British Airways

Investor Day

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Introduction
George Stinnes
Group Treasurer & Head of Investor Relations

Good morning everybody and welcome to the annual Investor Day. We have a real presentation to give today. It is one of those dry, boring ones the type that you would never dare give to any audience other than this one which relates to things like balance sheets, capital expenditure, all those type of those things. My only opportunity really to have fun with you is right now in my opening remarks.

The skill test question, what happened about 2.30 p.m on 11 February some 20 years ago. Do not be proud, someone stick up their hands and tell me. Well done, Chris. That was the time when British Airways shares for the first time traded on the public market. Today we are within a month of the 20th anniversary of BA being truly a publicly traded company. I do not know why we missed that but, of course, the only reason that I picked up on it was that when I looked through what I was going to say I consulted with the *Debrett's* equivalent of the airline industry, British Airways Fact Book. By the way you have a new copy for 2007 in your packs today. That was 20 years ago.

For me this is my 10th Investor Day, a horrifying thing to admit to and that makes me the longest standing IR person in British Airways history – even more frightening. When I took on this job 10 years ago there was an interesting relationship, we had a £7 share price, £700 million worth of operating earnings. I have to say I have ridden this horse all the way down to £80 million and 80p. Rest assured it is my best intention not to leave it in a state that was worse than when I started. Clearly +£700/+£7 are the numbers that certainly I am targeting.

Lessons from the past

Looking back a bit to 1987 and maybe even 10 years ago one of the things I thought about was what has changed and what has not? The airline industry is an amazing one. If I look back to 1987 and the time of the privatisation let me just read you a paragraph out of the prospectus: 'In order to replace the 747 100 the oldest aircraft in the longhaul fleet, BA has committed 16 new Boeing 747 400s and 10 spare engines'. There were a bunch of officers too you will be pleased to know. It goes on to talk about having entered into a big financing facility to pay for these and the 16 others.

It is funny we are talking about similar things again today although I wish the order of magnitude and scale was the same as it was then, because indeed it is a much bigger business today.

What else from 1987? Well, let me pick on the guys in the room here, all of you, let us look at the underwriters of our offering. The lead manager was Hill Samuel, any representatives here today? Baring Brothers? Robert Fleming & Co? Lloyds Merchant Bank? Morgan Grenfell? Schroder Wagg? I can refer to Lazards, they are still around. County Bank? Kleinwort Benson? Samuel Montagu? Rothschilds is still around. Standard Chartered Bank? And of course SG Warburgs. Existing in current form only two remain. So we do share something which is massive change in our industry.

Let us go back to the things that have not changed. Let me read you something here: 'British Airways and American Airlines submit a joint application to the Department of Transport in respect of their alliance in the North Atlantic'. We are still working on that one. We had another chapter just a couple of days ago. The topic of outsourcing, the airline transfers ground services operations for fleet at Heathrow and Gatwick to Ryder, Gate Gourmet outsource catering operations. What we are working on is the regional things which we announced just recently. Of course, the one which I have to say made me chuckle a bit, British Airways and the Transport & General Workers Union and the settlement of the cabin staff dispute. Yes, that was 1997. But some things as we look also stretch beyond our two industries. The order in which it was designed in the original prospectus were a firm called Ernst & Whinney now, of course, better known as Ernst & Young.

We are in a great stage of change in our business, and I am certainly excited about the change prospects we face over the next little while as we move forward finally in this year, with significant confidence to reaching 10% operating margin targets and re-embark into the future, hopefully for an era of profitable economic growth for our business.

With that, let me just have a quick look through the logistics of the day, which is important. [*Housekeeping details – information about afternoon BAA tour. Request for completion of feedback forms and information given about competition, prizes, etc*].

The Agenda again you have in your pack and there is nothing I need add to that. Normally this comes at the end of an event but because everyone seems to rush off at the end of an Investor Day, I would like at this stage to thank all the people who have organised the event today. The team that works for me is led by Ceinwen Williams, who did most of the organisation and Fidelma Horan who works in our conferencing/communications area – really big thanks for getting all of this together. We have managed to get all of you here, sitting down, reasonably on time, so I must express that gratitude. And with that, I will introduce Martin for some opening remarks.

OPENING REMARKS

Martin Broughton
Chairman

Thank you, George. Welcome, everybody and thank you for joining us today. Let me first of all introduce three of our non-executive directors who are here with us today. We have Ken Smart, who chairs the Safety Committee; Alison Reed, who chairs the Audit Committee; and Denise Kingsmill. They are all available for any questions that you want to ask them as well.

At a media lunch earlier this year, fully equipped, we changed the world's favourite airline into the world's favourite headline. It does seem that every day somewhere we are on the front pages for one thing or another; it is not a place to work if you get intimidated. Let me just go through a few of them. The security issues in August were the most serious and the longest lasting. Till then, the business had really been going gangbusters. The chaos and frustration resulted from that still exists today. To me, it is outrageous that between the dilatory of the security operations and the lethargy of the European Commission still today do not have a common standard …. As for the poisoning scandal – otherwise known as polonium 2 - obviously the worst incident for thirty years, just before Christmas. We have had baggage belt breakdowns – BAA baggage … - affected by those particular and of course, we had the cabin crew dispute. All of those hit the headlines. The media prefers to focus on the negatives; there are a lot of positives as well and one that did get a lot of headlines was the pensions deficit. It has been a huge achievement to get a resolution to the pensions issue, which has enables us to move forward. You saw recently the order for a 4-777 and some other options, the first expansion on the longhaul for six years. We have seen the launch of new Club class, better planes. This week, the tenth conversion comes out, and we are moving ahead.

That means that we have exited from the currently unprofitable and strategically irrelevant UK regional business, BA Connect, which has been another success. At the same time, although you have read a lot about the cabin crew, what you did not read much about was tremendous growth has been going on making advantages in working practices. Patient negotiation with the unions, with the staff across a range of different working units to change the very antiquated working practices. If you are going across to T5 this afternoon, that is just over a year away now and on 17 September we get the ceremonial keys to the door so to speak and we can start getting ourselves ready. So a lot of good work has been done over the last 12 months.

I ought to say something on Open Skies, which has come right to the top of the agenda. I do not need to go through our own views which are pretty well known to you. We think it is a terrible deal and that the US has everything it wants and the EU nothing it wants. American Airlines can fly wherever they like and yet retain the Fly America programme, the ownership, sole restrictions and the capital. It seems to be a real sell-out.

Not surprisingly, when we say that people accuse us of being protectionist, that we are trying to hold on. I believe that John Byerly at the conference accused us of being philosopher kings when all we were really seeking to do was to hold onto Heathrow.

I would just remind you, first of all, that Heathrow is the most competitive transatlantic route. When one talks about being restricted, there is no other route between the European capital and the American capital that has more routes, it is the most competitive. It is important to us, but we are not against staged implementation, what we are against is staged negotiation. It seems to us that the EU and US have absolutely no intention in stage two of delivering the open aviation era.

I want to read you an extract from John Byerly's presentation on Monday which demonstrates that. He talks about "There are others who worry that if the EU does not hold back traffic rights from the US, whether it is Heathrow access or intra-EU freedom, the US will not seriously negotiate further liberalisation. The validity of the argument, however, turns on whether holding back such rights would in fact lead the United States to change its statute to fit for example, foreign control of US airlines, right of establishment in the US of EU carriers or outright transatlantic ..” The answer to this question, I am convinced, is very clear. What he is saying is that they have no intention of meeting the mandate to deliver an open policy. What they want out of stage two does not enter into it.

Our proposal is a more constructive proposal. On 30 April at the EU/US summit, Malcolm… is putting forward a transatlantic proposal which includes a breakdown of the capital involved. That should be fine, and if it is fine, we will need to go to Congress and that is the time to go to Congress to say that aviation must be included in that overarching framework. Once Congress has agreed a date when ownership can come off in an overall framework, and I think 2010 or 2012 would be a realistic date – then we can look at it. But our suggestion is that at this stage simply to put it on ice, till we have decided what stage it is in. Put simply, there is no point getting halfway in a journey if you cannot agree the destination. At the moment that is really our position.

We will come back to that later. I will now pass to the third speaker, which is back to George.

BALANCING THE BOOKS

George Stinnes
Group Treasurer and Head of Investor Relations

I have to say, the title was chosen in my absence, when I was away on holiday with my daughter at half term. When I got back, I worried a bit about it because, as a non-accountant, the concept of balancing books is always a very difficult one. But on reflection, it is a great choice! Because the balancing of books referred to here is managing a balance between profitable growth, strong balance sheet and a significant capex programme, in a cyclical, capital intensive industry with large external influences and, dare I say, meddling. In short, what I have just described is the airline industry. What we need to do, therefore, is work our way through and deliver a balance which creates value for our shareholders.

My job, as I see it today, is to convince you that we are committed to maintaining a strong balance sheet and that the capital expenditure programme we are considering , can be financed without compromising the balance sheet that we have today. I must also convince you that in the event that the business is not able to deliver, for whatever reason, the margin targets that we have set ourselves, we have the flexibility to reduce capex and cut our cloth for the then trading environment.

Overview

To start, let me remind you briefly where we have been and where we are today, then demonstrate our commitment with respect to the future. We have not forgotten what we told you on Investor Day 2005 – nor, I suspect, have you. Two years ago today, Rod gave a presentation entitled *First to Worst and Worst to First*, which clearly took you through the mistakes of the late 1990s and the corrective action that we started, largely post 9/11, and the corrective actions that continue today. For the past two years, as that journey has continued, we have demonstrated that those corrective actions remain as valid today as they ever were. In particular, we have a relentless focus on driving ever increasing revenues from our assets. This year, we are targeting for the first time in the year ahead to achieve an operating margin similar to the one that we achieved in fact way back in 1996. It is indeed a long journey.

Between 1996 and 2000 we grew our fleet from 293 aircraft to 366 aircraft, an increase of 25%. Our longhaul fleet increased from 80 to 119 aircraft, almost 50%. Our total fixed assets increased by £3.6 billion to £10.9 billion and fleet assets increased by £2.1 billion, from £6.3 billion to £8.4 billion – a massive investment at that time in new and expensive assets. We grew far faster than the underlying demand for growth of travel. We grew our least profitable market segment the fastest.

So what happened? The common measure is something called profitability. First, the debt rose a whopping 60%; that, of course, happened because assets grew at 50%. New assets are always more expensive than old ones; capacity actually only grew by 25%. Costs grew by 26% and poor old revenue only staggered ahead by 15%. This will not surprise you: in 1996 we made more than £700 million in operating profit; by the year 2000, we had managed to reduce that to £84 million – a fall of 88%. I always describe that as a failed capex programme.

What was the agenda? We clearly had to regain control of our business and we did. We now look for profitable growth only which includes cutting unprofitable businesses. Four percent longhaul growth is consistent with that target. We now look for every opportunity to simplify our business. There are many examples and they continue: T5, ba.com, Exec Club, reducing fleet the list is endless and we have plenty more opportunity.

Asset Growth

We now have strong internal controls in place, particularly on assets: No investment return, no new assets. We are maintaining our relentless focus on costs. Going forward, we shall stick to the principles and now let us look at the impact of those actions in terms of the balance sheet and where we stand today.

Profitability

The story is quite simple: cash up, debt down, pension liability now down as well. The journey to achieve our now strong balance sheet was only possible with relentless focus and discipline.

Since 9/11

Since 9/11 our last wide-bodied aircraft was in October 2001, and the next one will not come until 2008/9. Yet over the period, because of our focus on assets and the use of those assets, we have considerably grown our capacity and the revenue that we earned from those assets. Today, because the fleet was very young in 2001, our average fleet age is still comfortably in line with our other network competitors, something which is frequently not recognised. At about 10 years, we are positioned right in between two other European majors.

We have also had a focus on non-fleet assets. Last year, or the year before on Investor Day, Alan McDonald took you through all the efficiencies that we have driven through the engineering organisation. Today, I am pleased to say that Andrew Grainger will join us after this presentation to take you through the property story, in its own right a considerable accomplishment. Our cash focus has allowed us to build a buffer against event risk, pay down debt and make a major contribution to our pension scheme.

Gross debt £3.4 billion

This slide largely speaks for itself. Gross debt peaked in 2002 at £7.5 billion and by March this year we shall be down to some £3.4 billion, a fall of 55%. Factoring in pensions, which we can reasonably easily do from 2003 when the FRS17 accounting standard began, net debt over that period will fall from some £8.5 billion to just over £5 billion by year end. If you factor in the second special contribution to our pension scheme, which will happen on 2 April, in fact gross debt including pension will fall to some £4.5 billion. Those are levels, even allowing for the pension scheme, that we have not seen in 10 years.

Over the last two years, we have done some considerable work in establishing a target level for cash holdings in the business and have concluded that a target of some £1.8 billion is appropriate for the business today. You can come at this in several ways but, broadly speaking, it is equivalent to the sum of our cash in advances carried, and one year's debt and interest payment – a nice security blanket to have. The figure of £1.8 billion is also the level agreed between the company and the pension trustees and their advisors as a sensible buffer against event risk for this business.

Cash buffer against external risks £1.8 billion

In 2006 cash rose to £2.4 billion in anticipation of the lump sum payment into the NAP pension scheme. In March 2007 cash is expected to decline, largely reflecting the first lump sum payment of £240 million, also the cash costs associated with the sale of BA Connect. After we pay our second instalment into the NAP scheme in April, we expect to achieve our £1.8 billion target level.

Net debt £1 billion

Let us also have a look at net debt. In December net debt fell to a low of £866 million. By March 2007, that is expected to rise to some £1.1 billion as a result largely of the pension payment. However, recognise that net debt including pension is at its lowest level.

Credit rating

What does that do for our credit rating? So far not much but I am very pleased to say that where we stand today, S&P have us on credit watch – those dreaded words. The words sound very good if it is for upgrade, that is where we stand today with S&P. Just recently, Moody's have moved our outlook up by two notches from negative to positive, skipping through the neutral range. Looking at the CDS markets, I can still remember CDS spreads of 900, and they are comfortably below 100 today.

Impact of pensions

Let us look at the pension scheme. In addition to the annual P&L impact on cost savings from benefit reductions of some £80 million, the changes to the scheme also have a significant impact on the balance sheet.

Pension risk reduced

Capping pensionable pay growth at RPI reduces the current deficit by some £400 million and, when combined with the lump sum payment of £800 million, reduces the pension deficit from £2.1 billion to £900 million, a reduction of £1.2 billion. Clearly, the final benefit numbers that we report in March may vary slightly as the actuary at every year end resets the valuation parameters to reflect market conditions. However, be clear that the financial value to the shareholders is considerable when you consider the reduction of £400 million in the deficit and an ongoing stream of at least £80 million of benefits going forward.

Just as important as the financial value of the benefit reductions is that we have significantly reduced the risk of the scheme to the company in the future. We now have a direct link between pensionable pay growth and inflation, making pensionable pay a key benefit definer, considerably better correlated to investment returns in the future. We have used mortality assumptions that best fit the experience of our scheme members, including an allowance for future improvements. In English, this translates to an expectancy of 85 years of age for 65 year olds today, and 87 years old for a 35 year old today, an increase of three years over previous assumption. Hands up here who comfortably think that they are going to live much beyond 85 years old.

