AIRLINES ASSOCIATION OF SOUTHERN AFRICA

AASA

THE AFRICAN AIRLINES ASSOCIATION

37th ANNUAL GENERAL ASSEMBLY

SUN CITY, SOUTH AFRICA

14 & 15 NOVEMBER 2005

“CHANGING DYNAMICS IN

THE AIRLINE INDUSTRY”

JOHN T MORRISON
CHIEF EXECUTIVE
AIRLINES ASSOCIATION OF SOUTHERN AFRICA

INTRODUCTION

President of The African Airlines Association, Dr Khaya Ngqula, Secretary General of AFRAA, Mr Christian Folly-Kossi, distinguished guests, ladies and gentlemen. It is my pleasure and privilege to be invited by AFRAA to address you on some of the critical issues affecting the airline industry.

The theme for my address is the "Changing Dynamics in the Airline Industry", and although I only have ten minutes to address you, I would like to focus on some key issues.

For the industry to sustain itself and perhaps even to survive, having regard to the experience of the past five years, we will have to apply our minds and ingenuity to change the way in which we do business. Some of the changing dynamics are beyond our control, and others are not, and the challenge is to find a balance that will enable us to generate the returns we need to satisfy not only our shareholders, but also our external investors. What we cannot do is to allow the losses of the last five years, which on a global basis exceed 40-billion Dollars, to continue, and therefore we have to address some very fundamental issues.

- YEAR IN REVIEW

In the past year the industry has had much to be pleased about, with global traffic growth being the highest since that fateful day of 11 September 2001. Traffic in the Middle East and Far East has fared the best, with European traffic being moderately strong and the United States market still lagging behind. Growth rates in Africa have also been encouraging, and in South Africa the domestic market has seen double-digit growth - with the low cost airlines being largely responsible for much of this growth.

In addition to this, industry statistics show that load factors on a global basis have averaged 80% in the past year, and this is an all-time record for aviation. So from the demand and supply side of the business the fundamentals appear very encouraging, particularly with global growth projected to average 6% over the next three years. On this basis we should have every reason to be optimistic in the foreseeable future. However, we have to ask ourselves "what has this apparent good fortune in the marketplace meant to the airlines in terms of profitability?". Well, I am afraid to say "not a lot", or certainly not as much as it should do. What then are the contributing factors or dynamics that we need to address to convert the industry into a viable business?

- YIELDS

It may sound absurd, but as traffic volumes rise - revenue yields fall, both in nominal and in real terms.

We cannot continue to blame over-capacity in isolation as we did in the last four years or so, as global load factors of 80% would suggest that the capacity is being satisfactorily utilized, but whether it is being utilized efficiently and economically is another matter. I think we have to accept that low cost carriers have driven yields down, which has impacted positively on their business, but has impacted negatively on the business of the full service airlines. It is my view that yields have now become the number one priority for airlines, and the continuing decline has got to be addressed on an industry basis.

The continuing decline in yields may be good news for the passenger, but not for the airlines - either low cost or full service airlines - and I would caution - that even the yields enjoyed by low cost airlines are dissipating to such an extent that it is questionable whether they are sustainable.

Full service airlines cannot survive on yields enjoyed by low cost airlines, as the cost base and operational techniques of low cost airlines are uniquely different, and if this is not recognized by the full service airlines then the net financial result, I'm afraid, is entirely predictable.

Of course, the eternal quest and passion by airlines to increase market share at all costs is a major contributor to the problem of over-capacity and low yields, particularly in the domestic and short haul markets. The net result is again predictable – a less profitable industry and less profitable airlines. Over-capacity is a fundamental contributor to lower yields and yet many airlines continue to ignore its relevance.

- FUEL

This year, the global industry will spend around 100-billion Dollars on fuel, which will account for between 25% and 30% of airline operating costs if the price of oil remains at around 60 - 65 Dollars per barrel. Managing fuel pricing and fuel efficiency has assumed a new level of importance, and is now a key dynamic in the management of an airline's operating costs. Fuel hedging is a science practiced successfully by a limited number of airlines as a means of optimizing fuel pricing, and it is my view that this complex practice will have to be considered by more airlines as a means of reducing cost, or at least leveling out price fluctuations. Coupled with this is the need for air traffic service providers and airport planners to introduce more efficient operational procedures that will eliminate the wastage of fuel by the continued use of outdated procedures and technology. Of course, the airlines can help themselves by the elimination of older and less fuel efficient aircraft, and I have no doubt the manufacturers will be willing to assist in this regard. But regardless of which aircraft are operated, our airport and air traffic service providers need to be more vigilant and focused in appreciating that wasted minutes in taxi or flight times means substantial real and unnecessary costs to the airlines.

