FINAL TRANSCRIPT

Thomson StreetEvents℠

BAIRY.PK - British Airways H1 2008/09 Results presentation

Event Date/Time: Nov. 07. 2008 / 4:00AM ET

CORPORATE PARTICIPANTS

Martin Broughton
British Airways - Chairman

Keith Williams
British Airways - CFO

Willie Walsh
British Airways - CEO

CONFERENCE CALL PARTICIPANTS

Edward Stanford
Cazenove - Analyst

Andrew Light
Citigroup - Analyst

Chris Reid
Deutsche Bank - Analyst

Penny Butcher
Morgan Stanley - Analyst

Jonathan Wober
Societe Generale - Analyst

Neil Glynn
NCB Stockbrokers - Analyst

PRESENTATION

Martin Broughton - *British Airways - Chairman*

Good morning, everyone, and welcome. Last year at this time, we presented a record set of half year results, but the world has changed a lot since then.

The global economic crisis and, of course, the vagaries of the (inaudible) and oscillating fuel prices, have conspired to produce one of the bleakest trading periods on record.

We've not reported record results today by a long way, but I think given the extreme nature of the challenges facing the industry, today's half year does actually reflect a good performance.

During the six months, we've managed to deliver operating profit of GBP140 million, pretax profit of GBP52 million, revenue of GBP4.8 billion, up 6.4% and cash remains strong at GBP1.8 billion. Keith will take you through those numbers.

The recession we're in looks set to continue for a year or two. Worldwide, some 30 airlines have gone out of business this year, and others have been issuing profit warnings.

So what actions have we been taking? We've reduced capacity on the winter flying program and are doing the same for the 2009 summer schedule. We've revised CapEx plans, continue to focus on reducing costs, simplifying the business.

But we are determined to maintain a competitive cost base now and in the long term, but it is crucial that we focus more than ever on providing the highest levels of customer service.

And in that context, I am delighted to report Terminal 5 is performing extremely well, is delivering great levels of customer service, and excellent levels of punctuality and baggage performance (technical difficulty). But it has transformed our operational performance, which I think is a credit to all concerned.

We'll be starting the new twice daily business class only flights from London City to New York next year, which will give the benefit of flying directly out of the heart of London financial center. The 318 which will be used will be fitted with 32 business class beds.

We've signed the joint business agreement with American and Iberia and expect the ATI application to be approved in the first half of next year. That's going to bring genuine customer benefits, with improvements to connections, network and frequent flyer schemes. I think it'll put us on a level playing field really with SkyTeam and Star Alliance.

Now we won't get all of the benefits of -- efficiency benefits that comes with other (technical difficulty) proper consolidation (inaudible). At the moment, we've only had the first stage of the OpenSkies agreement. We've seen five new entrants coming through in that time, and the US Heathrow flights increased by some (technical difficulty).

There are those who would still claim for access to Heathrow be restricted. (Technical difficulty) agree with that, that it needs a runway, and that's the way to get the extra capacity.

I was intrigued by a quote from Boris yesterday. I enjoyed the quote really when he scrapped the impractical transport proposals. I had Fantasy Island in mind when he said, I cannot and will not continue to waste our money and your money on consultants and planners who are currently spending millions and millions of pounds titivating plans for schemes which are either impractical, or for which we simply don't have the funding from government. Well said, Boris.

It's been pleasing to see that the Prime Minister reiterate the government support in principle for the third runway, and I think it's been going on now for six years and it's coming to a climax. It is time really for a final decision to be made in support of third runway.

Finally, a word on Iberia. Discussions have taken longer than expected as we've had to ensure they've had a full understanding of the arcane variation or valuation methods used for pension funds. I think we expect discussions to pick up speed more now they have a much better understanding of pension funds, of English pension (technical difficulty).

Keith Williams - *British Airways - CFO*

Good morning, everyone. There's quite a lot to go through again this morning, which I think is a sign of the times. As the Chairman said, we've described our performance as being good in tough conditions. And trading conditions are bleak, and we're still heading towards the eye of the storm.

,Nevertheless we've made a good response, both financially and operationally to the current challenges, and started to take action for the challenges ahead. But firstly, to the first half performance.

We said in May, and we repeated again in August, that we would need to increase prices in response to unprecedented fuel prices, seeking yield improvements rather than simply relying on driving volumes. That strategy has paid off. We increased passenger revenue by 6.5% in the first half, and overall revenues by 6.4% on capacity which was largely unchanged from last year. The second quarter performance was particularly strong, with yields up 13.8%, and revenue up 9.8%.

We said that the conditions were tough back in May, but today we still recognize that we're going into the storm, not coming out of the other end. So in August, we announced actions to reduce ASKs in the winter to realign capacity to passenger demand in order to reduce costs.

In the last six weeks, we've started to restructure the management of the Company and to reduce the number of projects that we're working on. As a consequence, we've incurred restructuring charges of GBP40 million in the first half, but this will both reduce operating expense and capital expenditure going forward.

We're also starting to see the benefits of Terminal 5, and that will reduce costs further into the future. I'll come back to that later in terms of financial performance, and Willie will talk you through the operational performance.

Now I understand that when approaching a storm, a pilot seeks to gain altitude. We've done that in financial terms, over the last 12 months.

Our balance sheet remains strong for the tough times ahead. We generated GBP333 million positive cash from operations in the first half, and maintained a cash balance at the end of September of GBP1.8 billion. Net debt is unchanged at GBP1.4 billion from last year. And, additionally, we've got committed facilities of GBP2.6 billion and, therefore, total liquidity of GBP4.4 billion.