When I saw this number I was really horrified: living that long may not have appealed. We have also significantly modified the discount return in the valuation reducing those from 6.8-5.2% - a major step. A major benefit growth obviously significantly reduced and any optional benefits in this scheme are now costed and priced to the members on an asset match basis. We are trying to make the deficit good over 10 years and be clear as more and more of you are including pension deficit into gearing numbers. This is a planned debt reduction over the next 10 years.

Maintaining a strong balance sheet

Having now brought the company to a robust financial position from a balance sheet perspective including interesting pension issues you will not be surprised that we are committed to maintaining that position. But before moving on to the implications of proposed capex let me just share with you our initial thinking on some balance sheet issues.

Since 9/11

Since 9/11 we have been frequently asked the question how much debt do you think is right for BA? Our answer is simple – lower. The reason being that we had a very long journey with a stable, robust balance sheet as well as taking the business to an economically profitable position. That is the business that earns its profit capital. As we stand here today that day is clearly in sight. Before moving ahead we need to be confident though about the appropriate level of gearing for the business in the future.

The gearing level that we target will need to consider the total cost of capital together with a balancing of operational and financial risks in the business into the future. We are looking for a long term balance sheet stability in the context of capital efficiency. The challenge is large on that issue. As I look around this room I will be very surprised that I can find 10 views that were consistent. The views across the airline industry are spread. You just have to look at how different airlines view the balance sheet.

Gearing considerations

Just to remind you we expect the following gearing ratios for year end. Net debt to total capital some 30%. We had the operating leases in round numbers 40%, and if you include pensions where they are today just under 60%. These levels are important to remember, because my next challenge is to demonstrate to you on what basis future capex will be gearing neutral, or put differently, will generate an economic return to the shareholders.

Gearing considerations

A few considerations that we look at for gearing – we expect to set a target gearing zone for the matrix that will be stable in the long term and easy to understand by our investors and other stakeholders. We are likely to continue with a minimum liquidity target, but in our volatile business we recognise the need that are actual gearing parameters will fluctuate over time, so you should expect that we will also include some time horizons on recovering the benchmark. We will also deliver a dividend policy giving due considerations to all forms of shareholder distributions. Finally overriding all is clearly efficient use of capital recognising financial offering risks in the business.

BA WACC

Let us just look at the latest average cost of capital for a minute. I will share with you our view of what we have done using capital asset pricing models, and indeed no groans from the audience, please, I know these theories are in great dispute. Many years ago I had the pleasure of studying under all three of Modigliani, Miller and Black and if tuition fees are a guide in terms of gaining this knowledge I can assure you this must be really good stuff. Theory apart the graph does make sense, extensive use of secured aircraft landing means the cost of debt is only sensitive to gearing when the gearing gets very high. It is a bit like running into a brick wall, and we certainly saw that when boring at any price was real tough post 9/11.

Also stable debt costs have quite a dramatic effect on the cost of equity as you move to deliver the business. The relatively flat curve gives interesting food for thought in the context of the gap between business and financial risk, and also for a ratings perspective where the level on unencumbered assets features strongly in their analysis.

Now almost the moment you have been waiting for, moving on to capex and our ability to finance the programme in a gearing neutral way. But before I move on to that topic it is helpful just to review a capex update for this and the next two years which will change slightly from previous guidance, in particular looking at the timing of capex around products and Terminal 5 and the impact of potential fleet orders.

Capital expenditure outlook

First this year capex will be around £135 million less than first thought as the product and T5 expenditures and a few others have slipped into next year. You will remember that we warned you in Q2 that 2007 would actually be less than £500 million and we posted about £450 million. Now as we are close to year we are comfortable with £365 million. Sadly, however, capex has not gone away and this will now feature as part of the 2008 guidance. You will have also noticed that in the year we chose to exercise some more A320 options and retire some of our older A320 100s. I am pretty confident in the belief that these are actually the oldest flying A320s in the world, and we were the proud owners of Serial No. 6. In aircraft terms that just about is the oldest airplane out of a production run. These aircraft have been sold for spares so not too many people will be flying them going forward except in pieces.

In 2008 we will also have to provide for some level of down payment, the longhaul fleet order that we are planning for later this year. In fact these numbers feature in 2008 and 2009. It is also well known that we are currently working on a review of our Gatwick operations. While we conclude that the business is viable we will need to consider replacing some 14 737s over the 2008/2009 period which also feature in this capex outlook.

Finally, we have made an allowance for slot purchases to give us more flexibility round the growth of these when the four 777s arrive in early 2009.

Capex – no early replacement

Let us look at the capex piece now. When looking at capex it is always a good discipline to consider how little you might get away with. We investors always like that approach and also, of course, still maintaining the size of the business. This scenario provides for no growth after the initial four 777s in early 2009 and replacement of aircraft as they reach 25 years of age. You can see with this scale capex is modest until 2014, and then rises to an average of some £1.25 billion until 2017. This would be the level of capex we could look at in the event that, for example, we saw no economic growth opportunities or value generation from early retirement.

Capex – early replacement and growth

The truth is our target operating margin of 10% for 2008 is indeed possible, i.e. the business is economically profitable. We see growth opportunities post-T5, and we do not believe we can achieve further sufficient efficiency gains from existing fleet to grow.

For the purpose of today, I have done some modelling on a quite aggressive capex plan. The likelihood, of course, is that in reality we are going to end up somewhere midway between this scenario and the one I am going to take you through now.

No ‘wows’ from the audience. It looks big, doesn’t it? A lot on the bar chart and lots besides. This scenario includes 4% longhaul growth – the top red bars; early replacement between 11 and 14; and Gatwick fleet replacement. First, a bit of housekeeping: you will also notice that the maintenance capex in 2008 is rather a spike, compared to other years, which is a function of the drift in the capital expenditure I referred to earlier around product and T5 from this year to next year. That should have been rather smoother.

In this scenario, capex in the year 2013 will drive to some £800-£900 million, excluding growth, or £200 million higher with growth. Beyond 2014, including growth, it rises to some £1.5 billion. Recognising that we have a 10% margin target, for the purpose of this exercise let us see what happens to net debt if we achieve a steady margin of 8%. In fact, net debt, excluding pensions, is stable at about a billion pounds from this year until 2012 and rises very slightly in the period to 2017. But this increase in net debt is actually in line with the growth of the business and the balance sheet – ie: cash flow at an 8% margin is sufficient to hold gearing steady. Moreover, net debt including pensions falls slightly through the period as the pension deficit is cleared. To sum that up, clearly if cash from operations is lower we will need, in the context of gearing targets, to review the capex. The balance sheet discipline is consistent with the core strategy of only accepting profitable growth.

A quick look at a very high level financing strategy. We currently continue to expect to finance the majority of fleet using on balance sheet secured lending. The model assumes financing at two thirds of the aircraft value for an average term of twelve years, recognising that maintaining some level of unencumbered asset is very important from a ratings point of view. We will use operating leases opportunistically to deliver fleet flexibility and manage fleet residual values.

We will look now at the debt repayment profile. Again, modelling early replacement, 4% growth and 8% margin, debt repayment remains flat until 2013, as new financing is broadly in line with debt maturity. Post 2013, as capital expenditure and funding rises, so does debt repayment but again, gearing remains stable in the context of a growing business. The anomaly that you see in 2017 is in fact the maturity of our 7.5% bearings £50 million bond, which is currently outstanding.

The 10% margin target: let me be clear that this is our target. We also have a secondary target that I have talked to many of you about at individual meetings, because the margin target is not necessarily robust in terms of shareholder value, and that is to deliver a ratio of revenue to assets of greater than one. When you take these two parameters together you in fact earn more than your cost of capital. They are put differently. From a cash perspective, our 10% margin target delivers sufficient cash for growth, asset replacement, dividend, tax as well as to protect the business from random business shocks without destabilising the balance sheet.

Looking at the asset turnover: again, modelling using an 8% margin, first the history. In the mid 1990s, when we were pretty close to a 10% margin, perfectly on target and on track. Asset terms collapse in the late 1990s with the capital expenditure programme that we already talked about and has now recovered as we have brought the ship back into line. Going forward, the asset turn ratio peaks over the first year of the plan, then, as capital expenditure increases during the second half of the plan, it stabilises at a level of 1.1 – comfortably above our target of 1.

Why that 10% again, given that it appears to work at 8? The simple reason is external shocks. One could obviously say that we are being prudent but in reality, we have two kinds of cycle in our business. One is the regular economic cycle and the other is the cycle of shocks. The worst time for this industry is when those two coincide, as happened in 2001/2002. I assure you that the shocks do exist. At a 10% margin we do not just allow for ordinary business cyclicality but that return discounts the shock that enables us to deliver shareholder value to the system.

We have talked about flexibility but what do we do with capex when life gets tough? How do we position ourselves today so that we can keep to our commitment of value generating growth. We start with a sensible set of growth assumptions. In the context of the markets that we understand today and to which we fly, 4% longhaul growth is consistent with sensible assumptions around expectations for GDP growth. Secondly, you enter into capex commitments that leave the flexibility to manage the capital expenditure consistently with a strong balance sheet. That is if your in Treasury. If you are in the Commercial department, you look at profitable growth but the end result is the same. The two are 100% consistent; they balance out. We create value for the shareholder on that basis.

Looking now at some of the issues: it is key to get the balance right between firm orders and options. However, the second consideration right now for us – and it is a very valid one – is to make maximum use of a fleet age profile where we are in a very strong position. As we come to the middle of the next decade, we have considerable scope for the retirement of older aircraft.

Capex – early replacement and growth

Within the structure of any orders, we will also target the ability to change aircraft type with any orders, which does not just affect capacity growth but allows considerable flexibility in terms of growing the network either in terms of depth or breadth. Managing that carefully is another big opportunity. Finally, asset value guarantees will also have a role and there are various structures of these, especially where the life of an aircraft type in the fleet may be unclear.

Look at early replacement, which is a form of flexibility. We will consider early replacements which are NPV positive and sensible in a cash and balance sheet context. The kinds of factors we will consider are environmental issues – both noise and carbon footprint; operating costs, driven by fuel and engineering; secondhand aircraft prices in terms of opportunistic sales of aircraft that are reaching the end of their useful life. Also capacity: both increases and decreases in capacity can be driven by early retirement. Think back to when we retired early the 747-200s and replaced them with 777s. Varying aircraft size, if you want to maintain the quality of your frequency and your network does not allow you to change your fleet numbers very much; but changing aircraft size is the way to deliver flexibility without destroying the customer proposition.

Slide

This is an amusing chart but, where we stand today, the envelope we are looking at is enormous. Providing for 4% growth would take us from some 36,000 longhaul seats today to over 50,000 by 2017. The red line represents no new orders, which is a serious option today, and clearly, though, our objective will be to give away as little as possible of this flexibility going forward. The replacement line is probably a good median point.

Let us wrap it up. To me the messages are gin clear. Make no mistake, we have learned our lessons of the nineties. A strong but efficient balance sheet is very much at the heart of our thinking. Disciplined capital expenditure aligned to economic growth, not uneconomic price-driven growth, will drive value for our shareholders as represented by our 10% operating margin target. I can still remember Rod in his early days saying that one of the big problems with this industry is that there are not enough people who believe that, just because someone turns up at the gate with a fiver, you don’t have any obligation to carry them. Customers need to pay their way, that is what part of the partnership is.

Our business will always be cyclical and subject to events: current topic Open Skies, which is a really recent example. There are also many others and it is important that we maintain a broad perspective around all the events that happen in this industry. What really matters is linking capital expenditure to profitable growth and a stable balance sheet, that is what matters. I firmly believe that our plan here will create value for our shareholders going forward. Thank you and with that, more about assets from Andrew.

PROPERTY
Andrew Grainger
Head of Property

Good morning, I am head of Property and I shall tell you a little about what we have been doing in recent years with our property assets and look forward.

Let me start with a quote: “Property, in my view, is an expensive, long-term and liquid asset”, and the quote indicates what a powerful tool property can be for the business to drive efficiency and change. However, it requires long-term planning and vision. To me, property is an asset which must be made to work hard for the business. It is important not to have too much and the real skill is to ensure that it adds maximum value. In my view, property in BA has made a difference to the business and I hope it will continue to do so.

Agenda

Today, I shall say something about our goals and objectives and the difficult legacy we have had from the past, and then I shall look at what we shall seek to achieve, what we have achieved in the last five years and what we shall achieve in the next five years – a bit of a journey.

BA Property goals

Starting with our goals: effective asset management, smaller, simpler, cheaper. Smaller because our legacy has given us too much property, a theme to which I shall return; simpler because the legacy also gave us a very disparate and complex property portfolio. Efficient infrastructure is an essential enabler of change for the business, and it has been used effectively in British Airways as a powerful tool to drive change across the business. Our management model is flexible and efficient, the intelligent client, as we describe it, with only strategic management retained in-house.

A legacy

Our legacy derives from our public sector heritage, past mergers of BOAC and BEA, British Caledonian, Dan Air – all these names from the past. Also rapid industry development over 30-odd years all contributed to a property portfolio that was poor quality, inefficient, disparate and probably too large even in the mid-1990s. In the mid-1990s we embarked as a company on a major £1 billion property investment programme as part of the business efficiency drive but also, as George has said, as part of a general increase in our assets across the business. That led to many new facilities being developed: the building we are in today, Waterside; the cargo building which I believe some of you visited last year, and British Airways maintenance base at Cardiff which I believe you visited two years ago – a fantastic new facility.

Notwithstanding that investment, the inefficiencies of the past were not driven out at that time, and there was still lots of opportunity to exploit. Much of this legacy property was situated here at Heathrow, on our maintenance base and, similarly, at Gatwick, and has given rise, as we shall see later on, to too much vacant property on our portfolio.

Objectives since 2000

That led to a major review of our objectives back in the year 2000, and it was clear that we needed to refresh these objectives and have great clarity to resolve the structural issues and focus on sweating all these modern property assets in which we had invested so much over recent years. We needed to drive asset utilisation, consolidate the business and radically simplify the property business in parallel with similar initiatives across the company. As a result of all of that, it would also release some opportunity to sell off surplus assets.

2000 to 2005

We achieved a great deal in the first five years of that programme. The events of 11 September 2001 provided the imperative to accelerate progress. In 2002 alone, we sold offices in West London and Crawley, industrial premises here at Heathrow, residential property in Japan and a New York City hotel. We realised over £90 million in that one year alone. Many of those sales followed some pretty rapid changes in the business – consolidate and get out of property.

Of course, the whole process was supported by rapid changes and improvements across the business, reducing manpower and rationalised business functions. In the UK, therefore, our operational space reduced dramatically. Engineering took 35% of their operational space out of the business. In the terminals we reduced space by 30% and, perhaps most impressive of all, in offices we took nearly 50% of our space out, which led to financial savings culminating in £25 million per annum and cumulatively £55 million over that period. I talk about space because space is the driver of cost for property, it is really a proxy for cost and that is something we focus on all the time.

Global property 2006

Where did that leave us by the beginning of last year? In value terms on our books about £850 million worth of property globally, and similar in terms of value. As you can see from the left-hand pie-chart, the bulk of that value is here at Heathrow and, frankly, in my view rightly so. It is where our core, absolutely essential assets are. In cost terms, looking at the right-hand pie-chart, £260 million per annum, just over 3% of corporate costs, and these are driven by volume and space, hence our relentless focus on driving down space.

