

HSH Nordbank Market Commentary

Despite Industry Difficulties, Environmental Regulation to be on Front Burner in 2009

Despite forecasts of substantial global airline industry losses for 2009, airlines can not expect any respite from moves to include aviation in further environmental regulation efforts. Indeed, 2009 represents somewhat of a watershed year with a global UN Convention on Climate Change set for December in Copenhagen. Aviation is unlikely to escape inclusion in further global climate change agreements as it did in the Kyoto agreement with the EU taking the lead in recommending aviation's inclusion in its Emissions Trading Scheme (ETS) and with the new US administration apparently more amenable to efforts to foster global environmental regulations. Charged under the Kyoto treaty with developing an industry consensus on a framework for including global aviation in efforts to reduce global warming, the ICAO will be considering proposals in a number of preparatory meetings in advance of the December Conference. Alarmed about more radical proposals to limit travel, the aviation industry has begun to take steps to try to take control of the agenda and ensure the needs of the industry are taken into account while also attempting to highlight environmental improvements made to date as well as new efforts to limit the industry's environmental footprint. Even with these efforts, increased environmental regulation is a foregone conclusion which will add significant additional costs to airlines.

Aviation Making Significant Investments in Environmental Improvement

As a fuel intensive industry aviation has largely had to resort to technological improvements to respond to environmental concerns. In addition to the general argument that aircraft and engines are always improving in their efficiency, the aviation community has embarked on a number of efforts to raise its environmental profile. These include efforts to incorporate biofuels in the jet fuel supply, efforts to focus on air traffic control improvements which could substantially shorten flight times, and other technological advances.

Alternative Fuels

One of the most high profile areas in which aviation has sought to bolster its green credentials is in its experimentation with biofuels and with gas to liquid fuels (i.e. fuels derived from natural gas). The aviation industry has begun to experiment with a variety of plant-based fuels in order to strengthen its claims of looking for ways of achieving sustainable growth. While biofuels do not eliminate emissions, they certainly add to the argument that the industry can grow without depleting natural resources. More importantly, biofuels and gas to liquid fuels are cleaner burning and emissions from biofuels do not require emissions allowances under the European ETS (i.e. their emissions factor is considered to be zero).

First generation biofuels such as ethanol posed significant problems for avia-

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tion since ethanol freezes at high altitudes. In addition, first generation biofuels have become viewed as competing with cropland and as potentially causing more harm than good. This has led the aviation industry to take the lead on developing alternative biofuels dependent on plants that grow in inhospitable areas, that need limited water, and that do not have any other useful purpose. Experiments have already begun with Algae, Jatropha, Camelina, and Barbassu. Of these, Algae and Jatropha appear to offer the most promise.

Algae has the advantage that it actually takes a lot of CO₂ out of the atmosphere in its rapid growth which could allow it to be considered as a carbon offset. In addition, Algae does not compete for water resources or valuable land. Algae is also not land intensive in that an acre of algae can produce enough oil to make 3000 gallons of jet fuel in a year – i.e., the entire jet fleet could be powered by algae grown in an area the size of Belgium. In fact, Algae is the most energy intensive of biofuels planned for aviation. The Jatropha bush is also considered a leading contender as a biofuel in that it is a plant that is high in oil content but that can not be used for anything else. The plant also grows in inhospitable areas and thus does not compete for farmland. Perhaps most importantly, fuel made from Jatropha has only half the CO₂ effect as petroleum does. Initial test results using biofuels appear promising with initial reports from test flights indicating biofuels appear to perform similarly to traditional jet fuel.

It will likely take some time before biofuels could be introduced as a true alternative to Jet-A fuel used today. The industry has set a requirement that any chosen biofuel blend be a direct replacement for Jet-A (i.e. require no modifications to existing jet engines or to fuel delivery and storage systems), be able to operate at high altitudes, at high temperatures, have a low freezing point, and be cost competitive with Jet-A. Most estimates indicate it will take at least 4 years to begin to commercially use biofuels in scale in aviation and that the initial use will not likely amount to more than 10%. In fact, IATA is a bit more cautious having set a goal of 10% use of alternative fuels by 2017.

