World promotions we ran through the last 12 to 18 months but we are seeing World Traveller Plus cabins fill and fill comfortably which is good and at good yields, so we are very happy with the way that is going.

In the context of the pilots, as I said in my set piece we are in discussion with the pilot community. Most airlines' pilot, cabin crew, staff pay scales generally build up over a period of time and, if you look at the way in which our pilot pay scales have been restructured over the last 30 years, it is clear that there are some strange anomalies in what we do. We are looking to restructure those pay scales in the context of not spending any more but restructuring them in a way which delivers salaries to our crew through their careers with us rather than skews them to the tail end of their career. That is the first and most important point. We will be looking to some sensible increases to pilot pay but those will be entirely in line with the agreements we have reached with other categories of staff within the company.

Andrew Light (Schroder Salomon Smith Barney): I have a couple of questions. First of all, going back to your low fares strategy, given the success of this strategy, is this an area where you would invest more capacity either in terms of more planes or bigger planes, or is it really just an optimisation on top of your normal business?

Secondly, if there is a war with Iraq, can you outline what your contingency plans would be and would there be anything different relative to, say, 1991. Thirdly, on insurance costs, can you give us an update on the current situation in terms of cost?

Rod Eddington: As you know, we are doing a whole range of things to restructure our shorthaul business. First, we are no longer flying to destinations which were unprofitable and a number of those have been taken out of our route network, and we will continue to take a hard-nosed view about where we fly. As part of that process, we have looked hard at overlap, where we fly to the same destination shorthaul out of both Heathrow and Gatwick, can the destination sustain services from both airports. In the case of the largest destinations in Europe, the answer is yes but in other contexts it is no.

We are also taking out larger aircraft from some of these routes, we are moving away from 767/757 operations, although we still have both aircraft in our shorthaul fleet, and increasingly you will see A319s and A320s on the routes – fewer seats but, importantly, much lower trip costs. So the route economics are much improved. On top of that, we have changed the pricing distribution model to optimise revenue across our shorthaul network. The price distribution model change is just one of a significant changes to our shorthaul model.

The only point I would make about fleet and aircraft in this context of shorthaul is that British Airways currently operate 737s (300s, 400s and 500s), A319s and A320s, 757s and 767s. It is clear to me that we are moving towards a world where our shorthaul fleet is predominantly/exclusively Airbus. It will take us several years to get there, we are well under way. We are taking delivery this year of a dozen A320s as replacement for 757s, which have been pre-sold, and if you look at the capex numbers that John speaks to, the major part of that capex is for those new aircraft. We will continue to re-equip the shorthaul fleet.

I have no doubt that British Airways is ultimately an operator of A321s as well A319s and A320s, because that enables us to meet the full range of opportunities on the shorthaul: 126-seat A319, 150-seat A320, 180-seat-plus A321. So I have no doubt that we are ultimately in the business of operating and flying A321s as well, and it is possible for us to take those in the context of the delivery deals we have already struck with Airbus. This is not any additional capital expenditure; it is capex in the context of already pre-agreed limits. That is the only change I would anticipate. We have not yet reached agreement with Airbus on taking the A321 into British Airways mainline colours: A321s already operate for GB Airways but they do not operate in British Airways mainline colours, and we will not be operating them in mainline colours unless we get the right sort of deal from Airbus. However, the only change that I would see in the short and medium term in the shorthaul fleet side is the obvious one which is to include the A321 as well as the A320 and the A319 in our shorthaul fleet.

On the contingency plan issue, we have operational contingency plans as, following the Gulf War 10 years ago and 11 September, sadly, it is something in which we are well versed and we have some financial contingency plans – Chairman, John.

John Rishton: The most important part of the contingency plans is to make sure we look after our cash. You know that we have £1.5 billion of cash, £0.5 billion of undrawn committed, so over £2 billion of liquidity readily available to us. As you may remember this time last year, immediately after 11 September, the worst that we got to was getting through £2 million of cash a day. So if we have £2 billion in liquid resources, there is no question about us surviving any more. In fact, if you look back in history, we came out of the Gulf War stronger than we went in and we survived and came out of 9/11 stronger than we went in. Therefore, survival is not an issue for us. The nature of the business will be determined rather by the length or the severity of any war which I guess we all hope will not happen.

As far as insurance costs, they are up significantly in the quarter, as you would expect, by around £17 million and those costs are in the engineering line. You will remember I said earlier that engineering costs were down 8% despite the fact that we had substantial increases in insurance.

Andrew Light: [*follow-up comment off microphone*]

John Rishton: As you know, the Government cover ends and we go to the commercial market. The cost change from0 the Government to the commercial market is very small, in fact it is slightly lower in the commercial market now than the Government were charging us.