UK property

A large proportion of our operating cost is also here in the UK and particularly at Heathrow and to a lesser degree, because we have more leased property, further afield. However, we have property almost everywhere we fly, mostly leased, and our recent focus has been to scrutinise this property and reduce it to an absolute minimum. That said, we have one or two very significant assets further afield, most notably JFK Terminal 7 in New York.

Returning to the UK and space, in the UK last year we had about 820,000 square metres – nine million square feet I sometimes say – and what does it mean in real terms? It is about 18 times the size of this complex, or seven times the size of the 50-storey Canary Wharf Tower. Of course, it is mostly not offices, I hasten to add. As you can see from the left-hand pie-chart, most of the property is at Heathrow and more than half is operational, particularly industrial property.

Our consolidations of the past were a great success but they left structural problems and, as you can see from the right-hand pie-chart and the red piece of pie, only 75% of our portfolio at the start of last year was occupied by the business, 20% was vacant and hence not working for the business or providing any real return, actually leaving some cost. This leads back to the legacy of the past that I described, particularly here at Heathrow and at Gatwick on our maintenance bases: obsolescent hangars designed for long past aircraft types, engineering workshops, defunct offices mostly behind high security fences, inaccessible, generally very poor quality and, in some cases, with very restricted leases from the airport authority. What does one do with that type of property?

The 5 year property plan (2006)

Early last year, we developed a new property business plan looking forward over five years to 2011 – as I said, property is a long-term business. Overarching that plan was, of course, Terminal 5, managing the wholesale property change associated with the Terminal 5 move and that had to be the centrepiece. We also, of course, looked at the remaining legacy issues as well as looking forward.

We also concluded our consolidation programmes into one office at Heathrow to resolve the outstanding structural problems of vacant property to plan the future particularly for future fleet changes and our business growth, and ensure there is sufficient concrete here at Heathrow to park aircraft when not in the air, and to respond and potentially contribute to BA's plan for airport expansion here at Heathrow.

Heathrow – an overview

It would be helpful if I gave you a quick sense of where all these property assets are. It says most of them are here at Heathrow, but just to orient you, Central Terminal Area – Terminal 4, the building we are in today – Waterside, our crew reports into Compass, the building we are exiting over the next few months. Terminal 5, our new operating base, World Cargo to the south of the airport where we have recently built a new cleaning products facility. In the far east, Cranebank, our training recruitment centre, both freehold sites we own, and then importantly our Heathrow maintenance. There are two sections to it, 180 acres of land, you can see in the context of the airport as a whole they are very substantial tracts of land. They are held on a long lease, 150 years, by us. We describe it as a virtual freehold. They will continue to play an important role for us in terms of our long term maintenance operation but it has much more potential.

Terminal 5 [1]

In a little more detail I will run through the key elements of our plan. Terminal 5 – in June last year we signed an unprecedented relocation agreement with BAA which established the commercial framework for our move from T1 and T4 into Terminal 5. That has in turn enabled us to put in place over 40 lease agreements for our occupation at the various parts of the terminal. In the second half of last year we started our own construction and fit-out programme for our dedicated facilities within T5. These projects are now reaching a peak of activity ready for completion in the late summer, and the all important operational resonance testing programme prior to opening next year.

The lower photo is that of our eastern logistics building for engineering and ground fleet services. We are also fitting out new concepts of premium and passenger lounges and extensive staff accommodation.

Terminal 5 will represent a step change in the quality of our facilities for our customers and for our staff. We have also increased the premium passenger lounge space to provide an improved customer proposition as well as, of course, a new concept. My colleagues will be saying much more about that later on today.

Terminal 5 [2]

The physical move for BA and other Heathrow airlines will be a huge logistical undertaking, 56 airlines are moving over about a two year period and the timely exit of all our property interests across T1 and T4 will be a significant challenge for us. At Terminal 3 the future home of OneWorld and up to 10% of British Airways services will be preparing for our occupation with First Airlines expected to vacate in the next phase for us in April 2008, we move in in June 2008.

Office consolidation [1]

Cranebank - I expect this to be the last chapter of our office consolidation and over the last 10 years we have gone from around 25 different buildings around the Heathrow area, the functions of those buildings are all now, or will be, within the next months housed in this building, this complex. We will drive the utilisation of Waterside back to a number of 4,000 staff in the building. As a reminder back in 1998 when the building opened it was planned to have only 2,500 staff in here. It is a modern cost effective space which runs the operations with all the staff being in one building. There will be a single corporate centre at Heathrow and it is now to be an operational building as well with our functions from the company centre up the road moving in here later on this month. Importantly it is only five minutes from Terminal 5. So effectively we will form a north west campus north west of the airport.

Turning to the Compass Centre we will vacate and clear in the next 15 months because our crew report function is moving into Terminal 5 on its opening. We will hand back the property to our landlords, we have a lease with the Airport Property Partnership. In the meantime if anyone is looking for about 200,000 square foot of prime offices please talk to me afterwards!

Office consolidation [2]

Also on the office front I mentioned Cranebank earlier an excellent 35 acre site of which we own the freehold. Many of the functions in that complex will also move to Waterside in the coming months and years and we will release about half the site for other uses, and a potential for third party development and disposal opportunities.

The story is not just about Heathrow. Further afield global call centres – major centres, as our own business has increasingly moved online call volumes have dropped. In 2000 we had 18 major centres, today we have seven, and as call volumes continue to decline we expect reduction.

LHR maintenance base [1]

Turning to the maintenance base, have said it is in roughly two equal parts, East and West base, it is nearly a third of a square mile in size. Each of the individual sites, the two equal sites, are huge in their own right, each about the size of 50 football pitches and bigger than the Canary Wharf site. Look at the West base first, the buildings are over 40 years old and mostly obsolescence with one notable example. Demolition is the only solution to release the latest potential of the site and enable future development opportunities and get some value from the land in the short term. We need to secure the ability to provide new housing capacity as future fleet changes occur and growth in our business. As I have said already we also need to ensure we have adequate land to park our aircraft when not in the sky.

However the scale of this site goes beyond BA's own needs. Potentially it is a key enabler for future growth of Heathrow supporting BAA's Heathrow east development. It could also have functions for other airlines in due course. We do believe that ultimately there maybe an opportunity to realign own ownership and dispose of part of the site.

LHR maintenance base [2]

The East base – again 90 acres and a long term home and core of our engineering operation. It also houses our principal data centre. Future developments in the east of the airport also impact this site, and again mostly, if not all, of the buildings are over 40 years with some much older. I have to say the legacy provides interesting challenges here.

Technical Block C as we affectionately call it I described as a conundrum. Who would possibly design a building like that today. Two floors of engineering workshops on the ground floor, two floors of offices at the top, sandwiched in the middle seven floors of car parking. Actually it is a functional building, it is useful but how could you design it like that?

Technical Block A – once the headquarters of BOAC and now a large and important area which is a 747 and 777 hangar. It is a listed building so we are not masters of our own destiny, but at some point in the future that site is likely to need re-development. It is probably 60 years old.

Heathrow Eastside development opportunities

Briefly I will summarise the opportunity around these remaining spaces. We are working with BAA in developing our thinking for the future development opportunities not only for us but also for the airport, and also in the context of the Heathrow east terminal.

Again to orient you the Central Terminal area here, this is a photo of our two bases, Heathrow east terminal, the re-development of T2 in this area and the west base and beyond is aircraft parking and also helps development of further phases of Heathrow east. Then opportunities for future hangar developments and other engineering facilities to support the airport. Very much work in progress but gives you sense of the scale of opportunity.

Gatwick

Moving away from Heathrow – Gatwick. Gatwick has been a long standing problem from a property perspective certainly in the last few years. It is a bit of a microcosm of the legacy I described earlier, large obsolescence buildings, an inheritance from BCal and Dan Air and particularly restrictive leases. Also a factor was our expansion in the 1990s, but recently we have been able to resolve these issues and in the last 12 months we have made an agreement with Gatwick Airport for a dramatic reduction in our property portfolio. We are currently demolishing 70% of the maintenance base and retaining just one, large flexible hangar for aircraft maintenance. Our dedicated baggage and check-in facilities will go across Gatwick as common user and we have a substantial reduction in our office and career report space. This will result in a reduction in our property overheads of about £7 million per annum.

Energy and the environment

The more general issues: the Stern Report, recently published, identified the built environment represents about 45% of all carbon emissions in the UK; 18% are non residential but property has a significant contribution to make across industries. Of course, that is rising rapidly up the political and corporate agendas. For us, our drivers are corporate responsibility but, more tangibly, rising energy costs – unit costs for energy have probably doubled in the last five years; rapidly changing legislation in the European Union; building regulations – all sorts of things, which amongst other things will require building certification, a certificate like the one you have when you buy a new fridge. That will have an impact on use, occupation and, perhaps most importantly, the value of property assets. But it is more than just energy. Also on our environmental agenda is, for example, waste management and recycling – both important issues.

Our energy policy

To give a flavour of some of the things that we do: on our demolitions at the moment we are recycling 95% of the waste that comes from those buildings; about the only thing we cannot recycle is asbestos. In the context of T5 – designed of course with environmental efficiency high on the BAA agenda – we are carrying BAA's objectives through in our construction of the terminal and also into the operation. We have, in addition, participated in recent years in the voluntary UK emissions trading scheme and we have been able to reduce substantially our property emissions and plan to continue doing so. To that end, we have recently agreed a revised energy policy for our property in working with the Carbon Trust. In short, in future – as to a large extent in the past –

we are going to procure energy efficient buildings, maintain and manage our buildings and processes for energy efficiency, educate people and design processes within our buildings in an energy efficient way – the way we use buildings, set targets for continuing gains supported by modest investment plans. With that we are confident that we can continue significantly to reduce our energy footprint, as we have in recent years.

The picture is the Waterside parkland, just outside this building: 260 acres of beautiful parkland surround the building, owned and maintained by us. There was a planning obligation relating to the original development of this complex but it is now an important environmental contribution to our local community.

Safety

I must address safety. Like every part of this business, safety is inherent in our culture, across our projects and in everything we do. We strive to adopt best practice in all our activities and, in T5 developments, we have integrated and aligned with the BAA on the T5 health and safety policy, which has meant full adoption of incidents and injury free, with a target is zero lost time for injuries and reportable incidents. Moreover, our record bears scrutiny. We have recently won two awards for our T5 project and our facilities management provider has won a ROSPA Gold Award for safety practice.

… and finally

In conclusion then, we have worked hard over the past seven years to 'right size' our property portfolio and sweat our modern property assets. We have succeeded in a substantial reduction of our space, which has fed through to financial savings and capital disposal receipts. There is more still to do and we have a clear plan and target to deliver by 2011, if not sooner.

… and

By 2011, we will have taken out 39% of our total space and that accounts for an increase in relation to T5. Our occupied space, used by the business, will have reduced by 37% and, importantly, our vacant space will be dramatically reduced and a lot of it resolved this year.

Finally then, since 2000 in the UK we have disposed of 27 properties, realising over £110 million. We have demolished 34 buildings and, overall, have 61 left. We have reduced our property interests by 200; we have saved £35 million per annum in property costs and reduced our space by 33%. By 2011: of course we will move to T5 next year; we will deliver further property consolidation – about 20% in the UK; we will have at least 45% less property interests and very likely a lot more than that; we will save a further £15 million per annum in the UK alone; and we will be ready for planned fleet growth and new aircraft types as they come in.

We have exciting and challenging times in properties forcing change across the business and ensuring that we make best use of our superb, modern property assets. Thank you very much for listening and I will hand over to Robert Boyle.

COMMERCIAL UPDATE

Robert Boyle
Commercial Director

Thanks, Andrew. George and Andrew have told you a lot about assets so far this morning. We are now going to turn to customers and to revenue. The Agenda I have covers our product investment plans for next year and beyond and then some discussion about current trading and the outlook for next year.

Agenda

We have a big and exciting year ahead of us. You have heard a lot about the new Club World products and hopefully, those of you who have not seen it have had an opportunity to sit on the seats outside. We have also had plans refreshing our First Class cabins just completed and further, major, plans which I will come on to later. As part of the Club World roll out we are embodying new inflight entertainment systems from our wide bodied fleet, with the audio visual on demand system. I will not say too much about Terminal 5, because you have heard a lot and there will be more about it this afternoon. I want to take the opportunity, however, to talk about what a difference it is going to make for our customers. Finally, I will come on to BA.com, recent developments we have made and our plans for the year ahead.

Club World

The new seats have been extremely well received by customers and I will show some statistics in a moment. So far, as the Chairman said, we have about ten 747 aircraft. Some of you at least have I hope had a chance to fly on one of those aircraft; they are operating to destinations such as New York, Los Angeles, Hong Kong, Jo'burg and Tokyo and recently Miami. As I have said, we are taking the opportunity when the aeroplanes are in the hangar to fit audio visual on demand to all cabins of the aircraft.

The new products have been well received, both at the large number of ground exhibitions, road shows, that we have been running, but in the air as well. This shows just a few statistics that we have from our regular monitor of passengers flying on the newly fitted out aeroplanes, compared to the ratings from passengers flying on the same aircraft type that still have the old products. In terms of the Club World cabin, we are seeing improvements in customer ratings of over 20% and, across the entire aircraft, improvement in ratings for in-flight entertainment systems of 30%. These are truly stunning increases and even though we had great hopes and confidence in our new product, these actually exceeded our expectations. We are totally convinced that we have a winner here, though it would be premature for me to quote any market share or yield benefits that we expect. We are very confident, however, that we will exceed our business case expectations.

New Club World seats roll-out

This new Club World roll out is also much faster than the previous roll outs. You may remember that it took us about six years to complete the programme of embodying the flat beds on all of our wide bodied fleets. This time we are going to do it in 20 months. We started in November and by next month, a quarter of the seats flying in the air will be the new Club World products and by August, they will be in half the fleet, with all of the 777s will be done by May 2008.

Another imminent milestone is New York. By some time next month, we will have enough aircraft to allow us to offer confidently a guarantee on Heathrow-JFK, so if you turn up to fly Heathrow to JFK you can be confident of enjoying the new product. Clearly, this is very high profile market for us and a very competitive one, with new entrants challenging us on that route, so there is a huge opportunity for us to fight back.

We are very conscious that the upgrade we are making to Club World was so significant that we need to do something with our First Class cabin. An increasing number of our competitors have given up on this market and exited completely. We are taking First Class off some of our aircraft and some of our routes but we have no plans for further removals of First Class. We believe in a post-Concorde era that this cabin provides a real flagship product for us: the people who sit in it are among the biggest influencers of travel in the business; it is a product that has been successful for us, and we have seen renewed growth in this market.

[*Pictures*]

The pictures up here are not pictures of what the new First Class cabin will look like. For that, you will have to wait until later this year when we unveil the radical new design we are going to do for First Class. This just gives you a little teaser of some of the areas we have looked to for inspiration: the best flying in the air in terms of corporate and executive jets, the best that is out there in terms of the top leading hotels of the world. We have looked to those for inspiration to bring in the new design, which we shall unveil later this year and which we shall embody on our aircraft once we have completed the Club World roll-out.

