

## Conference Shows That Industry Forges On In Spite of War, Bankruptcies

Attendees got a glimpse of the new era early, in the form of the keynote address by AirTran Airways' CFO Stan Gadek and back-to-back presentations by highly regarded industry analysts Michael Boyd and Peter Walsh.

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Taking place against the backdrop of the most difficult industry environment to date, the **Fifth Annual International Jet Fuel Conference & Exhibition** proved that in spite of war and bankruptcies, the industry forges on. In all 251 attendees gathered for three days in Orlando to analyze the issues and seek solutions for a new era in commercial aviation.

Attendees got a glimpse of the new era early, in the form of the keynote address by **AirTran Airways'** Chief Financial Officer

**Stan Gadek** and back-to-back presentations by highly regarded industry analysts Michael Boyd and Peter Walsh. Later in the day the event focused on European issues, and on subsequent days tackled various issues including price risk management, insurance, infrastructure challenges and aviation safety.

Gadek provided an overview of AirTran's operations, highlighting key areas that contribute to the success of the low-cost carrier. A big contributor to

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## Platts Methodology Change Sparks Concerns Among European Airlines

*By Robert Baal*

A recently announced change to European oil product assessments by energy information provider Platts has several airlines concerned enough that they may look elsewhere for price information in the future. Airline managers tell *JFR* that over strong opposition expressed by energy traders, producers and consumers alike in several forums held by Platts, the company decided to implement the changes effective April 1, 2003.

The most controversial aspect of the change is the adoption of a market-on-close

assessment system for all European refined oil products. That means Platts will track the evolving market price of the European oil product commodities up to 1730 (5:30 pm) London time, and will then assess reflecting the prevailing market price at that time.

Platts notes that it already assesses Brent and other key crude oil indicators using a market-on-close assessment methodology by 1730 London time, and assessing both crude and products on an m-o-c system at the same time will align crack spread values for the

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**Speaking of its Atlanta hub, Gadek considers the hub-and-spoke model alive and well, and says AirTran's results prove that the model isn't inherently broken, thank you.**

AirTran's profitability, Gadek noted, is the fuel-efficient Boeing 717 aircraft that makes up the majority of its fleet. By phasing out the older, less efficient DC-9's that it still operates, AirTran is achieving even greater efficiencies going forward, following the blueprints of Southwest and JetBlue in the manner of operating a single aircraft type.

However, AirTran plans to veer off that course in the near future because it sees the need to operate a second, longer-range aircraft that will help diversify its revenue exposure out of its Atlanta hub. Look for an announcement to that regards by mid-year, Gadek said.

Speaking of its Atlanta hub, Gadek considers the hub-and-spoke model alive and well, and says AirTran's results prove that the model isn't inherently broken, thank you. To analysts and insiders who say otherwise? "I say, Bunk. What's broken is the cost structure, not the model," he replied.

To illustrate, Gadek pointed out that even when US Airways emerges from bankruptcy later this year, it will still have unit costs 40% to 45% higher than those at AirTran. And those unit costs are trending downward at his airline, he noted, thanks to the 24% lower fuel burn of the 717 and fuel hedging contracts in place.

"If you have low costs, you can make money in any environment," Gadek said. That's why he feels confident about his airlines' future despite Delta's obvious attempt to knock it off course with the launch of "Song."

**Analysts Square Off**

Later that morning, **Michael Boyd**, President **The Boyd Group/ASRC** concurred with Gadek's comments about the hub & spoke model, but not before he took the time to again skewer the federal government for its failing aviation

policies. In regards to the Transportation Security Administration, not only are costs out of control, but airport security against terrorist threats is really no better than it was prior to 9/11, he believes. The TSA is "not anticipating threats," Boyd said, noting how blowing up a fuel pipeline or an access bridge can effectively shut down many airports in the US.

As for Boyd's other thoughts:

- On the hub-and-spoke model: "It works." Why? Because it's the only way for carriers to effectively provide service at secondary airports. "Point-to-point doesn't work unless it's between very large cities with very large jets," Boyd claimed.
- On continuous hubbing, (or "rolling hubs"), as American Airlines is implementing at DFW and O'Hare: Viable "only in a few places" with heavy O & D traffic, like Dallas and Chicago.
- On a low-cost carrier within a carrier, like Delta and United are planning: History shows that it's a "trendy concept, proven failure..." but, Boyd likes Song's chances, as long as it focuses on the right markets. "It could put JetBlue out of business," he stated.
- On regional jets: "The bubble is going away."
- On regional carriers: "Only exist to provide lift for majors in secondary markets."
- On low-fare carriers: "No new entries besides what we already see."
- On the point-to-point model: "The first point they go to is into bankruptcy court."