Now those are the financial highlights, but step back for a moment to market conditions. The Chairman had already remarked at the time of the Annual General Meeting in July that it would be a great achievement to be profitable given the economic background and fuel environment. That's been amply demonstrated by the industry's performance in the June quarter. I think post-tax profits for the industry totaled some GBP150 million, down from GBP5 billion the previous year.

Now not only has the economic situation worsened, but both oil and currency markets have been increasingly volatile. But before we go into the numbers in any detail, I thought it might be useful to give you some insight on to the revenue picture on fuel which is now a major cost, and on currency.

Now this chart is showing you the IATA data on international travel for the last 13 months. You will see the sharp fall in traffic from June onwards. In the six months to June, international traffic grew by 5.4%, but by September, international RPKs fell 2.9%, with weakness apparent across all major markets. And this is the first decline, I think, since the SARS epidemic in 2003.

Now although our aircraft have been grounded in response, and some airlines have failed, overall capacity across the industry was still up 1.1% in September, and is lagging the slump in demand, with the result that industry load factors declined some 3 percentage points.

Now looking at our own position, here's the trade-off between volume and price. We said at the time of the quarter one results that we anticipated volume decline as the result of economic slowdown, and that we would implement price increases. In the end, RPKs were down 3.5% in the half, and load factor was down some 3.8%. However, the impact of increased yields more than offset volume declines.

We've implemented both fare and fuel surcharge increases across the board, and together with favorable currency movements, these improved the yield for the second quarter by 13.8%, and 10.5% for the first half overall.

Now I mentioned jet fuel and fuel surcharges, which have increased in response to high fuel costs. This chart builds on one which we've shown you before, showing the price of jet fuel in dollars per metric ton over the last two years and the year-to-date, and the extreme volatility that we've seen this year.

Now if I overlay against that our exposure to jet fuel based on our hedging over the last six months, I think we were more than 80% hedged against price movements in the first half. And as we announced today, if you look at the shaded area, we made some GBP329 million of hedging profit in that first six months. This reduced the rate of increase on our own fuel costs to 52% in the half against a market for jet fuel which was up an average of 73% over the same period.

Now as you can see there, a part of this hedging benefit will reverse in the second half because of hedges placed at higher prices some time ago. So, and I'll show you later, we've added little or no cover for the second half in recent months while prices remained high, and I'll cover off that hedge position later.

Now finally, on currency, you'll all be aware of the recent sharp dollar appreciation against sterling. To some degree, as you know, our dollar and dollar-related revenues, with those, we tend to be naturally hedged on dollars, with dollar income offsetting dollar costs.

Given the high price of oil, we've found ourselves short of dollars, and so we entered into foreign exchange contracts early in the year at very favorable rates to cover that exposure. Some of those dollars have already provided hedging in the first half, and there will be further protection in the second half.

And if I show you the result in the first half, it achieves what I'd call a currency neutral position. Exchange over the first six months benefited revenue by some GBP128 million, which contributed 2.9% of the overall 6.4% increase in revenue. Fuel costs were somewhat higher from currency where, at around 3.1% of the total increase in non-fuel costs of some GBP91 million, was attributable to adverse currency impact. But, overall, as you can see there, currency had very little effect on the first half results.

Now all that's by way of introduction. I hope it's a useful introduction for you. Now to the half year results themselves.

Now I've already covered the revenue improvement, up 6.4% in total, and I said 2.9% from exchange versus last year, and 3.5% on an underlying basis. I've also mentioned the fuel cost's up 52%, or just over GBP0.5 billion to a total cost of just under GBP1.5 billion. And fuel contributed heavily to a total cost increase, up some 18% year-on-year.

However, all our costs came under pressure in the first half. We had four unusual contributory factors. Firstly, exchange, as you've seen; secondly, the GBP40 million cost of redundancy that we've took; thirdly, increases in airport and overflying charges; and lastly, the cost to move to Terminal 5. I'll come back and complete the cost picture in a little more detail later.

Now as you know, both operating profits and pre-tax profits were much reduced. However, it needs to be remembered that we're looking against a year last year where we delivered record profitability. Looking at the key statistics, they are as expected.

ASKs were up over the summer 1.3%, with long haul ASKs up around 0.5%, and short haul up just under 6% in line with what we'd said at quarter one. Volumes measured in RPKs, as I said earlier, were down 3.5%, and the load factor was down 3.8% to 74.6%. I've already covered yields, which were up 10.5%, and I said earlier, cost increases including fuel, were up some 18.2% in absolute terms, or 19.2% measured in terms of performance against ATKs.

Now looking at the yield performance by quarter, you can see that there's been a steady improvement over time. There has been some exchange benefit, as I've mentioned. But even at constant exchange, there was a yield improvement of over 7.5% in the half, and over 10% in the quarter.

Moving on to the breakdown in the revenue; passenger revenue, as I said earlier, was up partly from performance and partly exchange, and gave a total increase of 6.5%. Cargo revenue was also strong, and I'll come back to that in a moment. Other revenue was down, from a number of factors, including slower sales in Airmiles, and BA Holidays, and lower third party revenues.

Coming back to cargo, revenue strong, driven by volume, yield and exchange, which were all positive. Volumes were up across all geographies, and total tonnage was up 3.6%. We developed a very strong premium product offering, and volumes in that area were up more than 5%; on capacity, measured in ATKs, down around 3%.

