

## Star Alliance's FuelCo To Set New Format For Fuel Procurement

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The Star Alliance's recent announcement that it will form a joint company to manage the procurement of jet fuel at selected airports around the world had oil companies scrambling to assess just how the move will impact their businesses. Generally, oil companies have objected to such arrangements because of the varying credit risks of member carriers and the inability to charge higher prices to certain individual airlines.

After the announcement, oil company executives expressed qualms about the effectiveness of the strategy, but said they would adapt their business models to meet the changing procurement needs of Star Alliance

members.

“The history of these joint procurement activities is that they haven't generated the sort of savings everybody was looking for,” notes one oil executive. “I'm wondering what is different this time around. It's early days but we'll be responsive to whatever is out there.”

Star Alliance has experimented with joint purchasing in the past, notably in Los Angeles, Miami and certain international locations, according to **Bob Sturtz**, director, petroleum and purchasing, **United Airlines**. For example, Sturtz says that in the case of LAX, once the deal was

*(Continued on page 2)*

### Commentary...

## Year End Brings Higher Prices, Emerging Trends and Renewed Hope for 2004

Airlines are ending the year with renewed hope for an industry wide recovery in 2004 while confronted with the highest jet fuel prices since the post 9/11 spike. Having weathered the most difficult period in history, airlines are hopeful that robust economic growth will spur an increase in passenger traffic resulting in higher yields and a return to profitability. Major airlines have cut capacity and costs and have battled low cost rivals to protect market share.

Nevertheless, airlines can't seem to catch a break since higher fuel prices could stymie cost cutting efforts. According to OPIS, jet fuel prices are ending 2003 at their highest levels since 2000. Prices are up more than

20% and with the exception of 2000, yearly average prices are their highest in more than a dozen years. In the U.S. alone, spot jet fuel prices will average 86 cents per gallon, that compares to a price of 71 cents in 2002, a 21% increase. An increase few airlines can afford.

While some airlines are protected against the higher price levels due to their hedge positions, weaker and cash restrained airlines may end up bearing the full brunt of the price spiral. Additionally, even some healthy airlines may have guessed wrong over the last several quarters by not locking in prices that

*(Continued on page 4)*

**“Like it or not, (Star Alliance’s) combined volume makes us a player on the world stage, and we would be remiss not to try to take advantage of this fact.”**

negotiated each of the carriers had to sign individual contracts with a third party. “In the future we won’t do that,” he says. “The likelihood is that this entity will contract for the purchase of the fuel, and each of the carriers will then buy the fuel from Star Alliance FuelCo. It makes it easier for the third parties to then do business with us. Instead of having what would amount to 15 customers they have one.”

Sturtz says that is a key element of the new arrangement. One entity will be empowered to negotiate deals on behalf of any Alliance member that chooses to participate at a particular location.

Another key benefit in the minds of Star Alliance members is what they hope will be better prices from oil companies. “I guess the benefits we are all looking for in setting up this new entity is as an enabler to better leverage Star’s presence, estimated at about 20% of world jet fuel demand,” says **Bob Siwik**, general manager, petroleum administration, **Air Canada**. “Like it or not our combined volume makes us a player on the world stage and we would be remiss not to try to take advantage of this fact.”

How far the joint procurement arrangement will reach is still unclear. Sturtz says that the strategy will be used “wherever we need it,” and “when the opportunities arise.” Siwik says the Star Alliance FuelCo approach will be “opportunity specific” more than airport specific. “As with Star’s public declaration of joint aircraft purchases recently, we would hope that FuelCo could exercise some degree of influence in the jet fuel industry on a much broader basis than could be achieved on a specific location by location, or even carrier by carrier basis.”

### **Oil Company Concerns**

The announcement of a separate entity for purchasing fuel has certain oil industry executive uneasy. One executive at a major oil company notes that his firm would have a “huge difference in approach” to a single entity that purchases fuel then resells it

to members, rather than dealing with airlines individually. The same executive asks, “When would the transfer of ownership take place?” In other words, when does the oil company end its responsibility for the fuel, and when do the airlines take ownership? Depending on the answer, there could be significant legal and insurance issues that need to be addressed.