In his outlook, Boyd sees the all the network carriers surviving, assuming the war is short and the outcome never in doubt. But should

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**Today's growth market is in leisure travel, Walsh believes, meaning yields will be continuously pressured lower. "That's the primary reason why low-cost carriers will win and network carriers will not," he said.**

**In his short-term outlook, Walsh sees American Airlines filing for bankruptcy, with Northwest and Continental "one major shock away from filing themselves."**

it drag on, with increasing uncertainty, or should there be another terrorist attack on aviation, there will be a rush to bankruptcy court.

**Peter Walsh**, Vice President **Mercer Management Consultants** by contrast, sees a rush to bankruptcy court by the majors whether there is a protracted war or not. "Maybe the network (hub-and-spoke) model is not dead, but how many will survive?" he asked. In his view, three, maybe four majors will survive to compete with the continued expansion of the low-cost model. "The low-cost carriers will continue to win, so the network carriers will have to change," he said.

Those changes need to come in four areas, according to Walsh:

- Security and Insurance;
- Excise tax reform;
- Labor cost restructuring;
- Consolidation.

Because of the inherent high fixed costs, commercial aviation is a GDP centric industry, he said. When GDP is up, airlines do well; when GDP is down, airlines suffer. Between 1995 and 2000, US airlines had the luxury of a business traveler who was willing to pay premium prices, but between 2000 and the present, GDP has slid and business travel at hubs has nearly disappeared. Today's growth market is in leisure travel, Walsh believes, meaning yields will be continuously pressured lower. "That's the primary reason why low-cost carriers will win and network carriers will not," he said.

So are the network carriers doomed? If they continue to "hunker-down" the way they have been, struggling to cut costs to ride out the storm, probably, Walsh thinks. But Washington can save at least some of these carriers by acting on the four areas noted above, he said. He does not advocate another bailout, which could jeopardize

long-term restructuring, by the way.

What he advocates is "fundamental restructuring that will reduce costs, increase labor productivity and diversify options," the latter of which includes dropping foreign ownership restrictions. He believes the Railway Labor Act results in a "federally sanctioned labor monopoly," and that the excise tax burden on the industry would kill any other industry that had a similar burden. "(The industry) is fundamentally constructed for failure," Walsh said.

In his short-term outlook, Walsh sees American Airlines filing for bankruptcy, with Northwest and Continental "one major shock away from filing themselves." He thinks United's recovery plan might work, but believes that the "normal forces of consolidation" must be allowed to work on the industry.

"Seventeen billion dollars in market share will be lost to low-cost carriers in the next 10 years," Walsh said. "Assuming current trends, by 2012, low-cost carriers will be the dominant force in North American air travel," with major network carriers becoming less-and-less important each year going forward from here.

**Europeans Take Over**

Obviously the problems facing the US majors are not the only pressing issues in the aviation fuel industry, and the balance of the agenda reflected that. On Monday afternoon the European session began, highlighted by **Lars-Olof Hollner**, Head, **European Commission on Transport, Energy & Environment**, who discussed some recent developments in EC aviation policy. At the top of this list was the recent ruling that current "open skies" agreements are contrary to EU community rules. He said the bi-laterals are not null and

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**“This is not an unfriendly act towards the US, but a necessary step towards bringing our house in order,” Hollner stated.**

void, but have to be renegotiated to remove nationality clauses that are out of compliance with EU statutes.

“This is not an unfriendly act towards the US, but a necessary step towards bringing our house in order,” Hollner stated. The next step is a community agreement between the US and the EU that will lead to increased free trade in aviation, he said, in addition to advocating a reduction in foreign ownership restrictions. He noted that future consolidation is more likely once the new agreements are in place.

Hollner said many good recommendations on bilaterals and international treaties can be found in a study conducted by the Bradley Group, which focuses on the fallout of the new agreements.