Lord Marshall: It is still a source of irritation, because there are a number of other governments that continue to provide cover for their airlines including the United States.

Stephen ?? (Williams de Broe): I have two questions. Can you give us an idea of how important the City, the financial markets are to you, London and Wall Street, today versus two years ago?

Lord Marshall: In business terms or in borrowing terms?

Stephen ??: In business terms. Two years ago I used to get on a lot of plans and could not move for investment bankers in business class.

Rod Eddington: Was that a good thing or a bad thing?

Stephen ??: It is not quite the same now so could you give us a feel for how important that segment is? Secondly, on manpower you have done extremely well in the second quarter. Can you give us an idea of how we should extrapolate from that and also give us an idea of what provisions you have used and will need to use for what will hit the P&L in terms of voluntary severance - I know you said it was lower – and what will be the cash cost?

Rod Eddington: Many of our major clients have fewer people on the payroll than they had 18 months ago, and they have had some difficult decisions to make just as we have had. That, more than anything, has driven the fact that total premium traffic on the North Atlantic is well down on where it was 18 months ago. That is the stark reality and we do not anticipate that it will get better any time soon. What is important for us is that we get a good chunk of that business and part of our product range is our schedule and frequency, and we are working to strengthen that position even further. As some of our competitors on the North Atlantic move back, we are looking to move forward incrementally, sensibly and intelligently but these markets are important to them. In my view, the North Atlantic will remain a critical market for British Airways. The US economy will be a critical economy for us and we have to make sure we have the right frequency, schedule and product range in place. I came back from New York on us six weeks ago and I got the second last seat in Club World, and the time before I ended up coming back on a flight an hour earlier than I had anticipated, because the flight I wanted to come back on was full. That is not true on all aircraft and it is not just JFK.

Some of the people who occupied the World Trade Centre have set up shop in New Jersey and we are putting more capacity into Newark, we are moving from two services to three a day on five days a week, which is a reflection of the loads to Newark as well.

Furthermore, because the security arrangements we have put in place have been in place for quite some time, our customers have noticed less change to some of the security arrangements that have been put in place. Many of our US competitors, particularly in the domestic environment, operated in what was considered to be a zero threat/zero risk environment, so they have had to build their security procedures from scratch. Our customers tell us that they find travelling with us less of a hassle than with some of our competitors.

On manpower the goals are clear, we said we need to have 10,000 MPEs out of the business by end of March 2003 and 13,000 out by March 2004 and those are the targets we will deliver. We are just over 8,000 down that journey as the pie-chart I demonstrated shows. Seventy percent of those are “permanent”. The Business Recovery Scheme has been extremely useful to us, because it allowed us to get people out of the business immediately albeit temporarily but we are finding that, as some of them come back, others want to take unpaid leave or work part-time for a while, particularly in big battalion areas like the cabin crew community where it has been a very useful tool. Many of our cabin crew prefer to work part-time and it suits us in every way that they do so, if that is what they want.

On voluntary severance/early retirement, as the numbers show of the 8,200 just under 1,000 have left us on the early retirement/voluntary severance schemes, and those numbers are reasonably small primarily because we have been able to get people out through other mechanisms. As a result, there are big parts of the business where we have not offered voluntary severance and early retirement. We have used natural attrition, retirement, resignation and the Business Recovery Scheme to get the headcount numbers to where they should be. We have set aside £200 million in restructuring costs and, as John and I have said, we anticipate that on balance we will probably need around £150 million.

John Rishton: About £150 million. You will remember we took £80 million as a charge last year and we have not taken any addition charge in the first two quarters of this year, so there is another £70 million to go this year.

Robin Horne (HSBC): I have two quick questions. First, on yield. Could you break it out for us in terms of yield and mixed currency and price? Also in terms of the realisable assets that you express for us, could you give us the detail of what those are in your liquidity position?

John Rishton: The breakdown of price mix and exchanges is that price is up about 2%, mix up 1.3% and exchange was adverse just over 2% which gave us the increase in the quarter of 1.2%. In terms of realisable assets, that includes everything we have on our books. The Qantas valuations are in there and nobody should take the view that we are about to sell our Qantas shares. Iberia is also part of that, our property portfolio is part of that, aircraft are part of that. The reason why it has changed over the last few months and gone up is that we have been taking a closer look at the value of some of our businesses and we have concluded that they are worth more than we had originally estimated.