Another oil industry source says the attractiveness of a large contract with Star Alliance members could be tempered if such a deal damages the relationships the oil company has built with individual airlines within and outside the alliance group. “We’ve worked hard to build individual relationships and have to be very careful not to damage those in our desire to add new business,” he notes.

Despite certain qualms, oil companies say they will look at the tenders coming from FuelCo and certainly won’t rule out participating in the bidding process. “We’re very happy to adapt to whatever changes or purchasing cycles (our customers) are going into with regard to alliances or joint procurement,” notes one oil company executive. However, the executive notes that “we would have to review what terms and conditions are being associated with any piece of business...and what credit concerns there are regarding whichever entity is tendering, and obviously our ability to supply and their alternatives to supply.”

Siwik says he’s not concerned that major oil companies will shy away from a contract opportunity with FuelCo. Saying the oil companies are “much more dynamic in their thinking these days,” Siwik says “I don’t believe I’ve heard the word foolish used too often...when referring to most of the majors, especially when you look at their balance sheets, which most airlines would kill for. They are first and foremost business people capable of accurately assessing risks and rewards. We (the Star Alliance) are not the new kids on the block anymore and we have done business with the oils on this basis for a while now. I think the enlightened among them realize by now that the concept of airline alliances is not a flash

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© 2003 World Jet Fuel Report  
319 Clematis Street, Suite 211 West  
Palm Beach, Florida 33401, U.S.A.

Published biweekly by;  
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Subscription \$1,675 per year.  
Transmitted via first class mail, fax  
and electronic mail. License rates on  
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biweekly covering issues that  
concern airport managers, retailers,  
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**While they many bid on tenders offered by FuelCo, there is no guarantee that oil companies will view the joint entity with kinder eyes than they do individual airlines.**

in the pan, but its here to stay.”

### Credit Worthiness

While they may bid on tenders offered by FuelCo, there is no guarantee that oil companies will view the joint entity with kinder eyes than they do individual airlines. One lingering question is just how oil companies will assess the credit-worthiness of Star Alliance FuelCo. The entity will have no assets so essentially will be combination of the member airlines participating in a fuel purchase at any given location.

Sturtz says he anticipates oil companies will view the combined entity in a better light than they do certain individual airlines. “An oil company would be much more concerned with contracting with what could be some of the weaker alliance partners individually, as opposed to having the good credit of all 15 Star Alliance partners behind an obligation,” he says.

That’s not necessarily true, says one oil executive. While declining to be specific until he sees details of any proposed tender, the source says a joint tender might bring the group down to the level of the least credit worthy among them. “We would need to understand the fiscal nature and the guarantees associated with the contracting party,” he says. “Star Alliance being an amalgam of these companies without its own separate balance sheet or Standard & Poor’s or Moody’s ratings, that in and of itself wouldn’t give us any rational to change our credit policy.”

Finally, oil company executives point out that the larger volume tender doesn’t always translate into lower prices. “Paradoxically, there are often times where size isn’t always

access to lower prices,” says one. “Sometimes the business will be too big for an independent refiner, for example, and you may be actually limiting the supplier options. So there needs to be a lot of caution and thought put into implementing any changes....”

Siwik acknowledges that fact, but responds that “What incremental buyers usually can’t really do well is to develop solid longer term beneficial contracts to the same degree and incorporate other things that come with quasi-partnerships, such as access to resources or other arrangements, which can prove to be quite valuable over the long term if managed properly.”

Star Alliance is looking for greater cost savings, which may or may not come to fruition, and increased efficiencies in terms of invoicing and related tasks. The next several months will be crucial for the entity to establish itself with the major oil companies and assuage their key concerns. Other airlines will certainly be watching, and if the Star Alliance FuelCo works as well as its members hope, it could put in motion a change that could ripple throughout the entire airline industry. [JFR](#)

**Armbrust Aviation Group and the World Jet Fuel Report**

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## Year End Brings Higher Prices, Emerging Trends and Renewed Hope for 2004

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were deemed too high at the time. A few airlines could not bring themselves to lock in longer term barrels at significantly higher levels gambling that once Iraq fell price levels would tumble. That could prove a costly misjudgment.