Terminal 5. There is an organisation called Sky Treks that once a year carries out a poll of frequent flyers across the world and asks them to rate who are their favourite top airlines and top airports. You normally get complete correspondence between who wins the wards, the top five best airlines of the world and the top five best airports: Singapore Airlines/Changi, Cathay Pacific/Hong Kong, Emirates/Dubai. There is one notable exception to that which is British Airways that features every year in the top five, usually the top three, but Heathrow's appearance in such surveys is usually at the other end of the table. Heathrow regularly wins awards as the worst airport in the world. That is an important distinction. British Airways has been extremely successful but off the back of a significant handicap in terms of the infrastructure we have had to operate from here at Heathrow. With Terminal 5, I believe that for the first time we shall redress the balance on that. It will be a fantastic experience, I hope you will see it this afternoon, and you should not underestimate the importance that will have for our customers and for us as a business.

A long shot of the interior of Terminal 5: this is the departure concourse area looking down. Our main lounge complex will be on the right as you look here, this is just as you come through security and, hopefully, when we are up and running there will be a few more passengers than are shown in this picture. Even with good load factors, this will be nothing like the scenes you see here today at Heathrow which are typically of congestion and queues. T5 will be a radically different experience for our customers.

An area of particular focus is the lounge environment. I have a couple of pictures here which do not really give you the full impression of what you will see. Andrew mentioned earlier that we have an increase in space, and today our lounges are beginning to get pretty crowded. This is in some ways a good sign, as it demonstrates the strength of our premium business but we are very conscious that we need more capacity. The new lounges will be more efficiently laid out, we shall get more out of our space, and we have about a 25% increase in lounge space in Terminal 5 compared to what we have in Terminals 1 and 4. We shall also have some lounge investment in Terminal 3.

It is a huge amount of lounge space and there was a risk that we end up with big cavernous lounges which are not intimate or pleasant for our customers. It will not be like that, we have adopted an approach of breaking it down into smaller spaces, so we shall combine the best of being able to offer excellent facilities with the sheer scale of what we provide, while still retaining that intimate feel and an efficient, quiet place for people to work.

New ba.com design

Turning now to ba.com, our website has been a huge business asset for us, and I want to give you a few headline statistics. Every month we take more than a million bookings on the site. Last year we had 1.4 billion hits on the website, it peaked during January for obvious reasons with a lot of people using the site to get up-to-date information on the impending cabin crew strike, and we had 1.5 million hits on our real time arrivals and departures site. While this was a time of adversity for us, it made a huge difference to our ability to keep our customers informed and to deliver service to them, allowing them to rebook and get refunds where appropriate, a feature I return to where ba.com is increasingly a huge part of being able to deal with the inevitable disruption that happens in this airline business.

The end of Q2, we told you about the new design site of ba.com, which simplified the site navigation and made all the key information on the site much easier to find, a new updated look and we also took a look at all the content we had on it, adopt the 80/20 rule. We had some stuff on there that was not really getting much use, it was occupying a lot of space and cluttering the site, so we have really focused down on the key things that people are looking for. We have received very good ratings back from customers and depending on the market, we get scores of between 80-90% of customers rating the site as very easy to use. It is an increasingly important tool from a selling perspective.

Selling

In 2002 we led the industry by introducing calendar-led selling, which, if you are familiar with the site and some of our competitors have copied it now, allows you to view up to 14 days of flights and make that visibility of our cheap inventory if that is what you are looking for, or to make the trade-off if you wish to pay a little more for a more convenient flight time. That facility has made a big difference to the uptake of the site and, in particular, our ability to sell off-peak flights effectively. We have now rolled that out last year to connecting journeys, which technically was a much bigger challenge and we now have that operating. Once again, it has proved very popular and we have a big uptake in the usage of that and, importantly, that plays a big part in driving our business on line. Connecting journeys has been an area where we were lagging behind, and introducing this facility gives us the opportunity to push online selling in that space.

We have also made a number of changes to the way in which the whole selling process works, made it simpler and quicker so that customers know where they are and can get to the all important end of the process where they give us their credit card details.

The servicing side has become an increasingly important part of ba.com. Online check-in and home-printed boarding pass has been extremely successful with our customers, and we have been focusing this year on upping the eligibility. We now have over 95% of customers eligible to check in online and to print their boarding passes from home. The areas where we have been extending are in rolling it out to more routes and larger categories of passengers, importantly families, can now check in and print their boarding passes at home.

We have also added a number of parts of functionality to the site in terms of selling, so when people come back to do the servicing, check in online, check their bookings, add their passport details, we have added a number of prompts where we offer them opportunities to upgrade. For example, we have added a Gatwick £59 one way upgrade which is offered to passengers whenever they come back to the site to service their booking. Or shortly when they come to check in online, they will be prompted with an attractive upgrade offer. As I said before, ba.com is an increasingly vital part of our delivering good service even in times of disruption.

Future developments

Looking to the future, key priorities for the next year are on the ancillary selling. We are conscious we have a long way to go in terms of catching some of the ancillary selling of success of other airlines. We have significant developments coming on stream this year which will give us live access to hotel and other partner industries and give us the ability to package their prices with our prices. That will give us a step change in the range of inventory of non-flight products that we will have to sell and the attractiveness of the prices we are able to sell them at. That is a big initiative for us this year.

We are also extending accessibility, our online penetration in last year's development such as the UK and the US is very high, but they are still extremely low in places such as India. One of the reasons for that is we do not allow people to buy online in the Indian market. We will have to have that facility added in the next couple of months. Extending the accessibility of online payment will drive further ba.com channel shift and we are also adding a number of additional languages including Chinese over the next year.

Future developments

We have talked about disruption, and the last year where we have made improvements and will continue to make improvements is on Executive Club, the servicing of our Frequent Flyer base. One particular area of focus is significantly the ease with which our Frequent Flyer customers can find redemption opportunities and expanding the range of options we give them, for example if they were to pay a redeemed flight as cash part mile. All of which is delivering us two things, one an improvement in satisfaction with the redemption opportunities from our Frequent Flyers and secondly potentially some additional revenue generating stability for us.

Current trading performance

Let me turn now to current trading performance. As has been said 2006/07 was an extremely challenging year due to the events of changing the hand baggage policy impacting on the attractiveness of Heathrow as a transfer hub, and also on the attractiveness of in particular shorthaul business flying and the added inconvenience that has added has been a dampener on most of those business segments. We also had the fog compounded by baggage belt failures and then after Christmas probably the biggest impact in revenue terms the threat of industrial action. In total, we estimate those events cost us £220 million during the year.

Let me look at our four major segments, longhaul, shorthaul between premium and non-premium.

Longhaul premium RPKs

The five year shows three lines, there is a red line which is an historical benchmark back to 2000/01 which was, if you like, the peak of the last cycle. This shows the volume that we took through the months of the year during that time. The green line here is last year's performance, the blue line is year-to-date. You can see from this chart in this segment just how strong the first half of the year was. We described it earlier as going 'gangbusters'. We were above not only last year but also the peak before 9/11.

We then hit August and you can see there although we remained above the previous year, where we had disruption the previous year as well sadly, we dropped below the 2000/01 benchmark. We then began gradually to draw ourselves back from that and by November you can see the line was beginning to get not quite back to where we had been in the first half, but on the right trend to get there and we were then hit by further disruption in December and then the industrial action in January. Our belief is that this segment remains fundamentally strong for us. There is nothing that we are picking up which suggests a weakening of this market place. As we look next year, which I will talk about in a minute, we have extra capacity coming on stream and a new product which is getting those customer ratings and we are extremely confident that we can achieve good increases in premium traffic next year.

Longhaul non-premium RPKs

Not quite the same story on the non-premium side, this is an area where we have some weakness on the Atlantic. Again you can see the three lines there, we were running strongly last year despite the fact that we had already then a weakness in the non-premium market in the North Atlantic. I will turn to that topic later, but still there were other areas doing strongly enough that we were considerably ahead of last year although not back to the levels of the traffic that we took back in 2000. Obviously a lot of that is the capacity effect, we were running record low capacity during this period and we will have taken out capacity downwards.

We then hit August. Again this segment is less immediately impacted, these are passengers that have longer lead times in their decision-making than the premium passengers. It took a little bit longer to see the hits but it is also taking longer to bring it back. Again this is an area where in terms of the bookings that we have seen in recent weeks we are now seeing this business coming back, and we have a lot of activity in the market place to plug the gaps that we lost during that period where we were effectively closed for sale in the face of a strike threat.

Shorthaul premium mainline RPKs

On the shorthaul premium side still a long way even back in the first half of the year behind where we have been in 2000. In shorthaul premium travel the market has seen a lot of structural change, modal shift towards part of the change and downgrading of company policies from premium travel to economy travel. But if you look at the beginning of this year we were not far off those levels of 2000 and showing growth year-on-year compared with the previous year. Some of that was the stabilising of the structural shift but also represented the success we had in repositioning Club Europe at least on some routes at some times of year as a premium leisure offering. Although businesses seem to have less money they want to spend on a good quality travel experience, an increasing number of individuals do have the money and the willingness to pay for an upgraded product when they are travelling on leisure.

Again we have seen the impact as we go into August, this has been impacted by the inconvenience effect of only being allowed to take one item of baggage. We have now got liquids back into hand baggage and we are working hard with some confidence to getting two bags for premium customers added back into the hand baggage allowance. We are also confident of getting two bags for all transfer passengers agreed in the near future. Both of those things will make a big difference to our ability to get us back to where we deserve to be in this segment.

Shorthaul non-premium mainline RPKs

A different story again on non-premium shorthaul. The flipside of those structural changes is there is volume based in the non-premium segment. Early in the year and continuing through the year we have been up both on the 2000 benchmark and last year. Again a segment that has been relatively much less affected by the structures that we have had. Clearly we saw a hit during January and on into February of the industrial action, it is quite hard to sell things when they are closed for sale. It is a segment where the recent booking activity has been extremely strong.

North Atlantic

I will talk a little bit about the North Atlantic. It is a tale of two halves, at the front end volumes remain strong. On the non-premium side we have seen some weakness. Whether that is the dollar effect or US residents visiting Europe, perceived hassle factor of immigration and security checks in the US as a place to visit if you are a UK citizen, or just the increasing availability of attractiveness alternatives whether in Europe, Asia or the Middle East. Those are all having effects on dampening down leisure travel on the North Atlantic. Clearly the hurricane season that was had two years ago put a big dampener on people’s willingness to book holidays in Florida. We have had a very good holiday hurricane season since then, there have not really been any, hopefully that will give us a platform for some recovery in that market next year.

BA has maintained its share on North Atlantic in a declining market

Although the season on premium market has been weak we have been holding our share. It is not a BA issue, it has been a market issue. The chart here shows market share in non-premiums in London and the US. The market share bounces around a bit from month to month partly because of disruption or the seasonality effect. But broadly speaking everything we see is we are maintaining our market share. This is a market issue.

India

I want to talk a bit about India. Since summer 2005 shortly after the UK and India agreed a major liberalisation to the bilateral agreement. This has been a bilateral agreement which had constrained capacity pretty much at six levels for about a decade in a market that we know has been growing extremely strongly. It was significantly liberalised effectively in open skies, the agreement between the UK and India, and we have taken advantage of the opportunity to more than double our flights to India. We have gone to double daily, single daily on Delhi and Mumbai. We have started flying to Bangalore now daily and we have increased frequency on Chennai provided we still maintain our service to Calcutta.

We have had a huge expansion during that time and we have seen even bigger expansion from our competitors. Let me show you the chart of what has happened.

Growth to India

Going back, as I say, to the period where this market was liberalised, a huge increasing capacity initially from competitors. In the first round of liberalisation most of the opportunities went to other people, in the second round we got the chance to fight our corner. The green line there is other carrier capacity increases, massive increases as you can see over 100%. In BA we more than doubled our flights, not quite such an increase in seats because we have deployed 777s on some of the extra frequencies, but still huge capacity increases, 80% in numbers. As you can see the yellow line, the volume line, pretty much tracking precisely the capacity line. Clearly there has been a yield effect in the market and on our own flights from that increase, but it is not as big as you might expect because of the pent up demands that existed. Much of this traffic was going via the Middle East previously. Having said that as we go into next year, and we have what will be much more modest, if any, increases in capacity there is a real opportunity for improvements in yields in this area as the market demands what is still an extremely strongly growing market catches up with the slug of capacity that has been added.

Growth to China & Hong Kong

A similar story on China, the other great growth story, again liberalisation of the market, we were allowed for the first time to fly to Shanghai which we launched in 2005. We have gone from two to three flights to Hong Kong and increased our flights to Beijing up to daily. Our carriers, Cathay Pacific and other Chinese carriers and Virgin have standard air capacity, so a similar story a lot of growth in capacity but again our volumes matching the capacity increases made. And again with an opportunity next year in which will be a much lower capacity growth environment in a rapidly growing market to see a bounce back in yield as the market catches up with the capacity.

Outlook

Looking at the outlook for next year, the first major item in terms of our revenue growth for next year will be that bounce back from the events we had in the current year, both on the operational side and, critically, on the business we lost on the industrial action threat.

I want to talk about the operating challenges, because sceptics may ask what gives us confidence that we are not going to see further recurrences of operational disruption next year. We have done a great deal and we were doing a great deal to improve operational performance in our business. Some of that was being done for Terminal 5, which you will hear more about this afternoon – fundamental changes in the working practices that we operate in the airport, systems that we use to manage resources, processes that we use in the terminal. A lot of those processes and changes are being implemented or have already been implemented in existing terminals and, once those are bedded in we expect to see the pay off from those improvements.

We have also introduced a number of changes to our schedules. We have changed significantly the shorthaul schedule out of Heathrow, to make it easier to deliver, which should give us a structural improvement in punctuality this summer. We have also decided to move some volume from Terminal 4 to Terminal 1. It is clear that the Terminal 4 baggage system is more than on the edge with the extra baggage now being checked in in the hold, and we are going to move bank hoover route back from Terminal 4 to Terminal 1 – that is two 747s-worth of flying into Terminal 1 from the summer. Again, it will take some load of the Terminal 4 baggage system which has been struggling. The Terminal 1 baggage system has been far more robust.

I want to talk about capacity for next year and where we see volume going, and yields. On the capacity side, I first want to pause to reflect on something that is not always obvious to people, which is that although Heathrow has had no extra slots for as long as anyone can remember, BA has been growing its Heathrow business in fact pretty steadily over the last five years.

BA's percentage of Heathrow slots

This chart shows the percentage of Heathrow slots that BA has. During the 1990s, our percentage share of Heathrow was steadily declining as the few slots that came up were given to new entrants under the preferencing rules. We began during the 1990s to respond to that and look for opportunities for trading slots and ramped up our efforts significantly in the aftermath of 9/11, when more carriers were in financial difficulties and willing to sell. But fortunately, those opportunities continue to come and we still find opportunities to buy slots and expect to be able to do so over the next couple of years. From the low point there in the late 1990s we have in fact increased our Heathrow slots by almost six points – an achievement that is often overlooked.