ATC and Airport Infrastructure Improvements

Airlines have also pointed out that no matter how much they move to adopt the latest, most environmentally friendly equipment, none of that will be worth anything if governments do not improve air traffic control efficiency and if airport infrastructure is not adequate. With the global airline industry slated to grow significantly, additional air traffic efficiencies will need to be found to avoid congestion. Otherwise, aircraft will end up circling in the air or waiting on the ground merely burning additional fuel and adding to emissions. Airlines have been working with entities such as Eurocontrol to try to eliminate national boundaries in the air and improve the ability to fly more direct routes. Indeed the IATA estimates that air traffic management initiatives could improve fuel efficiency and CO₂ emissions by up to 12%.

Microwave Technology to Eliminate Contrails

Contrails are thought to potentially be a significant factor in increasing cloud cover and hence in global warming. At first glance, there would not appear to

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be much one could do about contrails since they form from the warming of water vapors from jet exhaust at high altitude. Indeed, there is evidence that more efficient engines actually increase the production of contrails. Nevertheless, Rolls Royce recently patented promising technology designed to dissipate contrails with a microwave beam positioned behind aircraft engines. The microwave beam warms the ice particles in the contrail to eliminate the contrail.

Engine Improvements

Aircraft engine technology is constantly improving. Traditionally, each new engine design justifying a new aircraft introduction resulted in about a 15% reduction in fuel burn with somewhat less of a reduction in emissions. Going forward, the Pratt & Whitney Geared Turbofan (GTF) is promising similar improvements over today's engines. However, some in the aviation industry are pushing for even greater improvements going forward in order to counter environmental concerns. Engine manufacturers are once again looking at so-called "open rotor" concepts that would result in a 25%-30% reduction in fuel burn although open rotors present significant technological challenges including vibration and where to place the engines.

Further complicating the situation is that accomplishing certain improvements often results in falling back in other areas. For example, to date, improvements in CO₂ and NO_x emissions result in a much louder engine. Open rotor technology probably couldn't be brought to market before 2017 at the earliest. At this point, it is likely the next generation of engines will offer about a 12%-15% increase in overall efficiency. This is enough to reduce some of the pressure on the industry to improve its environmental impact but probably not enough to argue that technology alone will be able to eliminate regulatory efforts to further include aviation in global warming solutions.

EU in the Forefront with Emissions Trading Scheme (ETS)

While initial alternative fuel tests appear promising and governments have begun looking at additional air traffic control improvements it is unlikely these alternatives will offset pressures for additional environmental regulation. Moreover, if the industry is not able to present a clear consensus through the ICAO to the December Conference, there will be an increasing risk of a patchwork quilt of regulations which would be much harder to plan for. Thus, the industry has a strong incentive to try to ensure the development of global rules that do not disadvantage any particular area and that do not place an undue burden on aviation.

The EU has already indicated that, while it will work with the ICAO on a global framework, if none should be forthcoming, it will unilaterally impose its Emissions Trading Scheme (ETS) on aviation beginning in 2012. Under the European ETS, airlines traveling to, from or within the EU must have carbon trading permits to cover their emissions or they will not be granted landing rights in the EU. Initially, airlines will be granted 85% of their permits for free with the remaining 15% to be auctioned. The scheme is supposed to be in effect until 2020 but the mechanism can be revisited depending on actual performance

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and it is possible even more stringent limits could be set over time. The ETS sets overall emissions from aviation at 97% of what the annual average emissions of the aviation industry were in 2004-2006 dropping to 95% in 2013.

At the moment, other than air travel taxes in place or being considered in several countries, the EU ETS is the main concrete proposal on the table for regulating aviation emissions. In the meantime, the US Congress has begun considering its own proposals to include aviation in a US carbon “cap and trade” scheme and it is increasingly likely that a form of global “cap and trade” scheme will develop. Nevertheless, unless the Copenhagen Conference is able to agree on an alternative way for including aviation in efforts to reduce emissions and global warming, airlines may have to deal with several different regulatory frameworks and even several different “cap and trade” programs depending on where they fly.