At the same time a review of 2003 reveals that some airlines have made significant headway in their cost cutting efforts. American, United and US Airways won major concessions from their unions to reduce salaries. British Airways and KLM implemented cost cutting strategies. As a result, several major airlines turned in profitable or near profitable third quarters.

### Europe Consolidates

In other developments the long sought consolidation of the European airline industry appears underway with the approval of the British Airways and Iberia alliance and the announced KLM and Air France merger which awaits final approval from regulators.

If approval is granted, reports have Alitalia eventually joining with Air France/KLM. While denying any plans of a merger, Lufthansa is not likely to sit back very long while BA and Air France carve up Europe. Most expect an eventual agreement between Lufthansa and SAS.

The impact of European airline consolidation on the jet fuel industry is less obvious. Most expect that mergers and alliances will bring additional cost cutting and if so staffing reductions among airline fuel departments may be in the offing. Additionally, the stakes are raised for jet fuel suppliers as consolidation reduces the number of customers and puts pressure on oil company margins.

### U.S. Airlines Outsourcing Fuel

If staff reductions may be on the horizon for merged European airline fuel departments, U.S. airlines may not even need fuel departments if recent

*(Continued on page 5)*

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- Is jet fuel a core airline business?
- Is jet fuel a core airport business?
- Are airports prepared to take a larger role?
- How long can airport operators survive with shrinking margins?
- Will CUTE become the CURE on the ramp?
- Are major oil companies getting out of jet fuel marketing?
- Why are resellers growing volume and influence?
- How serious is the environmental clean-up problem?
- How much are 2004 EPA mandates going to cost?
- What plans does TSA have for ramp security?
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**“The fuel administration will be completely outsourced – the procurement and accounting,” said John Wilson, America West’s vice president of financial planning and analysis.**

## Outsourcing Continues Among Airlines

The recent move by America West to outsource its fuel procurement and management marks another move it what appears to be a growing trend toward third party involvement in airline fuel purchasing activities. From United Airlines and its deal with Morgan Stanley – primarily a capital deal – to JetBlue Airways and now America West contracting with World Fuel Services, cobbled airline finances and a renewed focus on core activities have translated into smaller airline fuel departments and opportunities for third-party buyers and sellers of fuel.

America West announced earlier this month that it has awarded its system-wide fuel procurement and management contract to Miami-based World Fuel Services. World Fuel will take over purchasing of fuel and the back-office tasks accompanying that action by the end of the first quarter of 2004. “The fuel administration will be completely outsourced – the procurement and accounting,” said John Wilson, America West’s vice president of financial planning and analysis. “The hedging strategy will remain as he always was, which is an oversight committee made up of several internal decisions.”

America West purchases approximately 450 million gallons a year which, at the average October price of 82.6 cents per gallon, translates into a business worth about \$371.7 million a year.

The deal marks the second major airline client for World Fuel. In October 2002, the company inaugurated a similar deal with JetBlue Airways. JetBlue’s annual jet fuel volume was 105 million gallons, which translates into \$86.7 million at October 2003 prices. For the first three quarters of 2003, JetBlue burned more than 125 million gallons of fuel.

*(Continued on page 6)*

trends continue.

America West has reached agreement to outsource their fuel purchasing department to World Fuel Services (WFS). This follows a similar agreement that WFS reached with JetBlue last year (see story page 5). Earlier this year United Airlines inked a deal with Morgan Stanley who will supply the airline with 75% of their domestic volume.

Airlines that have outsourced their fuel departments have cited several cost savings reasons for their decisions including - increased demand on capital, higher insurance premiums and growing environmental remediation concerns.

Other airlines are watching closely to see whether there is a new business model emerging that redefines airline participation in jet fuel purchasing and supply.