Conversion from Low J to Mid J

I talked about the new Club World roll out. One of the things we are doing as part of this is increasing the number of premium seats on some of our 747 aircraft. We have two different configurations: a high J/high premium configured aircraft with 70 premium seats and a low J aircraft with 38. As we embody those 38 premium seat aircraft we are going to increase the number of seats to 52 which, by the time we have completed the programme will give about another 8% Club World capacity.

This chart shows the timing of that during the year. We start essentially to embody the Mid J aircraft in earnest after the summer so we will see growth in our premium air space cutting in from the second half to the year, quite quickly, with a flip side effect of reducing economy capacity. The good aspect of this is not the economy part of the plane, which is generally stronger in the summer. The strength of business demand is in the second half of the year, so somewhat propitiously we have the timing right in terms of when this capacity is coming on during the year.

BA's market out of London City is growing

On the shorthaul side, I would like to highlight the growth we are putting into London City. When we sold BA Connect, which operated the London City route for us, we kept the aircraft and the routes – in fact, more aircraft than the routes that previously existed – to continue to fly as part of the group. We started flying out of London City in around 2004, launching our first flight at about the same time as the start of the Gulf war – perhaps not quite such propitious timing. But over that time, it has proven to be a real success both commercially and from a customer point of view. We are taking the opportunity as we are keeping more aeroplanes than the existing group offer with the BA Connect disposal, to replay those aircraft into London City and to grow our position there. We will be growing up to 22 daily flights from the summer, with new routes launched to Zurich and to Glasgow.

Capacity outlook

Where does all that lead us from a capacity outlook point of view? In overall terms, it is a very low growth year – 1% capacity growth, which reflects the fact that we are concentrating on moving ourselves into Terminal 5, then starting on the growth agenda from the following year. It is quite a different story by the different ?segments.

I will start with the highest column there, the shorthaul side, where we have a 6% capacity growth, some of which is the London City expansion and some of which is the bounce back from disruption last year. When we cancel flights, we tend to protect the longhaul operation so it was the shorthaul operation which took the hits in capacity. However, a large part of this is also extra capacity we are getting from converting our shorthaul configurations, putting spacesaver seats in aircraft – that produces about an extra row per aircraft – which is nearing completion. That will give us a significant, essentially free, increase in capacity on our shorthaul aircraft. As you saw from earlier slides, the economy shorthaul volumes are doing very well.

On the longhaul side – we have talked about this – the roll out of new Club World seats, the conversion of low J to mid J is giving us about a 3.5% increase in premium capacity, at the expense of about 0.5% reduction in economy. Despite the fact that that conversion reduces the net seats on the aeroplane, we are going to manage to ring out a small capacity increase on longhaul in total, then more utilisation still to come.

Seat factor and yield outlook

Seat factors and yield: the three main elements I would point out are that we will get a kicker to seat factors and to yield from recovering from the disruption last year – premium business that is easiest to book away, so to avoid repeating that we will get a mixed benefit there. We also have low overall capacity growth, which will be positive for both seat factors and yield. We have the benefit of the new product, both in terms of the uplift that gives us directly and the mixed benefits we get from growing premium at the expense of non premium. We will also get a mixed benefit from the shorthaul capacity growing faster than the longhaul – mixed benefit in terms of yield per seat factor.

Summary

So in summary, all of those things together mean that on top of a 1% capacity increase we also see improvements in seat factor and in yield.

I am sure you would like to see one more slide here, showing what all of this means in terms of revenue outlook for the year. I will disappoint you in one sense, because I am leaving Keith to give you that slide. On the plus side, I have finished my presentation and leave you with a summary of how we see the future. There are exciting opportunities ahead: new product launches, new services, culminating at the end of the year with Terminal 5, which we will start to sell in April. 2006 was heavily impacted, we expect to see a big bounce back from that as we move into next year and, although the targets and revenue outlook that Keith is going to share with you after the break are challenging, we are very confident in the commercial team that they are very achievable revenue targets.

Thank you.

[*Further housekeeping details*]

[*Coffee break*]

JOURNEY TO 10%
Keith Williams
Chief Financial Officer

There is an old Chinese proverb which said to get through a long and arduous journey, we need only take one step at a time but we must keep stepping. Some of the steps that we have taken since we embarked five years ago now on Future Size and Shape and the journey to 10% have been small. For example, I always remember the emotion around the decision to remove the cheeseboard from the flight-deck post 11 September. Some of the steps have in fact been giant leaps such as the impact of ba.com on our sales and marketing model, or the recent changes to the future pension benefits for the majority of our staff. Whether small steps or giant leaps, they have one thing in common: they all represent permanent change moving us forward, step by step on our journey to 10%.

I have divided the presentation this morning into three parts. The first part looks at where we are on the journey today and the outlook for the remainder of 2006/07. The second part examines some of the step changes we have made in changing our business, which gives us such positive momentum and confidence going into the next financial year. The third part looks at the outlook for 2007/08.

2006/07 original plan

Let us start by looking at this year 2006/07. In his opening remarks, the Chairman spoke about the number of unexpected events that have impacted upon the results of the year, and Robert Boyle looked at the lost opportunity in revenue terms of some £220 million and the various disruptions that have befallen us. Given all these events, it is worth recapping on the outlook we gave you a year ago at Investor Day.

When we started the year, we expected revenue to be up some 4-5% on ASK growth of some 3%. Fuel cost was expected to be up around £400 million and our other non-fuel costs were flat. If you did the calculation, that would have delivered an operating margin which would have left us roughly flat year on year at around 8%. However, our fuel bill was rocketing skywards and we saw 8% at that time as a challenging but attainable target at the time.

Disruption impacts good performance

This slide looks at how the picture has changed today. Jumping first to the implied bottom line performance on this slide, we are within a point and a half of that original 8% operating margin target. Given the various disruptions, the fact that we are so close to that target is real testimony to the strength and robustness of the underlying business. Let us look at the detail, firstly at the revenue.

We said in July last year that the revenue would be strong in the first half of the year but slow in the second half as we cycled against stronger prior year results of ASK growth and we anticipated a weaker dollar. In the end, as you know, the revenue has been impacted by the August and December disruption and then by January with the threat of industrial action.

We have seen from Robert's presentation how customers stopped booking on British Airways following the threat of industrial action. The impact of that is clear from the traffic stats for February, which we announced on Monday. Total passenger volumes for February measured in RPKs were down 4.2% year on year with both premium and non-premium traffic impacted for the month. We stopped taking bookings for some strike days in February and the bookings just never came back. It is only in the last week or so that traffic has returned to last year's level. Taking everything into account, we now expect total revenues to be up around 3.5% this year despite having lost some 2.5% revenue as a consequence of the various disruptions. Most of this lost revenue has gone straight through to the bottom line of margin reduction. I should also add that within the 3.5% cargo performance has been poor in the second half. We had anticipated some reduction in revenue, based on a reduced rate of programme for the second half of the year, but the business has been worse than expected in volumes. This is in part because of the restriction on cargo space by the need to accommodate additional capital investment. We now expect cargo revenues to be down some 3% on the previous year. That is the negative side of things.

On the positive side, the underlying passenger revenue position has remained strong, with both seat factors and yields up through the year. The nine months to December, we reported seat factors up 0.6% and total yield up 3.7%, despite adverse currency impact for most of that period. We expect some further year on year improvements and yield in Quarter 4, but given the disruption, the seat factors will, obviously, be down.

Turning to fuel, our guidance is now for fuel costs to be some £350 million higher than last year, at £1.95 billion. This is £50 million better than the guide we gave last Investor Day.

Cost targets delivered

For non fuel costs, we started the year with a forecast of the flat. To deliver costs flat we needed to achieve some £225 million of cost savings across the business, to offset the impact of wage awards, supply price increases and volume changes. We are now indicating that our non fuel costs will be up £50 million on the year. I should, however, add that in the comparative year base we had some £45 million employee bonus payments, which are not likely to be repeated this year. Taking account of this, the true comparison of costs performance excluding fuel would be up £95 million or around 1.5%.

Let us look at the cost side in more detail. We said we would have a relentless focus on reduced costs across the business, with clear accountability for delivery. This slide shows where we have succeeded and how we have that £50 million shortfall. Our cost control has in fact been very strong, particularly in the second and third quarters.

Looking at the detail, our total costs from sales and marketing have been dropping, year on year. This year, we are on track to deliver around £70 million savings from channel shift to ba.com, the consequent reduced call centre cost savings in sales commission. On the ground we are seeing costs reduced in the UK from more efficient supply of management and different ways of working, and this is before the move to Terminal 5. Overseas, in Europe we are starting to see the benefits of cost savings on moving our ground handling services to outside suppliers. In the air, we have generated savings from moving to a single cabin crew fleet at Gatwick and from the close of the Manchester base. We will, of course, generate further savings from the recent agreement with cabin crew. In Flight Operations, we have seen a 25% increase in productivity over the last five years. In Engineering, improved productivity and better working from the introduction of EWS generates an annual saving of around £20 million. Centrally we have made the first changes to management reductions and Andrew Grainger talked earlier about some of the property rationalisation to reduce our infrastructure costs.

So we can see the impact that our focus on delivering on cost savings across the board, and making permanent changes to the cost base, is having all around the business. In total, we will have delivered some £245 million of permanent cost reductions by the year end.

Against this, we had two items – pensions and severance which were negative to our original plan. This will reduce in employee costs this year being slightly up, as opposed to around 3% down as originally planned. In resolving pensions, after long discussions and the agreement with trade unions and trustees, we have secured a way forward for the future benefit of both the company and the staff. Our agreement involves an £80 million charge this year, delaying the anticipated reduction in our annual pension burden till the next financial year.

Whilst we have been able to accelerate certain initiatives within our change programme, we have also incurred higher than expected redundancy charges, up some £30 million on our original forecast, but this has been the benefit of reducing manpower.

Headcount falling

This slide shows you where we are on headcount and manpower. We did not go into the year with published manpower targets, although most of the individual areas of the business have manpower plans and we have specifically announced a programme to reduce senior management by 15% and other management grades by 30%. It was always recognised that operational manpower numbers, both on the ground and in the air, were going to be fluid. This is because they were dependent on the timing of agreements to working practice changes. We have made significant progress. However, in view of the recent difficulties seen by the operations and because we require additional resourcing during the transition period into Terminal 5, there has been no major change in overall manpower at Heathrow this year. I will take you separately through the plans for Terminal 5 in a moment.

Looking overall, group manpower will have reduced by around 3,100, or over 7%, to just over 42,000 by year end. Of the 3,100, 1,800 arise from the disposal of BA Connect and another 1,300, or around 3%, from other leavers. As I said earlier, these reductions have not come from the operations but from elsewhere: for example, from the management reduction, from outsourcing ground handling overseas, and from the consolidation of call centres.

Looking to next year, we have not published targets but we should expect manpower to reduce to around 40,000, mainly from the completion of the management reduction programme and from some other ground handling changes which I will come on to in a moment.

In terms of productivity: we have seen productivity measures in terms of ATKs per employee increase by over 4% so far this year, against an increase in ATKs of around 1.5%. Further gains should accrue in Quarter 4.

Quarter 4 events [1]

There are two other events to be mentioned in relation to the fourth quarter, which will thus appear at year end. The first is to give you more detail on the disposal of BA Connect, which we announced earlier this week. As you will be aware, we indicated at the half year that the business had failed to meet its expectations, post its re-launch in March 2006. We were faced with three options. First, to re-fleet a business which could not justify reinvestment; secondly to close a business, which would have carried a minimum cost of £250 million, seeing the loss of 1,800 jobs; thirdly to look to dispose of the business to a third party. We reached agreement in principle for the sale of the regional operation, Flybe, as you know, in November last year. The agreement was subject to various regulatory and pensions clearances being sought and obtained and an agreement for sale was signed on Sunday and announced on Monday. We have been carrying an after tax cost of £82 million in our account for discontinued operations, to cover the cost of asset write down and losses to the end of December. This figure will be increased by a further charge of approximately £23 million in Quarter 4. As with the original £82 million, the additional costs will be recognised as a separate line charge, below our main line results.

In simple terms, the loss of sale represents the contribution of a cash lump sum of £96 million to Flybe, plus other costs relating to the sale. There are also some £33 million of accelerated pension contributions, by BA to fund the BA Connect pension scheme, which accounts for the valuation. So the total cash cost to BA arising from the sale itself is around £130 million. In return, we are receiving 15% of the joint business.

There is also one consequential business change of importance which we outlined as part of the sale on Monday. Flybe will not be using BA for handling its ground operations in the region. This has led us to a review of our regional ground handling operation at five of our UK airports, and to look to outsource the work. In all, there will be an impact on around 1,000 ground handling staff and negotiations are in process to allow them to move to the new employer, be redeployed elsewhere within the company, or to take redundancy. The costs associated with the closure of the ground handling operations are expected to be around £30 million. There is an old maxim in this industry, that there are no real barriers to entry but lots to exit and the sale of BA Connect is a case in point. The sale, however, is beneficial to shareholders. There are benefits both from the sale of a loss making business and from the cost savings relating to ground handling operations to the main line operations. Together, these should add at least 0.5% margin benefit to our results on an ongoing basis.

The disposal of Connect and the implementation of all the consequent changes to the ground handling is a complex undertaking but underlines the willingness of BA management to deal with difficult situations.

Quarter 4 events [2]

That brings me nicely on to pensions. George has covered off most of the detail but let me add a little more colour on what I called earlier a leap forward in the business. Although we closed the NAPS pension scheme to new members following the last valuation in March 2003, it was apparent based on value at risk analysis performed at the time that, as a management team, we could not allow the NAPS pension scheme to remain unchanged. We used to talk about two elephants in the BA rowing boat – death and pensions. A particular problem with the pensions elephant was not only was it large, it was also unstable and, therefore, ran the risk of tipping us into the water. The pension solution has taken around two years to complete but needs to be viewed in the context of a major change to the benefits structure of around 30,000 of our workforce, moving the majority of them from the normal retirement age for pension purposes of 55 to 65.

The cheapest solution, we have undertaken the biggest internal communication exercise ever made as a company. Together with both the trade unions and the trustees, and I would like to acknowledge the work of both groups, we have dealt with a major problem which not only hindered the company's plans to grow, but left unchanged might well have challenged its very existence.

I would like to clear up a few of the accounting issues which will impact the fourth quarter and beyond. Even for accountants, some of the accounting impact of the events can be a little obtuse and when it comes to pension accounting, it is enough to make one think of early retirement. You will be pleased, I think, if I cut to the chase and simply recount three accounting changes from our pension specimen. If you want more details, I can gladly pass you on to BASB or you can see me afterwards.

Here we go. Change 1, in Q4 there will be a write-back to the income statement of approximately £400 million attributable to the members' benefits reduction, which George spoke about earlier. This will be taken as an exceptional gain and a reduction of the balance sheet pension liability. Change 2, on an ongoing basis, based on the most recent valuation, a reduction in members' benefit will reduce our employee costs by some £80-90 million each year starting 1 April 2007. Finally, Change 3, there is some benefit in our financing costs also from 1 April 2007 estimated at around £50 million each year. In simple terms, this reflects better tax-free returns from monies in the fund and a reduction in the financing of pension liabilities. In short, and sometimes life is too short, what you need to remember is that there are about £140 million pre-tax earnings improvements arising from the new arrangement starting on 1 April 2007, a one-off benefit this year of around £400 million.