Cost of ETS and Other Regulations is Significant

The EU ETS scheme will, for the first time, add costs to the industry based on its carbon emissions and these costs will largely depend on the cost of pollution permits. Estimates of the cost of the EU ETS on aviation vary somewhat and amount to 3.5 billion-5 billion Euros for the first year, or up to about 30-40 Euros per ticket for the longest flight and about 5 Euros for the shortest flights.

Under the initial ETS scheme, airlines will have to purchase 15% of their emissions rights. Today there is an existing market under the ETS for emissions permits based on industries that already participate in the ETS. Assuming a permit price of 33 Euros per ton, the IATA has calculated the cost to the world’s airlines of inclusion in the ETS at 3.5 billion Euros in 2012. More recently, permit prices have traded as low as about 9.70 Euros per ton and even at that price the overall cost to the airline industry would still be over 1 billion Euros. Arguably, the permit price is likely to rise the more industries are included. Moreover, over time it is likely the number of free allowances will be reduced further increasing costs. The IATA has concluded that, if the total number of permits available for auction remains unchanged, because of increased demand the cost to the industry could rise to some 6.9 billion Euros by 2020. If proposals for airlines to purchase 100% of their pollution rights were to take effect, the total cost is forecast to rise to 12.8 billion Euros assuming a permit price of 33 Euros per ton. Most individual airlines have not yet publicly released an estimate of the cost to them of the ETS although some airlines have said it appears to amount to the equivalent of approximately a 10% increase in the price of oil in the first year of the program alone.

While some have begun to argue that a straight carbon tax might be simpler to administer than a cap and trade scheme, even if the EU ETS were swapped for a carbon tax it is unlikely the overall magnitude of the cost to aviation would be reduced significantly. Moreover, the current ETS applies to carbon emissions only and there are increasing efforts to begin curbs on nitrous oxide emissions which would further increase costs to aviation.

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Unintended Consequences of Regulation

Unless the aviation industry is able to work together to foster a workable, global regulatory framework, unintended consequences of planned regulatory efforts may harm both the aviation industry as well as make efforts to reduce aviation emissions ineffective. For example, if the EU unilaterally imposes its ETS on flights to and from the EU, it is possible that airlines with hubs outside of the EU will have an advantage over EU carriers. Carriers with hubs outside of the EU would only purchase pollution permits for the leg from the EU to their hub, so EU-based passengers might see lower ticket costs for flights transiting hubs outside of the EU. Routings via those hubs may also be longer, and if passengers move to those flights, overall emissions will not be reduced as much as intended.

In addition, if the aviation industry is unable to help forge a consensus, individual countries are more likely to institute their own environmental solutions including taxes that may have little to do with actual pollution levels. Indeed, even with the EU ETS, airlines are concerned that revenues from the program are not required to be spent on environmental improvements. With tight government budgets globally, airlines rightly fear that environmental improvement will be used as an excuse for additional taxes that are indiscriminate and that do not create the right incentives.

Over the longer term, increased environmental regulation could affect aircraft values as well. To the extent regulations favor less polluting aircraft, older equipment is more likely to be retired early primarily affecting the values of older aircraft. However, if aviation were to lose all influence in the regulatory process and regulation became too onerous, it is in theory possible the overall demand for aircraft could be reduced also affecting aircraft values.

Conclusion – Aviation Industry Needs to Continue to Guide Regulatory Efforts

Aviation will not be able to escape its fair share of responsibility for its environmental impact. The cost of regulations already planned to be implemented appear to be significant for an industry with such a weak overall financial profile. Arguably, a global solution with industry participation would limit the development of a patchwork quilt of regulations and taxes and avoid competitive advantages developing in hubs outside of any carbon tax or cap and trade regime.

What is encouraging is the aviation industry has already formed several working groups to try to participate in and guide the debate in order to ensure that any environmental regulation:

- Is consistent and global in nature,
- Is affordable to the industry while providing real incentives to cut emissions, and
- Takes into account both the likely significant additional techno-

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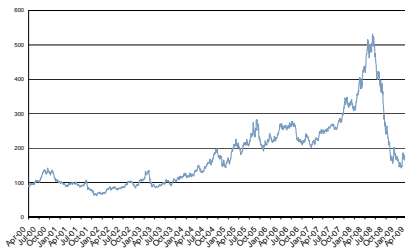
logical improvements coming in the future and the ability of other changes such as air traffic control improvements to aid in reducing emissions.