If so, airline participation in airport fueling operations may erode. Several third party companies such as WesPac and Kinder Morgan have become increasingly active in North American airport fueling operations. If that trend continues those companies may soon be negotiating with airports instead of airlines. In fact, airports continue to complain that many airlines are MIA (missing in action) regarding decisions on airport fueling

facilities. With reductions in experienced personnel at many airlines, some airports and airport operators are complaining that operational efficiency has deteriorated and could end up costing airlines more money in needless delays.

Another emerging trend is the growth in volume and influence of jet fuel resellers (see page 6). Primarily a U.S. trend, companies such as AvFuel, Phoenix Fuels, Valley Oil, Western Petroleum and World Fuel Services continue to build sales with commercial airlines as major and independent oil companies increase sales ex-refinery. Airlines praise the resellers for their customer service and flexibility.

### More Regulation Coming in 2004

Industry participants should be prepared for more government regulation in 2004. Issues ranging from the Environmental Protection Agency (EPA) mandates regarding retention wells for vehicles on the ramp to the Transportation Security Administration's (TSA) ideas on improving fuel farm security promise to bring increase regulation and costs to airlines and airports. **JFR**

**Additionally, the stakes are raised for jet fuel suppliers as consolidation reduces the number of customers and puts pressure on oil company margins.**

**Outsourcing Continues Among Airlines** (Continued from Page 5)

**Third Party Sellers**

**“I think the airlines are looking for some back-office administration – the paper chase, the handling of tickets, the multiple invoices...,”** Bartness says.

Whether these deals mark the early stages of a revolution in the way airlines structure their fuel buying remains to be seen, but at least for the time being, many airlines seem to be changing the ways they purchase fuel. Along with outsourcing fuel procurement, there has been a subtle shift in sourcing of jet fuel. Third-party sellers of fuel are growing and are gaining acceptance as a alternative source of jet fuel for airlines of all sizes.

Greg Bartness, general manager, aviation fuels, Western Petroleum, says an unusual confluence of factors has contributed to the current opportunities for third-party sellers. “All the sudden you have the airlines in a pinch for cash,” says Bartness. “They can’t afford to buy a batch of jet fuel on the gulf coast and not be able to burn it in their planes until 30 days after the fact. You have the oil companies that have been browbeaten for so many years and pushed all the way back to the refinery gates, and now you have the airlines, by virtue of their bankers and creditors, pushing them all the way to the airport. There is this gap in between the two which allows folks like us some opportunities.”

Valley Oil Company has also experienced bigger demand from airlines recently. Sales manager Al Ainsworth says the company’s national supply capabilities set it apart from competitors. Growth has come primarily from business with national airlines and through supply capabilities at hard-to-reach or niche locations. On a broad-base, however, Ainsworth notes that by necessity the nation’s largest carriers are relying primarily on major oil companies for supply. “There is a place for us but I don’t see it with the big airlines,” he says, adding that while airlines definitely want to minimize their inventories during these difficult financial times, they need to contract with the major oil companies that can handle the cash flow issues surrounding large inventories.

Convinced of opportunity in the current difficult economic environment for airlines, Western Petroleum is gearing up to expand its back-office management offerings. Currently the company has a contract for such services with a charter airline, and Bartness says interest from other carriers is there.

“I think the airlines are looking for some back-office administration – the paper chase, the handling of tickets, the multiple invoices...,” Bartness says.

As airlines continue to cut costs, demand for more third-party options for fuel management could increase. From back office functions to full fuel procurement, service providers are seizing the opportunities arising from the changing strategies of US airlines.

**News Briefs** 

**ChevronTexaco Announces \$8.5B Capital And Investment Program**

*Houston...* ChevronTexaco said it will spend about \$8.5 billion on a capital and exploratory program in 2004. About \$1.4 billion, or 16% of total spending, is targeted for global downstream. Refining and marketing investments are estimated at about \$400 million in the US and \$600 million internationally. Another \$400 million is budgeted primarily for supply and transportation projects, including pipelines to support expanded upstream production.

About 75% of total capital spending, or \$6.4 billion, is targeted for upstream investment in exploration, production and global gas-

related projects.