Now the outlook for cargo; the cargo market has shown shrinking freight volumes in the last four months as a total market. Our own volumes had been holding steady, and key markets out of the Americas and Middle East and South East Asia have been resilient. Operational performance has been excellent. However, we expect some decline in both volume and yield in the second half, in part driven by lower planned capacity, but also from a slowdown in the economic picture worldwide. This morning, we announced that CTKs for October were down 4.2%.

Now turning to costs, we'd already said in the first half that the first half costs were likely to be challenging on both fuel and non-fuel costs; the later, in part, down to increases in airport charges and the additional cost of the Terminal 5 move. In the event, we were also hit by the weakness of sterling, and we've made a provision, as I mentioned earlier, for GBP40 million for redundancy costs.

Underlying costs were up just under 2.5%, and costs before exchange up 3.7%. Total cost increase, as you can see, was up 6.8%. And if you look at the cost lines, as I said earlier, costs were up in all areas.

The single largest increase was the 13.4% increase in landing and en-route charges, despite volumes relatively flat. There is some adverse exchange impact there, but you can clearly see the increase in charges from airports and governments across the world, most notably of course in the UK from the increasing of charging at Heathrow and, to some lesser extent, at Gatwick.

Employment costs were increased, in part, as a result of the small amount -- the manpower increase over last year, but also from the redundancy costs.

And the picture for the three months, the last three months, is pretty much the same. But I would draw your attention to the drop in handling and catering costs, and as we benefited from the working in Terminal 5, and lower levels of compensation.

Now turning now to the balance sheet, all airlines are conscious about preserving their cash and liquidity as we go into a downturn. In our own case, we are clearly, very clearly helped by the fact that we've negotiated committed facilities which cover all our planned main line aircraft purchases through to 2012. And these were put in place last summer, and are untouched by the current credit crisis, and on extremely favorable terms when viewed against current financial markets.

Cash flow from operations, as I mentioned earlier, for the first six months was GBP333 million. Cash holding is at GBP1.83 billion, and capital expenditure for the half was GBP265 million. I'll give you the picture of the capital spend outlook in a moment.

So this chart shows you where we now are on capital expenditure program, and looks at the position at Investor Day and the revised outlook as we see it today.

At Investor Day, we were talking about a capital expenditure for the year of some GBP750 million, as I recall. In August, we'd reduced that to GBP650 million, and we now see that as GBP550 million for the year. Now some of that is related to projects that we've postponed or cancelled, but some of it relates to the [delivering] the Boeing 777 aircraft, which are likely to be somewhat delayed because of the strike at Boeing.

Now, this slide details the committed facilities that I referred to earlier. They're a mix of general purpose facilities, which are approximately $1 billion, and the rest covers the aircraft deliveries, which I mentioned.

Now new financing from those facilities will broadly cover debt repayments over the next few years. And if you look at the level of debt repayment, you can see that it's reducing over time. And that's because, if you recall, we had a major aircraft program, delivery program, in the late '80s and early '90s, and most of debt associated with those aircraft will be fully paid off in the next couple of years, so you'll see a large increase in the number of unencumbered aircraft.

Now I wanted to cover off pensions. We gave an update of our pensions deficit in both NAPS and APS for actuarial purposes on September 16. And we've now updated the accounting deficit as at September 30, at the balance sheet date. We've also recently adopted IFRIC14, which forces us to put part of the APS surplus on balance sheet. And it might just be worth explaining some of the changes.

I think, firstly, for accounting purposes, we've used revised assumptions as at September 30, based off appropriate bond rates, asset values, and real interest rates. Scheme mortality reflects the increases that we put in the accounts at last year-end. The number for actuarial purposes are similarly updated for higher discounts and real returns, and they're stated as at March 31, which was the -- which is, if you like, a preliminary valuation assessment, and those are specifics based on the scheme, based on APS and NAPS, based on data provided by the reporting actuaries.

And if I give you the output, now looking firstly at APS, for accounting purposes, there is a surplus of over GBP1.1 billion, of which part, GBP307 million, is recognized on the balance sheet. If you look at it on an actuarial basis, as at March 31, there was a deficit driven primarily by lower assumptions on discount rates and real return, and the deficit was some GBP245 million.

Now the same picture is true broadly of NAPS. Again, this is as at the end of September, restated at the end of September. You will see, on an IAS19 basis, the deficit is some GBP558 million, part of which is recognized on balance sheet. And again, if you look at the actuarial basis, it's somewhat different, and this is the figures we put out on September 16. Using revised discount rate and returns, the liability was about GBP1.5 billion.

Now what I wanted to show you next was -- this shows you the original deficit, which is the red line, and the repayment period, which was agreed with the Trustees to take effect from March 2006. So what you're seeing there is, at the beginning, is a steep decline in the liability, which was down to the cash payments that the Company put in. If you remember, we put in some GBP800 million, and have added annual contributions. And there were changes to the members' benefits of some GBP400 million. And the balance was to be paid off over 10 years.

Now this is showing you what's happened to the deficit over that period. Now as you can see, at March 2007, the planned recovery was actually ahead of target. We were actually ahead of where we planned to be. And indeed, if you look at the summer of 2007, we were somewhat ahead. Now market events have changed since then and, as you can see with the last line, the status line, is that we've now fallen behind the recovery plan.

Now the pension regulator has recognized that this is an impact not only on British Airways, but across many companies in similar situations. And they've stated that pension plans must be affordable. Now it's early days, and the next valuation of the fund is not due until March 31. It is, however, likely that any new funding plan is likely to involve some change to the deficit make-up period, the 10 year repayment period that you saw earlier.