There is one last point that I should note in relation to the balance sheet between December and March, which George hinted at earlier. At the end of December, our net debt excluding pensions reached the lowest level since 1990 at just under £870 million. This will increase to over £1 billion at year end as a result both of the combination of lower cashflow arising from the threat of industrial action, the disposal of Connect and the contribution of the initial £250 million.

10 years of change

I have taken you through some detail of the steps we have taken this year towards the 10% operating margin, and that is a very close-up view. If we start to pan the camera out a little, a little like Google Earth moving from the close-up view to a more aerial view, we can appreciate the scale of the chase today and look at some of the plans already in place and ahead of us.

Shift in the cost base

This slide looks in summary form at BA's costs today and BA 10 years ago in 1995/96. Why pick 10 years ago? Ten years ago, we reached an operating margin of 9.4%. In that 10-year period, both revenues and costs have increased by a little over 10%. In 1996 our revenues were around £7.7 billion, in 2006 they were £8.2 billion and today around £8.5 billion. In 1996 our costs were around £7 billion and today they are around £7.8 billion.

Looking at the costs, the obvious increase in fuel, shown in the blue section of the pie-chart. In 1995/06, fuel was under 10% of the cost base at around £660 million, it was our fourth largest cost. By 2005/06, that cost had more than doubled to £1.6 billion and today it is over £1.95 billion and our second largest cost. Of course, it has to be remembered that some of the fuel costs have been recovered into the revenue through fuel surcharges, so it is probably more meaningful to look at a comparison on cost between 1996 and today based on costs excluding fuel.

The change is more dramatic exc fuel

If we move on a slide and look at that, the most meaningful change is in selling costs. In 1995/96, selling costs were over 17% of total costs excluding fuel. We were spending over 14 pence to generate every pound of revenue. The chart shows how this has reduced to less than 7% of our total non-fuel cost today at just over 5 pence for every pound of revenue. Operating costs in red have remained fairly constant with other items slightly up, in particular the orange box representing employee costs, and I would like to revisit that in a moment.

Selling costs down by two thirds

First, let us look at the selling costs in grey. The decline in selling costs is a major success story where we have led other carriers. The biggest savings have come from commission savings and ba.com has played a critical role in this. Our drive to online selling will continue as we have greater use of technology to deliver further benefits to our customers and our business.

The story of employee costs

I want to pick on one other area of our business which underlines the need for ongoing change. This is on employee costs and here the story is more mixed. The first thing to note on employee costs is that as a percentage of non-fuel costs, employment costs are around 38% of the cost base today as opposed to 32% back in 1996 even though we have a lower MPE by around 10,000. Noticeably, however, there has been a marked change improvement in productivity. Cost increases are down to higher overall wage costs over time but, in particular, I would mention the pension cost increase. Pension increases account for around 55% of the increase in our wage bill between 1996 and 2006. To move this on to this year end, we would have seen a staggering 350% increase in pension costs over an 11-year period. This simply reinforces the imperative that we had to get our pension costs under control. This we have done but, clearly, that is not the end of the journey.

Our employment costs are something that we need to improve further if we are to remain competitive. We shall see our MPE numbers fall next year from some of the changes I have already mentioned that are in train, and then from 2008/09 following the move to Terminal 5, we shall see further reductions. At the same time, we should see the opportunity for further productivity gains as we continue to grow.

That is an overview of some of the ongoing opportunities for the business but the financial side of our business plan is about much more. It is about making investment in our products and aircraft, and about increasing asset utilisation all to grow the revenue and it is about the relentless focus on costs everywhere.

2007/2008 outlook

Let us now look at the outlook for 2007/08.

Revenue growth from passenger business

I shall start, first, with the revenue outlook. We expect revenue growth next year will predominantly come from the passenger business. Based on fuel prices where they are today, we are assuming that fuel surcharging will hold to its current level. On this basis, the total amount raised from fuel surcharging would be neutral versus last year. You might well point out that we have reduced some of our fuel surcharges on longhaul flights, but this is offset by the fact that last year the high level of fuel surcharging applied only to part of the year, so year on year we expect fuel surcharges to be roughly flat. There is some increase from ancillary revenues and Robert spoke a little to that earlier. He talked about dynamic packaging, we also have some income coming from baggage changes and from the sale of other products. We are also expecting some small recovery from the poor performance this year of our cargo business.

Passenger revenue outlook

Turning now to the outlook on yield, as you are already aware the first of our longhaul aircraft deliveries is not scheduled until the early part of 2009, and there is no planned aircraft growth for the shorthaul operation. However, in terms of capacity change, in shorthaul the introduction of the new space-saver seat which Robert spoke to earlier and the non-recurrence of disruption from this year should add around about 6% capacity in terms of ASK.

In terms of longhaul capacity, the introduction of the new Club World seat and the reconfiguring of the aircraft from low J to mid J will give around 3.7% more capacity over the year in longhaul premium, offset by just over 0.5% reduction in capacity which is making way for the new seats. We are also expecting a small improvement in efficiency on the utilisation of our longhaul aircraft. Overall, therefore, we would expect to see some 1.3% increase in ASK, that is a slightly better position than we have indicated previously when we said that capacity this year would be slightly down.

We anticipate an increase in passenger volumes of just under 2.5%, driven in part by new products and in part by the recovery of better service level and non-recurrence of disruption at the airports.

In turn this would give us a slightly higher seat factor, up just under 1%. On yields, assuming unchanged fuel surcharges, we anticipate price will be up around 1.2% and a further 2.2% increase from mix as a result of the greater concentration of premium seats.

That would result in total revenue next year being up 5% to 6%, just under half from the recovery from disruption and the rest from underlying growth.

Cost headwinds

Moving on to costs: cost headwinds are, seemingly, a recurring feature of this business and next year, we are likely to see further cost increases in fuel and some one-off costs related to the move to Terminal 5. I will cover both of those specifically in a moment. You will already be aware of the pay deal that we have done with the cabin crew. This is a two year deal, based on RPI + 0.2% in the first year and RPI in the second. We are now in negotiations to repeat the pay round with our other pay bargaining group, based on a similar principle. We also face some higher cost increases from inflation.

Looking first at fuel, it might be useful to start with a context chart. As this chart shows, prices have retraced from their peak. When we announced our Quarter 1 results last August, we said that we felt that the balance of risk on price had moved towards a fall in price; and at the half year, we indicated that we would place the greater proportion of our hedging programme in collars over swaps. That proved a successful strategy and has enabled us to participate in the fall in fuel prices. Although we have started to move some of the cover back into swaps, as you can also see from the chart, forward prices remained a significant premium spot so this poses a particular hedging problem.

Fuel price volatility

The other challenge is current volatility. Since the start of the year, prices have fallen and then risen by $10 a barrel. The use of collars allows us to benefit in price fall but equally, leaves us with some exposure to price increase.

Hedging cover

This chart looks at our hedge cover for 2007/8. Overall, we are in a fairly neutral position, being around 50% hedged overall for the year with around three quarters of the cover in collars. We will look for opportunities to minimise the risk throughout the year by adding additional covering swaps.

Fuel cost forecast up £100m

Given the fairly neutral stance we have on fuel hedging at present, it is more difficult than usual to predict our fuel spend next year. However, we can look at a central case scenario based on an exchange rate of $1.90 for sterling and a jet price of $660 per ton, roughly equivalent to $66 rent price. At those levels, our fuel bill will be up around £100 million, year on year, as a result of small volume increase and lower hedging profits.

T5 proposition

I mentioned Terminal 5 earlier. I hope that a number of you will take the opportunity to go on the tour this afternoon, to discover what a fantastic customer experience this will be. There will be a chance to ask further questions but I will give a basic outline of the cost implications of the move to T5. When we started the project, we targeted a zero NPV over a ten year period, excluding revenue benefits from either the customer experience or from punctuality. We are on plan to achieve this.

T5 capital investment

The planned capital spend is around £330 million overall, of which around £110 million have been spent to date, a further £160 million will be spent next year with a further £60 million, post the opening of phase 1. In addition, capital costs are increased rental costs for the best quality property. These increases are offset by improved operations and new working practices and from economies of scale from the centralisation of the Heathrow operation. These not only have cost savings from improved performance but in time will also reduce our manpower at Heathrow.

Transition costs

It is important that I comment both on the timing of the savings and the manpower implications. At present, the total workforce at Heathrow is around 6,700 MPE and this is not expected to fall until post the opening of Terminal 5. Although we continue to introduce new working practices, the benefits have largely been offset by significant launch revenue costs next year as we test the facility and train staff. In fact, next year we will face additional costs of around £25 million as a result of the launch readiness programme. In part, this will require the recruitment of some 350 temporary staff. That £25 million additional cost has been absorbed in the business plan for next year.

The opening of the terminal will take place in phases and will be finalised by October 2008. Post opening, we will expect to have achieved a reduction in excess of 1,000 MPE, and see the full benefit of the other cost programmes. At that point, we should expect to see annual cost savings of around £40 million. I said earlier that the business case for T5 was based on cost neutral, without revenue benefits. Obviously, that is not the same as saying there are no revenue benefits. The move to T5, as you will see this afternoon on the tour, significantly improves today's customer experience.

The land-side experience will be much improved as a result of better layout, improved check in processes and a better airport environment. There are other opportunities though. We are already looking at how we can adjust the schedule to improve connectivity and are working today on better time slot integration for directly transferred traffic, based on minimum connection time. There are other areas where we should deliver both cost and revenue benefit. For example, we have seen plans to improve punctuality and baggage performance for the benefit of our customers. In short, Terminal 5 really does represent a fantastic opportunity to move both our business and financial performance forward, beyond next year and into the next decade.

Cost efficiencies

We have already developed initiatives to provide cost benefits next year. As you saw earlier, we have achieved significant changes from sales and marketing and the drive to greater usage of BA.com. That drive continues, allowing us to reduce our distribution costs further and to consolidate even further the number of call centres. We achieved a £70 million cost reduction in sales and marketing this year and will be looking for a similar cost saving next year. On the operational side, we have put in place certain working practice changes which will reduce costs. For example, the change in crewing arrangements to replace pursers with junior crew and from the closure of the Manchester base. Centrally, we are achieving property cost savings and cost reduction from the management reduction which we announced last year.

We already have enormous momentum going into next year in terms of existing cost reduction. We will have lower manpower resulting from the management changes and agreed operational changes. We will have reduced pension costs. We will see lower severance costs. We will have disposed of the drag on margins posed by the regional business of BA Connect and will have reduced our overseas regional handling costs. We are looking forward to implementing other plans to improve further the picture next year and we can be very optimistic about achieving our target of costs up £50 million.

Summary

To summarise, in spite of the operational difficulties we are encountering this year, 2006/7 represents both steps and leaps forward in the journey to 10%. We have laid the foundation for solid type financial performance, not only for the next year as we move to Terminal 5, but for the period beyond.

I started with a Chinese proverb and given that it is a golden year, I thought I should finish with one. It goes something like this: remember modest in his speech and superior in his actions. superior man

With that, I will hand you over to Willie.

**THE ENVIRONMENT
AND
Q&A**

**Willie Walsh
Chief Executive**

Thank you, Keith. I have two issues I would like to talk about before opening for questions. The first is to comment a little further in relation to open skies.

Open Skies

The Chairman said in his introduction today that we believe this agreement is a core agreement for Europe. It is very clear that it is an agreement that is imbalanced in favour of the United States and, in economic terms, no different to those that were rejected by the Council of Ministers in 2004 and, most recently in November 2005. But we will continue to lobby over the next two weeks, before the Council of Ministers' meeting on 22 March, to have this agreement rejected, or at a minimum, to see counterbalancing measures instated to offset the imbalance in the existing situation.

I am, however, clear that Open Skies will happen at some stage and when it does – whenever that is – we will be ready for it. I can say that with confidence because we have been planning for Open Skies for some time, and it has been one of the drivers behind our continuing programme of improved efficiency and cost controls. It has helped us to focus on our network into North America. We operate 23 destinations in the US and elsewhere. We are the biggest operator in the market, therefore to ensure that we take measures to strengthen our position with Open Skies in mind. We have introduced new pricing policies.

Heathrow is not a high price airport operation, we are competitive and in many cases cheaper than other European hubs, Frankfurt, Amsterdam and Paris. We have been very successful, as Robert talked about this morning, in promoting what we call premium leisure fares. We have very aggressive pricing model in the market. When Open Skies happens we know what we are going to do. In the first stage of business you will see a transfer of activity from Gatwick into Heathrow. That is exactly what we will be doing. We will transfer our flights to Atlanta, Houston and Dallas from Gatwick. That is something that we could do overnight, however the timing of that will be influenced by both operational and other considerations. We expect in the initial stages that some of the carriers that seek to gain access to Heathrow such as Continental and Delta will also try to move capacity from Gatwick to Heathrow. They will be hampered as you know by infrastructure constraints at Heathrow. They will have to acquire slots.

One of the misunderstandings in relation to any Open Skies agreement is the slot issues at Heathrow. There is nothing in this agreement, or any other Open Skies agreement, that will require British Airways to give up slots. We will not be doing that. In fact when slots become available, as you heard earlier today, we will be active in the market in trying to acquire additional slots.

The second infrastructure constraints that these carriers will face will be terminal capacity. Although the terminal capacity issue will be greatly improved once T5 opens in 389 days, the plan for the BAA, as you know, is to use the opportunity presented to them to knock down Terminal 2 and start re-developing the extensive terminal area with a view to developing it though terminal capacity will continue to be a constraint at Heathrow for some years to come. It will be particularly difficult to get access to stands at Heathrow that are served by every carrier for quite a number of years to come.

Longer term we expect there will be additional competition at Heathrow, and many observers have commented of what that would mean. I was interested that one such person was Nigel Turner, the CEO of BMI, who is quoted in the paper as saying that the long term results will be new choices for consumers and fares falling to more realistic levels. I was curious as to what more realistic fare levels meant so I looked on the BMI website and it may interest you to know what more realistic fare levels mean for BMI. They currently serve a number of destinations in the US from Manchester. If you want to fly Business Class with BMI from Manchester to Chicago you will pay £5,237. If you want to fly Business Class with BMI to Las Vegas you will pay £7,337. Now, guys, we have obviously missed an opportunity there!

The economy fares are competitive with the economy fares that we have at Heathrow. If you look at the fares that we have been charging, we sell JFK out of Heathrow from £199. If you go on to our website today and look for availability in the coming days and weeks you will see widespread availability at £272. These prices are very competitive with prices to European destinations and we other carriers. So Open Skies is not going to be the major problem that people have to get to for British Airways. We are ready for it. The short term impact will be minimal and if anything probably positive for British Airways, and because of the steps we have taken to adjust our business to Open Skies using the very significant investment in our premium travel to ensure that we maintain an industry-leading position in relation to premium travel we believe that the threat to BA as a result of this is very manageable.