Nick Anderson (Lehman Brothers): I have two questions. First, your profit guidance for the year, could you clarify is that pre or post the restructuring costs? My second question is a broader one about ownership in the industry. Given the extremely strong cash flows that you and some of the other airlines are generating, and given that we have presumably seen the market walking away from the airline sector but we are also seeing, especially in the States if you look at the rescue of US Airways, a lot of private equity money coming in, do you think the time has come when we might start to see MBOs in the sector? In particular, would you, yourselves, be considering that route as you would be free from analysts?

Lord Marshall: Profit guidance first!

Rod Eddington: No, is the answer to the second question. [*laughter*]

John Rishton: As far as our profit guidance, putting aside a war or any other terrorist activity, we expect to be profitable at the PBT line this year, which includes everything for tax.

Lord Marshall: On the ownership issue, it is still very important to recognise that a nationality clause continues to exist in the air service agreements. That is what continues to prevent consolidation across the borders and, until that is changed or ideally removed completely, you have to focus within your own borders in terms of ownership. It does not rule out MBOs I accept but you heard Rod on that.

Matthew Steyner (SG): Presumably, one of the key reasons behind your increasing focus on core business is to put yourselves in a stronger competitive position and, ultimately, to regain a bit of pricing power. My question really comes in three parts. As you dig yourself into these core defendable market positions, do you think you will see any change in the relentlessness of the need to continually restructure? The second part is, in that context, do you see your target returns on capital becoming somewhat more sustainable in the future than they have been in the past? The third part is to what extent do the answers to those two questions depend upon the sort of regulatory change to which you refer earlier in the meeting?

Rod Eddington: The most difficult of times present opportunity and one of those opportunities is for us to be absolutely clear about what our core markets are and to strengthen our position in them. Some of the capacity changes that we spoke about earlier this morning are designed to do just that: strengthen our position in the core markets, particularly markets that are premium rich, because those are the markets where the returns are best. Those are also the markets where with our product offering and portfolio, which has traditionally been one of BA's strengths with our reputation for product innovation and for service, we can play to those strengths best. That has driven some of the restructuring you have seen in network terms. I have to say that the need to reassess what you do and how you do it has to be a never-ending prerogative for any business but particularly one like ours, and the good news for British Airways is that there are many opportunities for us to do a lot of more of this.

One of the things we have not spoken much about today here but which gets a lot of air time within our business is a focus on the need to build a much simpler business. One of the attractions to me of the new shorthaul pricing and distribution model is its simplicity, its simplicity in terms of the ability for the customer and our staff to understand what the proposition is. Because it is simpler, you can drive much more of it online. You could not drive our old pricing distribution model online as it was too complicated.

We have spoken earlier today a little about the issue of simplicity in the context of our shorthaul fleet but there are a huge number of opportunities, some of which we have just begun to grasp. Those of you who were at the Investor Day at Waterside earlier this year heard quite a lot of discussion around what we are doing on the engineering front and, perhaps I can just reflect for a moment about what we have done to reduce our engineering costs, as this is a journey that has just begun. As John said in his numbers, engineering costs were down 8% but that includes increases in some important areas like insurance, because, for the purposes of this exercise, they are bundled there.

We have substantially changed how we maintain our aircraft. We are moving towards manufacturer standards rather than a bespoke system that BA built to maintain and service its aircraft. We have changed the balance of what we do. We have closed some engineering bases. We do not need our business to be as fragmented as it is. So there is a big drive on simplification in every part of our business. We could speak for 30 minutes about what we are doing in the systems side to drive simplicity into our business. Therefore, the journey to be more efficient and more productive has only just begun and it is a never-ending journey.

John Rishton: On return on capital, our objective is to deliver sustainable returns on capital. We set ourselves the objective of a 10% operating margin through the cycle. There will be years when external shocks, such as the ones we have had recently, will prevent us from achieving that, it may be oil price revenue side, but if we control the costs better than we have done in the past, if we make sure that our costs are down, we believe that we can drive 10% through the cycle, which should give good returns on capital going forward.

Matthew Steyner: [*follow-up comment off microphone*]

Rod Eddington: The dependence upon regulatory change – in the context of aero-politics? [*yes*] That is a part of our business and there are times when we are frustrated by it, there are times where we benefit from it and there are times when it works against us, and we have to live with that extraordinary *pot pourri*. I am entirely comfortable with operating and living in a much more liberal world but I do not want to live in a world where our major competitors are massively subsidised by their governments and we are denied that.

I would much rather live in a world where governments were out of this business and they left airlines to get on with it.

Clearly, the regulation of safety is something that governments must always be involved in and they should be, and that is relevant not only to the flying and operating of aircraft but to things like air traffic control as well. However, they should not be regulating economic matters in our industry and they continue to do so.

Lord Marshall: Thank you very much for joining us this morning and we look forward to the next occasion.

- *Ends* -