So now looking forward, we've been saying for some time that these are difficult market conditions, and that remaining profitable at the operating level would be an achievement for the year. The first half results puts us in well placed to achieve that goal, but what of the second half?

Revenue guidance is difficult at this time given the uncertain market conditions. Booking activity in October was impacted by the recent turmoil in the financial markets, but is now starting to settle. You will see from our traffic statistics that we issued this morning that premium traffic was down 9.2% and non-premium traffic down 3.3%.

We don't have total visibility on the outlook. However, we expect volumes in all cabins to be down in the second half versus last year, with both premium markets in long haul and short haul showing significant declines. We expect non-premium long haul to show some weakness, but the short haul non-premium segment to show the leas impact.

We also expect some slowdown in the rate of yield increase, in part, because of lower fuel surcharges, and, in part because of lower mix benefits. Nevertheless, we still anticipate yields for the second half overall to be strong. Exchange will also be helpful.

Given all the uncertainties, the revenue outcome is difficult to predict. However, we still expect revenue for the second half to be up on last year. And as for the overall picture, we anticipate revenues for the year to be up at least 4%, but cannot give any certainty on the [level] of upside to that number.

We've got a clearer view of likely fuel spend for the year, and to some degree, this has also been impacted by volatile fuel prices and currency. We've previously guided to a fuel bill up around GBP1 billion over last year to just over GBP3 billion. This chart shows you the range of outcomes based on fuel price and currency. We still anticipate a spend, at this point of some GBP3 billion for the full year.

Now I mentioned hedging earlier. We added very little additional cover over the last few months when prices were at their high. And although we will give some hedging benefit back in the second half, our hedging position puts us in a good position to benefit from price falls. We're now around 75% hedged for the fourth quarter to March, and just under 40% hedged for next year, taking us through to March 31, 2010.

So looking at what that means to the price that we'll pay for fuel next year, looking at our hedge position, we will benefit from recent price falls. And this chart is showing you the effective price per barrel that we would pay for fuel next year with our current hedging position.

Now to give you an illustration of what you'd expect from the fuel bill, to take an example, if the exchange rate rather next year was $1.65 to GBP1, and the fuel price was $75, we'd anticipate our fuel bill for the year to be down around GBP200 million to GBP2.8 billion next year. And clearly that will -- the outcome will depend on what happens to fuel prices.

On costs, there's been mixed progress. In the first half of the year, as you saw, our costs have increased not only by significant supplier cost increases, but also from the one-off costs associated with Terminal 5 and redundancy.

Now some of those supplier increases are structural such as airport charges, but others are -- such as increased catering and other costs, have started to dissipate. Also we expect Terminal 5 running costs to start to reverse in the second half, and I'll show you some slides on that in a moment.

Accordingly, we expect the rate of cost of increase overall for the second half to slow, leaving costs up some 3% in the second half, and around 5% for the year as a whole.

Now looking at Terminal 5, I'll cover the financials and Willie will cover the operational performance in a moment. On the financial side, as you're aware, we'd increased our manpower to handle the moves into Terminal 5. Based on performance levels, we're now starting to reduce the resources, and are planning a lower headcount or MPE, at the end of the year, more than we originally envisaged in the T5 business case.

And this is a chart that we showed at Investor Day. We expect to incur around GBP41 million this year from the move, which is slightly higher than the GBP36 million we gave at Investor Day. However, we're now well positioned to take advantage of the completed move into Terminal 5m not only on manpower as you saw earlier, but also on other costs. We're back on track to deliver the benefits originally envisaged from Terminal 5.

So finally, to summarize the rest of the year and the outlook, we see revenue up at least 4% over last year, fuel is expected to be up around GBP1 billion, and non-fuel costs expected to be up around 5%. With strong first half performance, that leaves us still focused on achieving a small operating profit for the year. As the Chairman noted at the time of the AGM, that would be a good achievement.

Thank you.

Willie Walsh - *British Airways - CEO*

Thank you, Keith, and good morning, everybody. I would just like to spend a few minutes taking you through an update on a couple of issues that I addressed the last time we met about three months ago; consolidation, T5, capacity and then some of the actions that we're taking to change the Company in light of the external environment that we're seeing.

Now there's a lot happening in the industry. We've seen natural consolidation as a result of the failure of quite a number of airlines. Indeed, since I think we met last about three months ago, we've seen another seven airlines fail, including the likes of Zoom, Excel and most recently, Sterling.

There's quite a lot of uncertainty about the future of several European airlines, including the likes of Austrian and SAS, and indeed the future direction of BMI as a result of the exercise of Sir Michael Bishop's put to Lufthansa.

Now we're active on three particular projects at the moment; Iberia, the ATI application with American, and some discussions with Alitalia, or more correctly CAI, and I'd just like to give you some update.

On Iberia, as the Chairman has said, progress has been slow. Iberia have taken time to understand the accounting actuarial and funding issues in relation to defined benefit pension schemes. They don't have a defined benefit pension scheme. In fact, they haven't had one for quite some time, so they have used the past two months to better understand those issues, and we've now I think got to a position where that is clear to them. And as the Chairman says, we expect to start progressing other issues.

Contrary to what you might have read in the newspaper, there has been no discussion or agreement on the issue of merger ratio, or on final corporate governance issues. I think if you look at the metrics, the natural merger ratio I believe is somewhere in the order of 65/35, 60/40; and although the market cap doesn't currently reflect that, that's the nature of the merger ratio as I would see it.

So I believe we will now start making progress on these issues, but it's unlikely to be made to a degree where we can give you anything publicly until early in the New Year.