- **USER CHARGES**

It goes without saying that the issue of User Charges is still a major concern for the airlines, particularly from the monopoly service providers' perspective.

Ironically, while we criticize the monopoly service providers for their levels of profitability, it is the governments who are the main beneficiaries and who choose to do little to change matters. In many cases governments are the recipients of up to 50% of the income received from the airlines by the monopoly service providers, in the form of taxes, dividends, and retained earnings. Airlines are treated like the proverbial "cash cows", and governments need to take much of the blame for this unacceptable situation. It is a complete contradiction in terms for monopoly service providers to be making record profits, while the airlines are accumulating record losses!!

Global reliance on industry Regulators was predicted to be a compromise solution between cost-related tariffs for the airlines on the one hand, and reasonable levels of profitability for service providers on the other.

However, Regulators often find themselves in a conflict of interest situation between - the shareholders of the company - the airlines - and the passengers - and of course the shareholders in most cases are the governments. One solution to this conflict of interest scenario would be the appointment of independent arbitration structures to which stakeholders could refer in matters of dispute.

- **FREEDOM TO DO BUSINESS - LIBERALIZATION**

I believe the time has arrived for governments and airlines to stop paying lip service to issues of liberalization, and to make liberalization a reality and let market forces determine the future of the industry, not only domestically but across borders. Airlines must be allowed to serve markets wherever they exist, and in addition they should enjoy the right to invest, or be the recipient of investments in any part of the world, and not be subject to artificial limitations and restrictions. Airlines are currently restricted by policies and regulations and artificial boundaries that belong to another era, and Africa is no exception to this.

It is common cause, I believe, that most airlines would prefer to see government's role as a facilitator and regulator of aviation, and not as an owner or operator competing with the private sector. It is questionable economic policy for government owned airlines, which are often inefficient, overweight, and the recipients of significant financial subsidies, to compete with the private sector. This applies not only to airlines, but also to airports, air traffic service providers, and other government monopoly service provider structures.

- **NEW BUSINESS OPPORTUNITIES**

Apart from cost issues, airlines must look at ways of achieving new business opportunities and greater revenue generation.

For African airlines, the obvious dynamic change that needs to be implemented is the Yamoussoukro Decision (YD). I am not going to belabor this point, as the issues have been well debated and are well known to all of us. The real objective of YD, in my view, has either been forgotten or misunderstood, and the benefit to airlines, passengers, and States, in terms of economic development, has been put on hold, mainly for the benefit and protection of government-owned and sponsored airlines.
Unless the political imperatives change, this unacceptable situation is likely to continue indefinitely into the future.

Five years ago the number of airlines operating within Africa was in the order of 60, with the large majority being government-owned. The latest statistics show that the number of airlines operating within Africa is now in excess of 100, of which approximately 50% are private airlines. Having regard to the demographics of Africa, there is a clear case for rationalization, and for those airlines that continually require subsidies from their governments, it would make economic sense for them to be merged or absorbed by those airlines operating on a viable basis.

- **SAFETY ISSUES**

One of the key dynamics of African aviation is the unacceptable safety record on the continent. On a worldwide basis, safety statistics have been improving, with 2004 being the best recorded year in aviation history. However, this is not the case in Africa, where the safety record is five times worse than the world average.

There is a perception amongst the travelling public that the poor safety record of Africa is due to the number of older aircraft that are flying within the continent. This perception in isolation is incorrect, as airlines are required to maintain all aircraft, old or new, to minimum standards laid down by the aircraft manufacturer. The key issue is not the age of the aircraft, but the oversight and enforcement of maintenance and safety standards by the Civil Aviation Authorities. I make bold to say that this is a major cause of concern in Africa's aviation accident performance, and requires the urgent attention of States if we are to bring our safety statistics to a comparable level with the rest of the world.

IATA has a global Airline Audit Safety Programme known as IOSA, which operates on a voluntary basis, and I think it is significant that very few airlines or Civil Aviation Authorities have volunteered to undertake the audit. I would urge airlines and Civil Aviation Authorities to subject themselves to this audit, and if there are shortcomings in safety standards, let them be identified and rectified for the benefit of Africa's aviation industry and safety record.

- **CONCLUSION**

Mr Chairman, my allocated time has run out, and if I could leave the meeting with two messages it would be the following:

- The re-engineering that is required of the industry requires strong leadership - not only of the airlines, but of the industry as a whole, and on a collaborative basis.

- And, if we are to overcome the challenges of the industry in terms of over-capacity, low yields, high costs, and freedom to do business, then we must not only use leading edge technology in our aircraft, but also in the way in which we do business.

* * * * * *