**David Rushmer**, formerly of British Airways and now of **Widecut Fuels Ltd.** continued the Euro-session with a look at European trade flows of jet fuel. He noted that Middle Eastern imports to Europe have increased dramatically in recent years, and that the Mediterranean and southern Europe in particular have become far more dependent upon exports. His conclusion was that Europe as a region will continue to face high levels of price volatility because it’s at the mercy of arbitrage, with barrels often waylaid to North American markets.

**Keith Carter** of IATA followed with a discussion on European airport pools, noting that

consortiums often serve to limit competition.

**Presentations to be Available**

As noted above, the conference went on to cover a wide range of topics affecting the aviation fuel industry, and space doesn’t allow us to highlight them all here. However, by the end of this week, **JFR** subscribers will be able to download the majority of the onscreen presentations delivered in Orlando from the **AAG** Web site at **www.armbrustaviation.com**.

The changes that are affecting the industry are significant, and with them will come a changing of the guard in terms of the players involved. What the Fifth International Jet Fuel Conference proved, both in its attendance and agenda, is that the evolution of the multi-billion dollar global industry has begun, and the search for solutions is going full throttle. By the time we gather again next year in Orlando, more players will have changed and the way we do business may have changed as well. We look forward to covering those changes in these pages in the months to come. **JFR**➔



**Platts Methodology Change Sparks Concerns Among European Airlines**  
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European markets, allowing more accurate evaluation of refining economics.

Platts also announced its intention to revise the loading times reflected in its European oil products assessments to 10-25 days forward for cargoes, and 2-15 days forward for barges. In addition, it will no longer differentiate between refinery

and storage grade material in its European assessments.

“Underpinning these changes is the need to address market distortions,” says **Jorge Montepeque**, **Platts** Director of Market Reporting. “With the current system, outright and spread values may not be correctly aligned if an

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**“We doubt very much that traders, producers and consumers can wait until 6:30 pm their time to participate in the market.”**

assessment is based solely on the average of trades over the whole day.”

**Airlines Disagree**

While Platts says the changes are the end result of a meticulous process that included the aforementioned forums, and its only intentions are to assess markets accurately and with integrity, several airlines that we spoke with disagree in terms of the outcome. They believe that by altering the current methodology – which relies on averages reported throughout the day – so drastically, Platts will no longer reflect what is happening in the oil markets, but instead influence the behavior of market participants, enabling them to sort their deals according to which ones they like and which they don't.

“Five-thirty pm London time is 6:30 pm Continental time and the jet barge market is traded in the Netherlands, Belgium and Germany as well,” says a European airline fuel management team member. “We doubt very much that traders, producers and consumers can wait until 6:30 pm their time to participate in the market.”

As a result, she says traders might attempt to cover their demand or sell their surpluses outside the proposed trading windows in order to avoid being left out of the market.

“Our main concern is that any limitation of the trading windows to less than the actual business hours would be highly supportive to price manipulations as even much more limited quantities than today would be sufficient to influence the assessments and gain a higher leverage effect than ever before,” says the airline manager, noting that this is especially true for the jet market, which is not very liquid.

The activities on the spot oil markets are fundamentally a result

of the supply and demand equations in the respective markets, the airlines say. These equations fluctuate in accordance with the underlying refining and marketing activities in the inland markets. While production usually runs 24-hours a day, marketing and wholesaling activities take place during normal business hours and thereby have the strongest and most direct impact on today's spot markets. By tightening the respective trading windows, the airlines believe Platts will move away from reflecting “real” market activities, reducing its quotations to an almost random “snapshot” view of the markets, which in their minds could hardly tell much about the actual market prices for oil.

The airlines are also equally concerned about Platts' intentions to normalize trades and to revise the loading times as detailed above. This concern is based on what they see as uncertainty on Platts' part as to how these normalizations will occur.

**Alternatives Considered**

Since trading happens all through the day, the European airlines want prices all through the day, explains **Chris Judge**, European products editor for rival oil industry publisher **Petroleum Argus**, which understandably hopes to capitalize on the dissatisfaction with the Platts changes. “There is more uncertainty about having just one supplier of prices,” he says.

Argus has stated that its goal is not to replace Platts as the provider of basis prices for over-the-counter oil markets, but for crude exporters, refiners, traders and banks to conclude a growing volume of their deals against a basket of published prices. While it has had some success to that end, for now Argus admittedly remains a distant

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