On American, our [HI] application is progressing pretty much as we had expected. We've had the advantage of understanding what the regulator, the US DoT, has looked for from the other two alliance filings, the Star and most recent SkyTeam filing. And that's given us the advantage of being able to provide a very complete filing to the US DoT.

Now the DoT has been interested in how OpenSkies has impacted on the market, as you would expect, given that it's only been introduced or in place since the end of March. But I remain as confident today as I was when we first announced this, that we will get approval for our application in the first half of next year.

Our planning assumption is that the operation of that joint business agreement will not go into effect until the winter '09 season, and that's always been the planning basis of our discussions.

We have had some dialogue recently with CAI on the future of Alitalia. I believe the restructuring plans that the consortium has for Alitalia are both credible and realistic. And as a result of that, we believe it is absolutely right that we should have discussions with the consortium.

I believe we offer CAI and the new Alitalia a very credible alternative to what Lufthansa and Air France have proposed for the future relationship. Just to make it clear, however, and we have been clear with CAI in relation to this, we are not talking about any equity stake in the new company. And that has been addressed up front with the consortium, and they've been clear to us that that does not represent an impediment to a potential relationship.

So the discussions, negotiations I think have been quite good, and they are continuing and we expect that to continue in the weeks ahead.

So they're the three issues that we're currently active on. I'm sorry to say not a lot to update in relation to Iberia, although then I believe we have now addressed the pensions issue, and American and Alitalia are progressing in line with my expectations.

Turning to T5, pleased to say it is fantastic. It really is performing well, better than we had expected. We're seeing record customer satisfaction scores on several key metrics, and not only on T5, but on other parts of our customer proposition as well. For example, booking processes at the highest level in terms of customer satisfaction that it has ever been. But in T5, we're seeing very high scores on issues like the check-in, connections process, the overall departure process, and punctuality, reflecting the significant improvement in the punctuality performance of the airline.

The chart here shows you our departure punctuality, and represents a very significant improvement. We now have all of the planned T5 flights in place. We completed the final move, what we call move 2.3; it's reached 2.3 on October 22. Interestingly, on that day, first day we operated, 250 flights at T5, 119 of the 250 departing flights left early, and we had overall punctuality figures of 88% within 15 minutes.

We've had a record performance on October 14 when we had 95% of flights depart within 15 minutes. That's a record performance in the history of our operation at Heathrow. Yesterday, our performance was 82% and on Wednesday it was 84%.

So we're seeing consistently high levels of punctuality. That has been recognized by our customers, and is having a significant operational and financial benefit in terms of the cost of operation in T5.

We've also seen very strong performance in terms of arrival punctuality. We tend to focus on departure. I know from a customer point of view, arrival punctuality is probably a more important issue, but given the just-in-time nature of Heathrow, our focus on departure punctuality is very important because we need to ensure that aircraft depart on time so that we have parking stands available for arriving aircraft.

Heathrow struggles from a lack of runway capacity, but also from a lack of stands capacity and, therefore, the way we manage our punctuality at Heathrow is very important to us.

We've had 12.2 million customers use T5 to date, and the vast majority of those customers have had a very good experience. This chart reflects the other area of focus, and that is the baggage performance, and I'm pleased to say again, we're seeing record levels of performance there.

You can see a spike there; it's notated the SITA system failure across London. That was a SITA communication system failure that impacted on a number of European airports. That happened on October 1. If we exclude that, we would have had a record October performance in terms of both direct and transfer baggage at Heathrow.

And I'm pleased to say that the BA to BA transfer operation is working incredibly well. We still, however, do suffer as a result of the poor performance of other carriers transferring their bags to us. And independent statistics, the BAA statistics demonstrate that British Airways is now operating at the top of the league in terms of transfer bags; what they call chocs to docks. That's getting the transfer bags off the aircraft into the transfer system. We're at the top of the league there with a performance that is significantly greater than most of our competitors.

However, their performance where they're transferring bags and passengers to us does impact on the overall level of performance that we report. But we've made very significant progress here, and that has had a significant financial benefit as a result of a reduction in the overall level of misconnect bags. So T5 performing really well.

The other key metric that we have focused on is the baggage into the arrivals hall. From a customer point of view, this clearly is an important issue. You can see that we're again achieving the standards that we had set for the terminal.

It has been slightly more difficult as a result of the full operation now in T5 where we have more remote parking on the T5C campus area. T5C will not be complete until early 2011, and that does impose some additional operating restrictions and difficulties on it.

However, even with that, we've consistently exceeded 80% of our short haul bags being delivered into the -- onto the baggage carousel within 25 minutes, and for long haul we're achieving almost 50% within 25 minutes. And for the vast majority of passengers, that will mean their bags will actually be on the carousel before they arrive into the baggage hall. So we're really pleased with the progress that we've made there.

Overall scores in terms of customer satisfaction are at record levels. So it's not just me telling you this, it's our customers telling us this as well. So I think the standard of operational and customer performance is benefiting us, both in terms of our financial results, but also in terms of cost, but also in terms of revenue.

The improvement in customer service is having a positive impact on our revenues; it is having a positive impact on transfer traffic. And we believe that this is an area that we can continue to exploit in the months ahead.

Looking to capacity, for the summer period, we now expect our capacity in ASK terms to be down approximately 1%. Now there is a greater reduction in frequency over the reduction in capacity, and that's a mix now of capacity reductions, ASK reductions and long haul.

There are some ASK increases on short haul as we change the network, moving flights from short domestic operations into longer short haul flights, so we do get an increase in ASKs in the short haul operation as a result of that, but there is a decrease in the number of sectors that we will operate. But overall you'll see about a 1% reduction in capacity in ASK terms.