The Environment

The second issue I want to comment on is the environment. I believe that the environment will represent the biggest single challenge to the industry in the next few years. I believe, however, this is a challenge that we can overcome. The reason I say that is the challenge is one that is based on the perception of the performance of the airline industry rather than the reality. For that reason I was pleased to the publication of the Stern Report recently because Stern puts the figures into context. Stern clearly shows that aviation worldwide contributes 1.6% of greenhouse emissions, that is one sixth of the contribution of road transport. Stern also says that even if we do nothing as an industry to clean up our act, the likely contribution from aviation by the year 2050 will be 5%. Just to address that, that factors in all of the likely growth in our industry up to 2050. It also factors in the effect, as yet unproven, of emissions at altitude and emissions of non-CO_2 gases. The actual figure is 2.5% but he has applied a factor of 2 to upgrade that to 5%.

British Airways has a good story to tell because our track record in recent years has been very positive. We are the only airline in the world to participate in an emissions trading scheme through our voluntary participation in the UK ETS. Through that programme, and Andrew made reference to some of the progress we have made in terms of our sales to emissions from our building, we have reduced a sale to emission in that period by 18%. That covers buildings and aircraft emission in the domestic aircraft operation, an 18% reduction. We are also one of the few airlines in the world that accepts hard targets for our business. We set ourselves a target of improving our fuel efficiency between 1990 and 2010 by 30%. Again at the end of 2006 we have achieved fuel efficiency by a measure of 28%. That is equivalent to almost 57 million tonnes of CO_2. That is a significant saving that we have achieved over that period. We are taking steps to ensure that we operate our aircraft in the most efficient way possible with the environment and also costs in mind, because anything we do there reduces our fuel burn. So it not only reduces emissions but it also helps to reduce our costs.

We are very active in terms of programmes around Heathrow participating in a number of schemes to improve our performance. T5 will give us an opportunity to significantly improve our environment performance in relation to ground base activities. We have also campaigned for the past seven years to see aviation included in the EU Emissions Trading Scheme. We are pleased to say that last December the Commission has indicated that aviation will be included from 2011. That I see as a positive, because I believe emissions trading is the most environmentally effective way of dealing with the impact that our industry has on at this time.

The challenge to our industry is to try and get the industry to go on board. I do not see this as a competitive issue. I do not see British Airways trying to out-green one of our competitors. It is an issue that industry must face up to. Until recently I was concerned that the real effect of this challenge is not being considered genuinely by a number of other airline CEOs. However we are now seeing momentum within the industry. For the first time ever I have heard the CEOs of some of the US-based carriers talk about the environment. So it will be a challenge. The track record for British Airways is very positive and it is a positive story that we will be telling. The industry does need to get together to speak with one voice to put our performance into context - 1.6% of global emissions. People could be forgiven reading the newspapers if they believed that aviation was the sole contributor to global warming. We are not, we are a very small contributor, we are a growing contributor to global warming but we can take measures to address that. Our inclusion in ETS will be a positive. The steps that we are taking within British Airways in terms of these replacements will also have a significant impact on our emissions.

I would like to open it to you now for questions. Keith, Robert, Andrew and George are also available to answer questions.

Question & Answer Session

Question: You made the comment that the US/EU agreement in no way shape or form involved BA divesting any of its slots. Assuming the draft agreement in place becomes a reality, does it make sense for BA once again to seek anti-trust agreements with the US carrier. Given the backdrop that this is within a completely separate scenario playing out here, is BA likely to be forced to give up slots this time around?

Willie Walsh: We have looked at that and we believe there is nothing in this agreement that would change the regulatory penalty that we have seen in the past when we have sought anti-trust immunity. So, despite the fact that some, including members of the Commission, have highlighted a potential benefit of this agreement being our ability to get ATI, we believe that we would still face a regulatory penalty in terms of slots at Heathrow, and we see that little has changed since we last applied. For that reason, we do not believe it provides us with an opportunity to acquire ATI with American, and we are unlikely at this stage to pursue it. Having said that, when the agreement, in whatever form it is reached, comes into force, we shall seek to maximize any benefit that that agreement represents, and we shall certainly push all aspects of the agreement and test all aspects of the agreement. That may be one of the issues that we look at in more detail when we see a final agreement, but we do not believe anything has changed so, for that reason, we believe it is unlikely that we shall be able to achieve ATI as an acceptable …

Question: I bought a ticket to come to London a couple of weeks ago coach and over half of the ticket price was British tax. I wonder what the Brits are doing, are they trying to kill the air industry in London, how can you counterbalance that?

Willie Walsh: That is an excellent question and that is why I made the comment that I believe the inclusion of aviation in the EU ETS is a positive because the fact that we are not playing a part in the ETS and the fact that international aviation is not included under the Kyoto Protocol, it provides the government with an easy option, and certainly it is the option that the Chancellor took when he increased APD by 100% on 6 December last year.

To put it into context, British Airways will pay Gordon Brown – not him personally but the Exchequer - £400 million through APD. We generate 16.1 million tonnes of C02 per annum, and if you looked at offsetting that 16.1 million tonnes based on the current price of carbon, we estimate that you would spend about £90 million offsetting in total that 16.1 million tonnes. That means through APD we are giving the Chancellor the opportunity to offset our total C02 production more than four times over and yet he successfully pushed that APD through because people believed the perception of our industry is much worse than the reality. I have written to the Chancellor pointing out that the amount that he is generating through APD is way in excess of the actual contribution that we make to climate change, and also pointing out that with our including in ETS from 2011, APD should be removed given that he used environmental concerns as the lever to introduce that payment.

Part of the problem we face is that the perception of our industry is poor and, therefore, we are seen as a soft target when it comes to taxation. Unless we take steps to address that, which is why we were so actively campaigning for the inclusion of aviation in ETS, we are like to continue to face a penal form of taxation on the back of environmental issues. It is a genuine concern but I believe it is one that we can address through the lobbying that we shall engage in and through better advertising of what it is our industry does.

Question: Going on the ETS for a second further, there is nothing in the proposal at the moment that appears to penalise older aircraft. Is that something that ETS needs to incorporate as a second stage, or is it almost too sophisticated at this early stage of trying to get ETS in? Secondly, on Terminal 5 there is some mention of revenue issues, but the point is with no mixed mode or no third runway, the congestion at Heathrow will remain that the runways still run on the edge. Can you attract much more premium connecting traffic, when the reliability of the connection is still as unreliable as it is today?

Willie Walsh: On ETS it would be too complex to try to address the issue of older aircraft. I believe what ETS does is it gives you a simple option. You either cap your emissions or you pay for the excess, and how you cap your emissions is clearly down to you. There would be an incentive to people, clearly driven by the price of carbon, to reduce their emissions and, therefore, avoid the cost of paying for additional CO_2, but keeping the system simple is the best way forward. We have certainly encouraged the Commission to do that and I am pleased that our arguments with the Commission were taken on board, because, as you know, their initial proposals were for a complex scheme that would apply to aviation worldwide, anything going through Europe. We felt that the prospect of that being implemented was pretty low, so the Commission has come up with a workable scheme. There are some issues that need to be resolved but I see that as a positive step forward and the simpler we can keep the scheme the better.

The second issue is a very important one. Heathrow operates about 98.5% of maximum capacity on a daily basis, so there is very little scope for recovery in the event of any operational disruption. We do, however, believe that much of the disruption that we currently face is as a result of the poor terminal infrastructure at Heathrow. We encounter significant problems waiting to get aircraft onto stand, which therefore delays passenger arrival, baggage arrival and baggage transfer. With the move to T5, we shall have a much more efficient British Airways operation, and it will significantly improve our punctuality performance.

Apart from the benefits we get from T5, we are introducing significant initiatives in the current year to address punctuality, and we believe that we can make a big difference through a greater focus on the operational robustness of the BA schedule. So we have made some schedule changes to enable us to recover better in the event of disruption, and I believe it will make a big difference when we get into T5. I believe that it is possible, given the massive improvement in customer standards that you will see in T5, for us to attract high quality transfer traffic over Heathrow again.

It is also important to point out that in recent months the BAA have delivered on some of the promises they have made around improving the security situation at Heathrow. It is not as good as we would want it to be but it is a hell of a lot better than it was, and on average in T1 we are seeing security queuing times of around three and a half minutes, in T4 it is five minutes. Where we continue to see some difficulties is on the flight connection centre where they are averaging around 10 minutes, but that hides the fact that during peak times of the day, the delays coming through flight connections are significant but there are changes being introduced there that will increase the number of X-ray machines available and will improve the transfer performance at

Heathrow today. However, T5 will be a massive improvement and, therefore, we are confident that we can attract additional premium transfer.

Question: Just on labour, can you give us an update on the position on wage negotiations with working groups outside of cabin crew. Moving to Gatwick, can you give us an update on that profit improvement target that you have been talking about.

Willie Walsh: In terms of wage negotiation, we have resolved that and we saw that as an opportunity to address wage negotiation while resolving the other issues that were in dispute, and many people felt that the wage round this time would represent a significant challenge to us, so that was a bonus in terms of the cabin crew and we were clearly able to benchmark for the negotiations with the other work group. We have had one formal meeting. We have had some informal discussions. The meetings will continue and I am confident we will be able to resolve the negotiations on this wage round and it will be a wage round that will take us into 2009 and therefore beyond the move into Terminal 5, without any difficulties. The questions we have had so far have been constructive and I would expect that this issue will be resolved.

In relation to Gatwick, Gatwick is an opportunity for British Airways. When we reviewed the operation of our shorthaul business and particularly Gatwick, back in September 2005, we recognised that the product offering at Gatwick was not ?evident, and that led us to the change in our pricing structure which we introduced in April 2006. What we have seen since we introduced the new pricing structure, one way fares has been a very significant increase in seat factor for Gatwick. But we have seen seat factor increase in the order of 11% or 12%. So there is clearly a lot of demand at Gatwick. We have a good route structure out of Gatwick and we can achieve a competitive position there.

Part of the problem we have had is that our core structure at Gatwick has been way out of line, largely down to some of the issues that Andrew touched on. We have a legacy at Gatwick from the time we tried to develop Gatwick as a second hub. We have been stripping out a lot of bad costs and we have succeeded, through negotiations with the airport, as Andrew pointed out, in getting rid of a lot of excess property, exiting from a number of leases that we had, selling the transfer baggage facility, which was a dedicated British Airways facility, back to the airport.

We are making good progress on the costs. Our cost reduction programme is on target, if anything, slightly ahead of target. And in terms of the commercial activity we are doing there, we are very pleased to the response to the change in pricing structure, the increase in seat factor has been slightly better than we had expected to see. The yield that we are seeing at Gatwick is slightly lower than we had expected to see. In overall terms we are on target to achieve the improvements that we have set for the business, and that will be a crystal issue in the context of a decision to move forward with fleet replacement. As George indicated, we have 33 727s at Gatwick, of which 14, the 737-300s and 500s are leased. The leases on those aircraft expire between September 2008 and June of 2009, so the decision to re-fleet Gatwick will be one that has to be taken in the current calendar year. We will only move forward with that decision if we are satisfied that we can make a proper economic return on the shorthaul operation at Gatwick. But I am pleased with the progress that we have made so far.

Question: I have three questions, please. First, coming back on Open Skies and your comments earlier that there are obviously slot and terminal constraints at Heathrow with respect to any new entrants – a very good point. But would you see any threat from incumbents at Heathrow that have significant slot holding currently in terms of Atlantic routes going forward. The second and third questions I have relate to presentations given earlier. I think it was Robert's presentation which looked at the capacity growth on India and although there was not a chart of yield, he suggested that yield had fallen. Can you talk about what happened to profitability following the capacity growth there? The third question goes back to George's presentation and his very interesting outlook over ten years of capex and balance sheet projections, depending on the various scenarios. I wondered what assumptions George was making on yield over that period? I know these are illustrative and I do not want to pin you down too much, but it seemed that you were removing cyclicality of the yield?

Willie Walsh: In relation to Open Skies, I suppose one of the incumbent carriers, BMI, have talked about their desire to operate transatlantic out of Heathrow. You have to look at this from a fleet position. They currently have two operating longhaul aircraft – I think they have three in total but one has been out of operation – so for them seriously to engage in transatlantic operations, they are going to have to look at major fleet expansion. They are not going to be able to do that in the short term. We do not see any significant change in the dynamic from the incumbent operators. We may see some additional capacity, but again, in the short term we do not see it as being significant.

Your second question, on capacity to India, Robert made the point that as you would expect with a significant increase in capacity yield has declined, but in profitability terms, we have seen an improvement in profitability. You need to look at how we have funded the capacity growth in India. To fund that growth, given that we had a fixed number of aircraft, we stopped a number of unprofitable routes that we were operating, so the overall benefit has been positive. Yes, we have seen a yield at times, but you would expect that and we planned for it, but the revenue and profit contribution has been positive.

In relation to capex, perhaps George would like to comment on that? I think the modelling was based, as George said, on an assumed operating margin of 8% to demonstrate that at that level of operating margin the programme that we have made sense.

George Stinnes: I can just add that yield does not come in to the modelling because you make the assumption that you have delivered a margin. What I was trying to make clear was that if the margin does not happen, neither does the capex. So if the business continues to deliver those kinds of margins, and is profitable – which implies that the relationship between fares and profit delivers an 8% margin – then the capex programme is fine.

Willie Walsh; Again, to repeat something that George said, we are not targeting an 8% operating margin. We are targeting a 10% operating margin. To remind people, it is not that we get to 10% once. Our objective is to achieve a 10% operating margin through the cycle. However, in looking at the modelling and the capex programmes, we did look at what an 8% operating margin would mean for the business and that is why we showed you the graph that we did. But it was based on an assumed operating margin which you could say takes a number of different things into account. But you could say it was an improved model looking at an 8% operating margin through the period of the capex programme.

Question: I have two questions, if I may. On the outlook, was there anything in the yield assumptions for currency and foreign exchange? Also, the same question on the staff bonus and whether that is included in the cost angle. Secondly, probably more strategically for Willie, with the new fleet coming along, as in a replacement fleet, what would that mean in terms of retraining? Or changing the way that the staff actually fly them? Because we are obviously talking about a new type of planes.

Willie Walsh: Keith gave figures on yield, showing the mix in price impact.

Keith Williams: I am not sure I understand the question. We are assuming that in the current year we will not achieve the target to trigger the employee rewards.

Question: It was really a question on next year's assumption. Because the employee reward programme is –

Keith Williams: Yes, because the employee reward programme is currently performance based, based on operating margin, there is no assumption in those figures.

Willie Walsh; The second question, on aircraft; as you know, we have ordered four 777-200 ERs as part of the fleet expansion programme for delivery in 2009 and we made the point that the airbus option, which was attractive in financial terms, was the 8-330-200. However, when we looked at the operational impact, including issues like crew training, that shaded the decision in favour of Boeing. So we did factor that into our consideration for the initial fleet expansion and, given that we currently operate 43 777s, increasing the fleet is not a significant challenge to us in terms of employee training. Moving beyond that into fleet renewal, we are looking at a number of options still. The 777 is one of those options but the other options, from a Boeing point of view, are the Boeing 787 and the Boeing 747-8. From an airbus point of view, it is the airbus 8-380 and the airbus 8-350 XWB. There are different challenges there. If it is a 747-8, we see that the impact on training is not as significant. The 787, to a large degree, given the scale of our 777 fleet and 747 fleet, we do not see as a major issue either. It clearly will have an impact, because transferring from any of the current types to a new type like that will involve down time as crews go through both the ground crew technical training and the simulator training for the aircraft, but that will be factored into our considerations when it comes to a final decision. But we do not see it as a major issue. We operate 67 shorthaul 8-320 Airbus aircraft, and we have experience in operating the Airbus fleet, and we do not see either an Airbus option or a Boeing option as representing a major challenge to us in terms of crew training either from a time and cost point of view or a complexity point of view.