If aviation is able to help guide regulators to a workable solution, that solution is more likely to be global in nature and to lead to meaningful and successful participation by the aviation industry in emissions reduction efforts.

By Daniel W. Stone

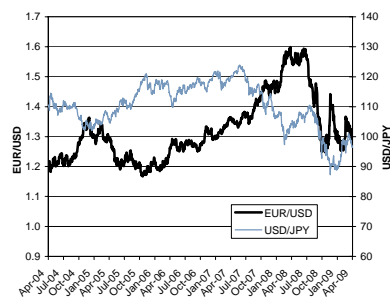
General Aviation News

Jet Fuel Price Index



Source: HSH Nordbank; Base year 1991 = 100; Average of the spot markets US Golf, US West coast, Mediterranean, Rotterdam, Far East Singapore.

Currencies



Source: Bloomberg

World

IATA forecasts a 4.7 billion US-dollar loss worldwide in 2009

The International Air Transport Association (IATA) has revised its loss forecast upward for the global aviation industry. In its report, the IATA said that the global air transport industry would lose 4.7 billion US-dollars in 2009, nearly double of its December forecast of a 2.5 billion US-dollar loss for the current calendar year. Industry revenues are expected to fall by 12.0% (62 billion US-dollars) to 467 billion US-dollars. By contrast, revenue declined 7% in the aftermath of the 2001 attacks, which sent United Airlines, US Airways, Delta Air Lines and Northwest Airlines into bankruptcy. Yields are expected to drop by 4.3% in 2009, while demand is projected to fall sharply with passenger traffic seen to contract by 5.7% over the year. Cargo demand is expected to decline by 13.0%. On a somewhat positive note, the IATA said falling fuel prices are helping to curb losses. With an expected fuel price of 50 US-dollars per barrel (Brent oil), the industry's fuel bill is expected to drop to 25% of the operating costs (compared to 32% in 2008 when oil averaged 99 US-dollars per barrel).

The IATA believes the Asia-Pacific region will continue to be hardest hit by the current economic turmoil, accounting for more than a third of the global loss (1.7 billion US-dollars). Overall, the region is expected to see a 6.8% fall in demand but only a 4% drop in capacity. European airlines are projected to lose 1 billion US-dollars this year. A forecast 2.9% fall in the continent's GDP is expected to result in a drop in demand of 6.5%. Capacity cuts of 5.3% will not keep pace with the fall in demand, driving yields and profitability down. In North America, airlines are seen to deliver the best performance in 2009 with a combined 100 million US-dollar profit. A 7.5% fall in demand is expected to be equally matched with a cut in capacity. The Middle East is the only region with a projected demand growth of 1.2% this year, but capacity will see an increase of 3.8%. The result is expected to be a loss of 900 million US-dollars.

In addition, IATA also revised its forecast losses for 2008 from 5 billion US-dollars to 8.5 billion US-dollars.

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Airline News

U.S. / Americas

Mexico awards Grupo Mexicana concession for new airline

Mexico's Communications and Transportation Department has awarded Grupo Mexicana a concession to operate a new domestic airline. The new carrier, named MexicanaLink, will enable Grupo Mexicana to reestablish services and connections previously provided by extinct low-cost airlines, several of which disappeared from the market in the latter part of 2008. The new airline made its debut with flights from Guadalajara to Puerto Vallarta and Monterrey. Mexicana plans to serve at least 25 destinations with this new carrier by yearend. The airline started with a fleet of 13 Bombardier CRJ200 planes with a 50-passenger capacity each. According to Grupo Mexicana director Manuel Borja, the company invested 7 million US-dollars to launch the new airline, which will create 500 new jobs. Grupo Mexicana operates Mexicana Airlines and Click Mexicana. The two airlines transported 11.7 million passengers in 2008. With the incorporation of the new aircraft, Grupo Mexicana will operate a fleet of 103 aircraft, one of the largest in all of Latin America. Mexicana expects the new airline to carry about 800,000 passengers a year when the fleet is at full strength, about 3% of the country's domestic traffic.