We have taken the decision to temporarily park a number of 747s, and we will replace those 747s with the 777-200s that we're taking delivery of. So the capacity reduction for the summer is not as significant as it was for the winter where we reduced capacity by over 3%.

We will in the months ahead look at winter '09. I think it's far too early to say what the capacity in winter '09 will be because I believe that despite the difficult economic external environment, we will see capacity coming out of the industry as more airlines fail in the months ahead.

Now finally, just to touch on some of the actions that we are taking, I think the delay in progressing the discussions with Iberia has actually given us an opportunity to focus on some internal changes, and that's been very helpful to us. We are taking decisive action to address the change in the external environment. As Keith has said, we've reviewed all of our project activity and either cancelled or suspended a significant number of those projects. We continue to review capital expenditure, and Keith has given you the figures in relation to that.

We have a major new culture change program that is being rolled out across the business. One of the first steps we've taken was the voluntary severance scheme for managers. Now that delivered on the commitment that we gave you in December '05 when we said we were going to reduce senior managers by 50% and managers by 30%. So not only have we now delivered and accelerated that commitment, but we've gone further, reflecting the change in the work that will be done within the business.

All of the -- sorry, the vast majority of those managers will leave the business by December 31, and we're using that now as an opportunity to restructure the organization. That will start from the top, and I believe this gives us an opportunity to accelerate the culture change program, but also to make our operations decision-making processes more streamlined, more efficient, and reflect the need to be able to move faster to take advantage of opportunities, and to move fast to address any changes in the external environment. All of the revised plans will be in place by December 31.

So we are taking decisive action to address the changes that we're seeing, and you should expect us to continue to do that in line with the presentation that Keith has shown you.

And I think it's now questions.

QUESTIONS AND ANSWERS

Martin Broughton - *British Airways - Chairman*

Thank you very much. We've had the results and the story behind the results. Who wants to kick off with questions?

Edward Stanford - *Cazenove - Analyst*

Morning. Edward Stanford from Cazenove. Three questions, please. First of all, looking at the CapEx chart, it looks like the CapEx plans for succeeding years has gone up a little bit. Could you perhaps give a little bit of flavor of what's going on there? If you could possibly remind us what the average rate for the hedging is for next year.

And on a strategic basis, British -- what is your view of the future of British Midland, and will you be taking an interest in what's going on there?

Willie Walsh - *British Airways - CEO*

I'll deal with the BMI issue, and then Keith can give you the update on CapEx and hedging.

I think the important thing to point out in relation to BMI is it's exactly as we had expected. Everybody has been aware of the put and call options that have been in place. I had expressed a view some time ago that in the current economic conditions that I wouldn't be surprised if Sir Michael Bishop exercised his put, and I think if I was in his position, that's exactly what I would have done. And what we have now is a competitor that has a new owner. It's not a new competitor, it's an existing competitor with a new owner.

In the short term, quite honestly I think BMI will miss the guiding influence of Sir Michael Bishop, but clearly, Lufthansa will take steps to address that in due course. But I actually don't see it radically changing the competitive landscape at Heathrow.

I'm not clear at this point as to what Lufthansa intend to do with BMI, given their activity in M&A elsewhere as well. So they appear to be spoilt for choice at the moment, but have I think difficult decisions to take in the months ahead. And we will continue to watch with interest what happens with BMI.

But clearly BMI, like every other airline out there, is facing a very difficult trading environment, and will have to take steps to restructure the business. We saw yesterday I think it was the announcement of the cancellation of the long haul services from Manchester. Again, that doesn't surprise me. That follows on from our decision to exit Manchester JFK.

And I'm sure what we were seeing in that market is very much the same as what BMI was seeing in that market. They have a number of long haul aircraft that they can use. It's not going to make any impact if they decide to use those on the transatlantic, given the scale of the operation that's possible. I'm not clear at this point that they will actually decide to do that.

So we'll watch with interest, but it doesn't change things. I think the company will require restructuring and, as I said, in the short term I think Sir Michael Bishop's departure will create a vacuum there that will need to be sorted out pretty quickly. So it's watch this space.

Keith Williams - *British Airways - CFO*

And on your other two questions relating to capital expenditure and fuel, on capital expenditure first, what you're seeing in those charts is in part the deferment of 777-200 deliveries from one year into the next, which is why you're seeing it come down in this year and increase next year.

But what we're also reflecting, as I spoke to, is we've cancelled a number of projects and deferred other projects. So that's reflected in the numbers. And we will continue to refine the capital expenditure over time and I'd expect we'll give you another update at results at quarter three and probably at Investor Day. So you should expect some refinement still to those numbers.

And on fuel, I tried to give you some guidance really. At $75 and $1.65 exchange rate, the fuel spend would come down next year to GBP2.8 billion. In terms of the breakeven level, I think you can see it from the chart that I've included in the pack that it's around $90, but to give you an illustration, if the price of fuel next year is $70, with the hedging that we've got in place, we're about 37%/38% hedged for next financial year, we'd expect to pay around $75 a barrel.

Andrew Light - *Citigroup - Analyst*

It's Andrew Light from Citi. I've got two questions; one on capacity. To what extent is your minus 1% capacity for the summer comprised by your need not to lose slots at Heathrow? Would you rather do what the American's are doing and go into a minus 10% situation? And they seem to be entering quite -- a period of quite decent profitability.

And secondly, can you give me some idea of the projects you're canceling, and to what extent are these strategic projects?