Question: Three quick questions if I may. What is the situation with the GMB in relation to their intention to ballot for something or other? Secondly, on the 767 have you any intention to transfer any more from the shorthaul to longhaul network? Finally, in the event that Open Skies takes place, you say you know exactly what you are doing. Would you want to revisit the configuration changes and the increases in the size of your premium cabin were that to play out?

Willie Walsh: In relation to the GMB, we have made it clear that the deal we have concluded on pensions is final. We have signed the funding agreement with the trustees of the pension scheme and there is no prospect of renegotiation on any of the issues regarding pensions. We have said that very clearly and, although the GMB conducted a consultative ballot, they asked two questions. The first was: were GMB members happy with the changes, and I believe that was two thirds against. They asked a second question which was: would you be prepared to engage in industrial action, and they never told us what the answer to that question was. Regardless, we are not going to reopen the pension discussion, that deal is closed and finished. The GMB are the smallest union in British Airways, they represent about 5,000 people. The public position is that they tend to represent many of our lowest paid employees in the baggage halls and check-in – that is not quite true. They have very little representation in the baggage halls, they do have members in what we call the A-scale, the check-in staff, and they also have people generally in our IT sections and members in a number of the regional airports, so they are impacted by our decision to move to outsource our ground handling activity in the regional airports. I do not think that I can make it any clearer than that. The pension deal is done, it is closed and we are not opening it. I shall not change our position in relation to pension no matter what we face from the GMB.

On the 767, no, we do not intend to change the configuration. We believe the balance of seven shorthaul/14 longhaul is the right one. We reviewed it recently but we have no plans: the seven 767s operate efficiently and profitably for us on shorthaul, and we believe that is the appropriate balance in the 767 fleet.

On configuration, in an Open Skies environment we do not see any reason to change the reconfiguration plans on the 747 and, as Robert highlighted earlier today, we shall reconfigure 31 of the low-J 747s into mid-J giving us around an 8% increase in premium or Club World seats. It may have some impact on the configuration of some of our 777s and, as I mentioned, we would move flying activities from Gatwick where we operate 10-777s to Heathrow, so we may look to adjust the configuration on some of our 777s currently operating out of Gatwick, but that is something we are looking at. We do not see it as a major issue, we have 10-777s there and some are in a 3-class configuration and some are in a 4-class configuration. There may be some impact on those 10 aircraft but it is pretty minimal.

Question: I have a question on fleet replacement. I think it is fair to say that over the last year on longhaul fleet economy, fuel consumption has been pretty dramatic. Some people say that that has not yet been the case in the mediumhaul products available, so are you stalling for a truly next generation medium/shorthaul fleet to be available, or are you happy with the 737-800 and Airbus equivalent?

Willie Walsh: That is a good question and I shall ask Robert to respond to that.

Robert Boyle: Our immediate shorthaul needs are limited to the Gatwick decision we have talked about. In that timescale, we have current generation aircraft to choose from. After that, the next replacement decisions we shall have are in the 2014/15 timeframe, which is when the Airbus A320 family aircraft that we re-equipped with some time ago begin to get to replacement age. Everything that we say to manufacturers and manufacturers say to us is that the next generation of aeroplanes needs to have a step change in fuel economy in particular. We need a minimum of 15% improvement in unit costs for the aircraft, ideally more. The view of the manufacturers is that currently technology does not quite enable them to meet that and it probably will be more around 2014/15 when the technology is at a stage where they can deliver that and, from our point of view, that timing is fine. We have very much encouraged them to get the next generation right, rather than rush out an aeroplane that does not deliver the real potential that is there in terms of improved fuel economy.

Question: Unfortunately, it is back to Open Skies again. The question concerns the nature of the rhetoric. You have laid out from a moral perspective of UK PLC why it is a bad thing to accept the deal, and you have also gone on to say how, from a British Airways perspective, it seems to be, as far as I can tell, a very good thing. It seems that the two elements of the deal to which you are opposed are restrictions on cabotage in the US and ownership, both of which do not seem to be relevant in a strategy for you at all. Bearing that in mind, why, if there are the positives to British Airways, would you take a stance that is so aggressively against it?

Willie Walsh: There are a couple of issues that I need to address. I believe I highlighted that the initial impact would be possibly positive given the benefit we would get from the transfer of activity capacity from Gatwick into Heathrow. The reasons why we object to it are fairly clear. First and foremost, the agreement does nothing to address the Fly America programme which I believe is one of the most anti-competitive aspects of any agreement in place. I do not understand how the Commission can allow that programme to continue in place. There is a significant volume of traffic and much of it is premium traffic travelling on the transatlantic, US Government employees and US Government contractors who cannot fly with us, and that is wrong. That is a potential positive that should be addressed and would be positive to British Airways. The agreement does not do anything to tackle that and it does not do anything to provide access to the US domestic market but, more importantly, the US international market for EU carriers. While we have been consistent in British Airways in saying that we have no desire to enter the US domestic market, we have definitely an interest in operating internationally from the US.

Transpacific is one example I would give you. We have a very strong brand in the US and in the Far East. We have a product that is superior to that of any US carrier and that would clearly be a significant benefit to British Airways if that market were open to us, and we see no reason why that market should not be open to us given that the US are prepared to open those markets to American carriers from the EU. So there is most definitely an imbalance in the agreement, it does nothing to address ownership and control which we believe needs to be tackled if we are to see genuine cross-border consolidation. We are firm believers in consolidation, we believe consolidation would benefit our industry and this is a missed opportunity so, for that reason, it should be rejected. The EU has a much stronger negotiating position than I believe they think they have, and they should that strong position to extract the maximum amount of benefit at this first stage from the US.

Failing to do that, they should do what the Chairman says. Rather than having phased negotiations, to my mind what that will mean is we shall negotiate on the first stage and then you will never see us again, because the US will have achieved all that they sought to achieve from the agreement. We should have phased implementation and let us conclude the negotiation on a genuine Open Skies environment, an open aviation area that would provide significant benefit to European operators, US operators and consumers. If there are concerns about the implementation of that, let us phase the implementation but let us identify where we are going to and let us get to that end position and then look at the implementation, rather than what I think is a very poor agreement because it fails to address several of the fundamental issues in terms of the competitive environment on the transatlantic today. For me, it is a lost opportunity, the EU has played what is a significant card and received nothing in return for it which is a mistake, and we shall continue to lobby to have the agreement rejected on those grounds. So very important strategic issues for the future of our industry and for the future of British Airways, and that is why we are unhappy with the deal.

Question: Terminal 5 gives you a big opportunity to make network changes and perhaps improve the structure of your network. Could you say a little about that, whether you intend, for example, to expand the longhaul capacity to Latin America or perhaps to Asia where you are slightly lagging some of your competitors? Secondly, you have come out very publicly against the BAA increasing airport charges at Heathrow. Can you say what level of increase, given that you are getting a substantial asset, you would be prepared to live with and any other update on that debate with the BAA? Thirdly, George's very colourful slides on capex and the 8% operating margin target, does that assume, as would be natural, the increasing amount of depreciation charges, because that has been one of your big cost savings over the last five years?

Willie Walsh: Let me comment on the network and I shall ask Robert to add to it if he wishes to. The first thing I would say is that the move to T5 in itself does not give us any opportunity to increase the network, because we believe we are operating the existing fleet of longhaul aircraft about as efficiently as we possibly can. We are getting some additional efficiency out of the fleet this year, we are managing to get an extra Los Angeles trip in out of the existing fleet. Beyond that, we shall have to wait until 2009 when we get the additional aircraft to expand the network, and the markets that you have identified are some of the markets we are looking at. We have seen a positive situation in Latin America, South America, and we have increased our flights to Sao Paulo from seven per week to 10 per week. We also see opportunities for further expansion in India and China. The expansion there will be conservative but we do have opportunities there. Unfortunately, we cannot access that profitable growth until we get additional aircraft, so it does not come about as a result of the move to T5; it will come about as a result of the additional aircraft that we shall take in 2009. Robert, do you want to add anything?

Robert Boyle: I have nothing really to add. Just to say that as far as the employment benefits that we get from Terminal 5, today we have our longhaul and our shorthaul fleets split either side of the runway, so we do get some utilisation benefits from Terminal 5. Secondly, because we have a land-locked longhaul fleet in the central area, we restrict ourselves for operational simplicity reasons to flying all of those flights with 747s. So when we get the opportunity to have all of those in the same terminal, we can do a better job of matching capacity to demand, perhaps put some smaller aircraft on some of those flights at certain times of the year, move the capacity to other routes. Therefore, we get a deployment benefit but it is not a net increase in the network with the exception of a small utilisation gain.

Willie Walsh: Thank you. On charges at Heathrow, given that this is a public forum, I will say that we won't accept any increase, we want to see the charges decrease. I think the charges at Heathrow are higher than they need to be. We are pleased with some of the statements coming from the CAA, particularly in relation to the cost of capital. We have always felt that the cost for capital that the regulator allowed at Heathrow was excessive and we believe that through bid premium and the defence document, the defence in relation to the parochial takeover, there was plenty of evidence there to support our case and the CAA has indicated that they intend to reduce the cost of capital significantly. That makes BAA very upset. I would argue that it should be reduced because it was excessive in the first place. So we will continue to push for moderation in terms of the charges at Heathrow. We believe that the opportunity for expansion and return remains significant. You also have to remember that a lot of the cost of the building of T5 we have already paid for through the significant increase in charges that we have seen at Heathrow in the past four or five years.

On capex, George, do you want to comment?

George Stinnes; Depreciation is included in the model. The other point to make is that our operating margin target is 10%. For illustrative purposes, we used 8 as a constant level but the target continues to be 10.

Question: Three questions please: Robert talked about 6% growth on shorthaul. Is that all recovery in London City? Or where else is that going? Secondly, on Open Skies, how confident are you that your lobbying will be successful, given that there is an impression maybe that a majority of the EU countries – perhaps even 26 of the 27 – would be in favour, rightly or wrongly? Thirdly, would Open Skies, whenever it eventually happens, be the catalyst for you to look more seriously and perhaps more quickly at consolidation, whether that be Iberia or anybody else?

Willie Walsh: In relation to shorthaul, most of the capacity increase comes from the reconfiguration of the shorthaul, the 67 Airbus aircraft, what we call Project Strike, which is to install space saver seats which gives us six additional seats on each of our 67 Airbus shorthaul aircraft. So that is where most of that capacity growth will come from. There is some benefit, as Robert pointed out, from the additional capacity at London City. That is a small part of it, and the operational disruption. We cancelled 800 shorthaul flights in the four days before Christmas, the 19th to 23rd. During that period we cancelled 800 shorthaul flights. So most of that capacity benefit is from the reconfiguration of the aircraft.

Open Skies: yes, I believe we have a strong argument to make. In relation to the UK could, in effect, veto the application of the agreements to the UK. It would not be usual for that to happen but given the size of the market from the UK, the UK represents about 40% of the transatlantic market. It is fair to say that the UK has more skill in the game than any other of the European countries and, for that reason, has significant influence at the table. But even in the event that the rest of the ministers were to agree with this proposal, they could influence the application of any agreement that applies in the UK.

Will Open Skies change our view or accelerate our thinking in relation to consolidation? We always highlight the fact that we operate to almost 100 countries in the world and, while the regulatory environment between the EU and the US is important, it is not the only one we have to consider. Many of the other countries that we serve that are very important to our network and our operation also include ownership and control restrictions. It is one of the reasons we are disappointed in the progress between the EU and the US, because we do not believe that this proposed agreement will address that sufficiently to give us confidence in our ability to move forward with genuine cross border consolidation. We have to remember that one of the arguments we made with the Commission was the negotiations with the US could provide the template for negotiations on a world wide basis. It is a core example to be used to negotiate with the rest of the world. So while it may remove some barriers, it does not remove all and does not go far enough. Our thinking on consolidation then, to a large degree remains unchanged. Consolidation would benefit the industry. We want to participate in consolidation. Our view is that it is not a case of chasing sides. We want to consolidate to improve quality and performance of British Airways, not its size, and we will continue to look for opportunity. We are not active at this stage. We have not identified any particular opportunity.

Question: Still on the Open Skies situation, I would like to clarify my understanding of your perception of it. You seem very confident that there will not be any major problems for such a development but ultimately you are controlling about 50% of the slots at Heathrow, which means that 50% of Heathrow could in effect be redirected to North America. We know that Bishop is potentially planning to move planes across to the US. Aer Lingus, which he used to run, would potentially also be going back to the US and you have got SilverJet, MaxJet and other jets going to the US as well. So is there a risk that we will see some deflation on the premium class into North America within the next 12 months?

Willie Walsh; Again, going back to BMI, they have two maximum – three – longhaul aircraft. They do not have a competitive premium product to British

Airways. My former employer, Aer Lingus, has seven longhaul aircraft, 8-330s. I think they have two additional aircraft on order. Their premium product is years behind. So in terms of competition in the premium market, neither of these carriers would present any competition to British Airways. SilverJet out of Luton – again, I do not see that necessarily as being a premium product, more a premium economy product. Luton is not an attractive airport to operate transatlantic operations from, certainly less attractive than Stansted would be and there, yes, we face competition, as Robert mentioned, from the likes of EOS who I would describe as a premium product and MaxJet who again, I would describe as a premium economy carrier, given the configuration of their aircraft.

So we currently face competition and I have no doubt we will see more carriers choosing to compete with British Airways, whether at Heathrow, Gatwick or any of the other London airports. But again, I would argue that our premium product, and given our investment to operate the premium product, is industry leading and the nature and strength of the network that we have into the US and Canada provides us with an advantage that other carriers just cannot come close to.

The point I am making in relation to Open Skies is that people seem to see it as meaning the skies fall in on BA. I do not see it that way. I see in the short term very little impact because of the infrastructure constraints at Heathrow. I see opportunities for us to switch capacity from Gatwick to Heathrow that will be positive. We will see initially a shift in capacity from Gatwick into Heathrow, so it will still be in the London market and it will be some time before we see any significant increase in the capacity that is being offered in the market. But the US carriers will take years to get to a stage where they can provide a product that is competitive with British Airways in the premium market. They are years behind us and will struggle to get anywhere close to us. So we remain optimistic about our ability to compete in this environment.

I would, however, go back and say that our objective is to see genuine Open Skies. Our objective is to see a removal of all of these barriers, to remove the protectionism that the US continues to apply to its industry, to give us free access to all US government employees and contractors, so they can take what is a quality service when they are flying across the transatlantic and to open up international markets out of the US to British Airways and other European carriers. That should be the objective and is why we are disappointed in the progress that has been made in negotiations so far.

I am conscious of the time and we are particularly tight because of the tour of T5. So on that, I would like to thank you and I look forward to talking to you over lunch.

[*Housekeeping details on lunch, afternoon tour of T5, and completion of feedback forms*]

- *End of morning session* -