Continental Airlines approved to join Star Alliance / EU launches probes into airline alliances

Continental Airlines won the nod for its plans to join the Star Alliance. The US Department of Transportation (DOT) approved the entry into the alliance, granting tentative antitrust immunity to the carrier. Additionally, Continental received approval for a transatlantic joint venture with Air Canada, Lufthansa and United Airlines, called "Atlantic Plus-Plus". According to the DOT, antitrust immunity allows airlines to coordinate their services and act as a single carrier for international air services covered by the immunity. The DOT said the alliances would increase service in international markets, give consumers more options, shorter trip times and reduce fares. Atlantic Plus-Plus must be implemented within 18 months as a condition of immunity, DOT said. The US department added that airlines would remain subject to antitrust regulations with respect to their domestic services. In June last year, Continental had announced that it was pulling out of the SkyTeam partnership with Delta Air Lines and Northwest Airlines. Members of the third major alliance, Oneworld, which includes American Airlines and British Airways, are awaiting word on their own application for antitrust immunity. Those carriers have complained that they are at a disadvantage to Star and SkyTeam members, who already have antitrust immunity. Oneworld members American Airlines, British Airways, Finnair, Iberia and Royal Jordanian expect the DOT to issue its decision on their antitrust immunity application in the second half of this year.

Meanwhile, the European Union is taking a look at alliances between the US and European airlines to see if they are anti-competitive and harm passengers.

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Two formal inquiries have been started; one for the co-operation between British Airways, American Airlines and Spain's Iberia under their Oneworld code-sharing agreement; the other for the Star Alliance Partnership between Lufthansa, United, Air Canada and Continental. European Commission officials said the level of co-operation in question appeared "far more extensive" than that among the alliances' members generally. An existing investigation is already looking at the SkyTeam alliance of Air France-KLM and Delta-Northwest. If the alliances are discovered to have engaged in anti-competitive behavior in the past, they can be fined up to 10 percent of global turnover. The investigation could also impose limitations, conditions or a ban on any further co-operation. Unlike the Transportation Department, which has jurisdiction over airline antitrust here, the EU doesn't issue grants of immunity. Rather, it looks into proposed partnerships and opposes them or lets them move ahead.

Europe

SAS Group sells Spanair and AirBaltic

The SAS Group has completed the sale of an 80.1% stake in its money-losing daughter Spanair for a nominal price of one euro, although the total book loss to the financially troubled Scandinavian airline group is valued at almost 580 million US-dollars. The SAS Group is to remain a minority shareholder with 19.9% ownership. The definitive agreement was reached with a group of investors from the Spanish region of Catalonia, led by the "Consorti de Tourisme de Barcelona" and "Catalana d'Inciatives". Following the transaction, SAS will act as Spanair's industrial partner to assist in the implementation of a strategic plan, which aims at further strengthening Spanair's position in Spain and as the leading carrier in the Barcelona region. The sale is an important step in the restructuring of the Scandinavian group, which has faced a prolonged struggle to find a buyer for the Spanish airline. In addition, SAS announced it had also completed the sale of its 47.2% holding in AirBaltic, its Latvian affiliate, to the airline's management. According to SAS, that sale was "in line with our strategy not to maintain minority holdings in our airlines".

Czechs ask Air France-KLM and Unimex to bid for Czech Airlines

Air France-KLM and Czech consortium Unimex-Travel Service were picked by Czech government as candidates to take over state-owned Czech Airlines (CSA). In its two-round public tender, the Czech Republic had received four preliminary bids for its 91.5 percent stake in CSA. According to the finance ministry, Aeroflot, Air France-KLM, private equity firm Odien and a consortium comprising Czech Unimex Group and Travel Service, all submitted applications in the first round of tendering. Bidders needed to meet conditions such as keeping CSA's national identity status. Those two companies, which passed the first round will be allowed access to CSA's internal information necessary for setting up the final price bid. The two chosen bidders will be soon invited to proceed to the binding second round, in which only the price will be decisive. According to the government plan, bids are expected by the end of June.