Willie Walsh - *British Airways - CEO*

Okay, on capacity, I think the capacity reductions that we've taken reflect the 80/20 rule on slots, and we don't see that rule changing. So if we're compromising, we are compromising to some degree to ensure that we comply with AD20. That doesn't really change the capacity reduction; it changes more the way we're taking the capacity out, because it's not taking a single flight out throughout the season, it's changing flights through the schedule where we have multiple frequencies on routes. So it's more complex from an operating point of view. In a T5 context, complex from a stand planning point of view because it's not a consistent schedule day after day. So it's added some complexity to it. I think the overall capacity reduction hasn't really been compromised as a result of the AD20 rule.

Keith Williams - *British Airways - CFO*

And in terms of projects, if I understood slightly in the reverse, there's a number of projects that will continue, and I would like to emphasize that. So for instance, the Club World rollout that will continue. We're investing in in-flight entertainment, so there are lots of projects that we're continuing. We are postponing or canceling some back office projects. A major one is an ERP replacement that we'd intended over the next couple of years, and we'll be deferring the first rollout and some lounge expenditure.

Chris Reid - *Deutsche Bank - Analyst*

Hi. It's Chris Reid from Deutsche. I've got two questions actually; sadly on pensions firstly. So I guess my understanding is that the actuarial deficit is the number that counts really in terms of what you will have to put into the pension. So is it fair for us to assume that that figure has worsened from March 2008 (inaudible) [BT]?

And then secondly, my other understanding is that the trustees can or should review pension contributions in the context of a material change, i.e. takeover or a merger. So is that correct? And also, what's their view on that, because obviously there's been various issues expressed about their opinion on Iberia?

So those are the two on pensions, and actually the only other one was on just a general sense of what's happening in the planes at the minute. At the Q2 Lufthansa put up a good slide showing that the number of people from Asia had increased in their [hauls] on the long haul, and that had been offset by a reduction in direct traffic. What's your feeling of what's happening within the planes? Is there a change in the mix of people actually using the service? Thanks.

Keith Williams - *British Airways - CFO*

Yes, shall I do pensions first? Can I take the easiest side of pensions, if there is one? In terms of the trustees, the trustees actually have no direct input into the merger talks with Iberia. What they are looking for is the strength of the covenant attached to the merger, and if anything, we see the covenant as improving not decreasing. So that's their one input is if the covenant was being worsened and that wouldn't be the intent.

And in terms of the valuation, yes, the valuation we were showing you was at the March 31. If you look at the position at the end of October, and there's a ready reckoner, it would be slightly worse at the end of October. But I would emphasize that pensions, it moves around weekly, and the real question that will come up next year is the question of affordability, which is what I was trying to emphasize in the presentation.

Willie Walsh - *British Airways - CEO*

And in terms of what's happening in the cabin, one of the points I made in the presentation was the very strong connection process at T5 where we've seen a significant improvement in that recognized by our customers. It is by far the best connection process at Heathrow, and I believe indeed better than the connections experienced at the likes of Paris Charles De Gaulle and Frankfurt. And as a result of that, we are seeing some changes in relation to transfer volumes, and that's us deliberately targeting sales in Europe, and also sales in the US to Europe.

And we get the benefit of the change in the currency there as well. So we have switched our, if you like, our sales focus to reflect the change in currency, but also to take advantage of what we now believe is one of the best transfer products around. So that's probably the area of change if you like, and it's an area that we believe we can leverage going forward.

Penny Butcher - *Morgan Stanley - Analyst*

Penny Butcher from Morgan Stanley. Just as a bit of an extension to Chris' question on the types of customers, with the 4% revenue growth you've now given for the full year, I guess I'm trying to get a sense of what visibility you have now in terms of forward booking; how many weeks, and is that what you're basing the 4% on, and more or less hopeful then for the later part of the Q4.

And my second question is in relation to I guess the cost saving programs and restructuring that you are talking about for next year. Are there any potential risks on the union front in that respect? When is their next consultation on wages and things with them due?

Willie Walsh - *British Airways - CEO*

On the cost saving and restructuring, we are in ongoing dialogue with our trade unions. The issue of taking advantage of the T5 benefits that we're seeing, it's been well known and well documented, and we're in active dialogue with the trade unions on that. On the wage front the current wage round expires at the end of February, and that's clearly a discussion that we will have to get in to.

But I think everybody understands the incredibly difficult external environment. People can read the newspapers, they can see what's happening. And I have to say I think we're getting fantastic cooperation from our people at the moment, and that's reflected in the performance of the business where we've seen the strongest operational and customer scores that we've seen for years; indeed, in some cases, the strongest performance on record.

In terms of the outlook, I think we're being very realistic when we say that we believe our revenue forecast will be up at least 4%. Clearly, visibility is limited, but we're basing that on what we've seen so far. We're closely tracking booking patterns right across the network, and in different segments of our business. And we believe that that figure of at least 4% improvement in revenue for the year is a realistic target for the business.

Jonathan Wober - *Societe Generale - Analyst*

Jonathan Wober from Societe Generale. Three questions please. First of all, coming back to the CapEx question that Edward was asking earlier on. And you've said that you will revise numbers as well going forward, but what flexibility is there in the second and third years where CapEx has gone up to bring it down again if necessary?

Secondly, on your revised cost guidance which has increased relative to previously, apart from exchange and restructuring, what is there in the new cost guidance that's different from what you had before?

And then thirdly, just coming back to this question about the revenue growth, clearly, volumes are going to be down so it's all going to be yield growth. In the first half, you had exchange helping you, you had mix helping you, and you had price helping you very strongly. I assume that exchange will continue into the second half, mix will get worse, but what's your feeling for price? Because it seems in a downturn you'd expect pricing to start coming down at some point, or is the capacity reduction going to continue to drive price increases? Thank you.

Keith Williams - *British Airways - CFO*

If I cover the CapEx; and there is flexibility on CapEx going forward actually. What you're seeing reflecting in those numbers is aircraft deliveries, and as Willie said, we intend to take -- continue to take those aircraft deliveries because it's sensible for us to take fuel efficient modern aircraft. Now that might actually lead to the disposal of some of our older aircraft types, though to that degree the net CapEx might fall. And going back to what I said earlier on projects, we keep the projects under review, and that will be an update coming forward.

On costs, and you're seeing the costs increase slowdown in the second half, and that's really as you see some of the T5 stuff start to benefit. And a general lowering, which I gave you on the slide there, of supplier increases which had been very high in the first half, will start to slow in the second half.

Willie Walsh - *British Airways - CEO*

And on the revenue, our view has been quite clear. We have stated for some time that prices need to reflect the costs that we're seeing. We have deliberately increased prices, recognizing that that price increase would have some impact on demand, but we believe that that's the right thing for us to do, and I think that's reflected in the performance that you've seen so far.

So going forward, I think the price environment is still going to be one where we can see some price increases. I think capacity is coming out, and the capacity reductions that we have taken I believe are sensible. I don't see a radical change in the competitive environment in the months ahead, and I wouldn't necessarily say that mix is going to be negative.

Mix is a complex one. We've talked previously about transfer volumes; the low transfer traffic is at a lower yield to point-to-point. You can get quality transfer traffic, and particularly premium transfer traffic, and then factoring in currency into that transfer mix as well.

So it's going to be a moving situation, but we're confident based on what we've seen and the steps that we've taken in relation to pricing and capacity, that we will be able to achieve that overall revenue target of at least 4%.

Martin Broughton - *British Airways - Chairman*

Thank you. We'll take two more questions; one here and one there.

Unidentified Audience Member

I wanted to come back to the dollar. If I understand Keith's presentation, the mechanical effect of exchange rates is pretty much a wash between the revenue and the cost line. But when you look at the dynamic effect of what's happening, the US originated part of your business has been weak for some years, I guess with the dollar having been so weak. Are you seeing, whether in real bookings or in intentions to book, when you look at the US-originated part of your business, is there an increasing propensity for that to come back with a strong dollar? Can you make any comments around that?

Willie Walsh - *British Airways - CEO*

I think it's a bit too early to say that we've seen something. I think we believe that there is still a propensity to travel. I think the issue in the US is consumer confidence. What we'll be looking for now is to see an improvement in consumer confidence which really has been at the, I think, the lowest level that's ever recorded. And I believe that will, if we see it, and I believe we will see some -- not back to the levels that we had seen two or three years ago, but that can benefit us.

And interestingly, there is still good traffic flows from the US. It hasn't necessarily been traffic flowing into the UK, but there are good traffic flows from the US into Europe, and that's somewhere where I think we can participate more actively in, as a result of the transfer product and systems that we have in T5, than maybe we have done over the past couple of years when transfer to Heathrow has not been a pleasant experience.

But it's fair too early I think for us to say. The significant strengthening of the dollar has only really taken place in the last couple of months, and we haven't got sufficient data to give you a definitive answer in relation to -- in relation to that.

Martin Broughton - *British Airways - Chairman*

Last question now.

Neil Glynn - *NCB Stockbrokers - Analyst*

Thanks. Neil Glynn from NCB. Just that you've alluded to it a couple of times today in terms of transfer traffic and T5. Can you just expand a little bit in terms of where you are in terms -- relative to where you expected to be. Obviously, the environment has deteriorated significantly, but how that impacts the timing going forward.

Then on to the fuel side of things, can you talk a little bit about where you see your hedging strategy right now? Obviously, not a lot done over the last three months; the crack spread is currently at particularly wide levels, so the thinking on that.

And then if you could just confirm the [strike] prices for the rest of this year and the near 40% for the next financial year, and I think you have a little bit in (inaudible)?

Willie Walsh - *British Airways - CEO*

On transfer, I think one of the major changes that will influence the volumes of transfer traffic that we will see is the reduction in minimum connection times. We have had significantly extended MCTs at Heathrow while we were operating across the three terminals, T1, T4 and T5. Now that we have 90% of our operation within T5,we can now go back to industry standard MCTs. That makes us more competitive from a consumer point of view.

So combined with the improvement in the transfer product, we've got the change in MCTs, and we've also then got the changes I talked about earlier where we're looking at our pricing strategy and capacity that we make available in Europe and in the US for traffic flows between Europe and the US. And all of that we believe will be positive to the business.

Keith Williams - *British Airways - CFO*

Yes, I didn't show it in the presentation, but we are 10% hedged for 2010/2011, and that hasn't moved since the last quarter. In terms of hedging, I think we made a good decision over the summer not to continue putting on additional hedges, and clearly, we've been looking more recently with attractive spot prices that it might be appropriate to start hedging again. However, if you look at it, if you look forward, there's a very steep what's called contango on the fuel prices, and next year's prices are still relatively high. And I expect that we will put in some additional work or collars over the next few months to try and protect against a reversal in fuel price, but give us some downside participation. The price is low.

Martin Broughton - *British Airways - Chairman*

Okay. Well, thank you very much. We'll have to call it a close there. Thank you.

Keith Williams - *British Airways - CFO*

Thank you.