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ESAS and Tui buy stake in Air Berlin

German and Turkish investors are taking significant minority stakes in Air Berlin, ending months of uncertainty over its future ownership. According to Air Berlin, Turkey's ESAS Holding, which operates the airline Pegasus, is set to acquire a stake of about 15.3 percent of the voting shares in Air Berlin from Swiss bank UBS. The move by ESAS follows a separate agreement between Air Berlin and Europe's biggest travel firm, TUI Travel, under which it will acquire a 19.9 percent stake for 64.8 million euros through an issue of new shares. In return, the German carrier will get the same stake in TUI's carrier TUIfly. Air Berlin will pay 36.3 million euros for the TUIfly stake. The central component of the agreement is for the previous city flight business of TUIfly to be transferred to become the commercial responsibility of Air Berlin starting with the winter flight schedule 2009/10. Of the in total 38 aircraft that TUIfly will operate from 2010, 17 planes will be chartered to Air Berlin via a long term wet lease. The remaining aircraft will be operated under the TUIfly brand purely for TUI Deutschland tourism flights.

Privatization of Olympic Airlines finalized

The Greek Government signed an agreement to sell ailing state airline Olympic Airlines, which was founded a half-century ago by Greek shipping tycoon Aristotle Onassis, to Greece's private Marfin Investment Group (MIG). MIG won bids for all three branches of the company on sale (flight operations, technical maintenance and ground handling services) and agreed to pay 177.2 million euros for Olympic. The investment company, whose main shareholder is Dubai Financial, was chosen over Aegean Airlines, a profitable private Greek airline that last year carried more passengers than Olympic. Aegean's last-minute bid was ruled out on competition grounds. The last of six unsuccessful privatization efforts ended in January after failing to attract sufficient bids. The European Commission last year opened the way for the carrier's privatization by approving the write-off of more than 2.6 billion euros in accumulated debt and suspending court action over the repayment of 850 million euros in state aid.

Asia/Pacific

Dubai's first low-cost carrier ready for take-off

The Gulf emirate of Dubai, owner of Emirates Airline, has announced the launch of its first budget airline Flydubai. The carrier will begin daily flights to Lebanon's capital Beirut and Jordan's capital Amman in early June, President of the Department of Civil Aviation, Sheikh Ahmed bin Saeed al-Maktoum, said. Operations will start out of Dubai International Airport's Terminal 2, a budget airline centre, which will be upgraded to increase capacity from three million to five million passengers a year. Flydubai will begin operations with two Boeing 737-800 narrow-body aircraft, which it will increase to six by the end of the year. Dubai first announced the establishment of Flydubai in March 2008, with a start-up capital of 67 million US-dollars. The aircraft are part of a 3.78 billion start-up order made at the Farnborough Air Show in England last summer for up to 54 planes. Flydubai will become the fifth budget carrier to operate in the

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Gulf Arab region. The neighbouring emirate of Sharjah operates Air Arabia, while Kuwait's Jazeera Airways operates also from Dubai and Kuwait, Bahrain Air flies from the neighbouring Gulf archipelago, and Nas from Saudi Arabia.

Upcoming Events

2009	Organization/Company	Event/Announcement
May		
5	Austrian Airlines	Results of Q1
6	easyJet	Half Year Results
	Skywest	Results of Q1
8	ACE Aviation	Results of Q1
12	Iberia	Results of Q1
	Thai Airways	Half Year Results
	EADS	Results of Q1
	Japan Airlines	Full Year Results
14	Singapore Airlines	Full Year Results
	IEA	Monthly Oil Market Report
15	Jet Airways	Full Year Results
	Frontier Airlines	Full Year Results
	Mesa Air	Half Year Results
	Kingfisher Airlines	Full Year Results
17-19	Routes Regional Europe	in Prague, Czech Republic
18-21	Regional Airline Association Annual Conference	in Utah, USA
19	Air France-KLM	Full Year Results
20	Malaysian Airlines	Results of Q1
22	British Airways	Full Year Results
27	Air Berlin	Results of Q1
28	OPEC	153 rd OPEC Meeting in Vienna, Austria
29	AirAsia	Results of Q1
30	SkyEurope	Half Year Results

Source: HSH Nordbank, Bloomberg

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