**Dreamliner Lures Airlines with Significant Fuel Savings**

*Seattle...* Boeing’s move earlier this week to begin offering for sale the new 7E7 Dreamliner passenger airline could mean huge fuel savings for carriers that purchase the aircraft. Boeing is estimating a 20% reduction in fuel burn, which would translate into millions of dollars in savings for a major airline with an all-Dreamliner fleet.

A Boeing spokesperson said the 20% reduction comes primarily from a combination of better engine design and better materials. Boeing estimates that 8% of the reduction is due to the

# Crude Prices Continue To Rise Due To Fundamental/Technical Factors

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**The recent spell of cold weather in the U.S. Northeast has resulted in a substantial increase in the demand for natural gas and heating oil.**

Crude Oil Prices have been on a tear lately. On Monday, December 15, the WTI prompt month January 2004 futures contract settled at \$33.18/bbl. Since October 30 of this year, the market is up nearly \$5/bbl. In just the last three weeks, US crude prices have risen 9 percent. Globally, other Benchmark crudes such as the OPEC basket and Brent are up substantially as well. The value of the OPEC basket has gained \$1.30 over the past week in moving to \$29.73/bbl. Following the news of the capture of Saddam Hussein, the market initially traded down \$1.30/bbl. However, despite his capture, the market is still wary of sabotage attacks. After the initial sell-off, the market turned around and actually settled above last Friday's close.

There are several fundamental and technical factors that are behind the recent surge in prices. The recent spell of cold weather in the U.S. Northeast has resulted in a substantial increase in the demand for natural gas and heating oil. The huge run-up in US natural gas prices (from \$4.90 to \$6.95) over the last two weeks has pulled crude prices up. Additional fundamental factors include: signals that OPEC may cut production in February, the tightness of crude inventories, and the closing of the northern pipeline from Iraq's Kirkuk oil fields.

It is interesting to note the high level of jet fuel use in both Iraq and Afghanistan. According to the Defense Energy Support Center (DESC), DESC has supplied 638

million gallons for Iraqi operations, and over the past two years, 1.8 billion gallons in Afghanistan. While these volumes are small in terms of global oil consumption, these volumes together with other non-DESC supplied fuel use for Middle East operations, are large in terms of global jet fuel consumption. This has even led to the unusual occurrence of some jet cargoes leaving the US Gulf for Europe.

The latest inventory statistics from the DOE are generally seen as bullish for crude oil and bearish for oil products. At the aggregate level, the deficit in total inventories from their five-year average continues to increase, moving out by a further 3.1 million bbls to now stand at 55.3 million barrels. As in previous weeks, all the tightening has occurred in crude oil. Over the last three weeks, crude oil inventories have been falling relative to the normal pattern at a rate of 650 thousand b/d, and oil product inventories have been rising relative to normal at a rate of 270 thousand b/d.

The inventory reports for the week ending December 12 will be released on Wednesday morning. The early market expectations are for a crude draw of 1.5 to 2 million barrels. If these forecasts are correct, this would be the fourth straight week of a draw. Distillate stocks are expected to show a draw of 1 to 1.5 million barrels.

The latest Commitment of Traders report as of 12/9/03 from the NYMEX showed a slight increase in crude oil futures and a sizeable increase of 6,869 contracts in heating oil futures.

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## Indicative Forward Prices For Jet Fuel

|          | Jet NWE Rotterdam Cargoes (\$/mt) | Gulf Coast Jet (cents/gal) |
|----------|-----------------------------------|----------------------------|
| Q 1      | \$304                             | 89.8                       |
| Q 2      | \$278                             | 80.5                       |
| Q 3      | \$272                             | 78.7                       |
| Q 4      | \$273                             | 78.9                       |
| Q 1 2005 | \$266                             | 78.5                       |
| Q 2 2005 | \$257                             | 73.3                       |

# World Jet Fuel Prices

## Spot Cargoes

Trend ?

| Rotterdam |       |       | Mediterranean |       |       | Middle East |       |       | New York  |       |       | US Gulf Coast |       |       |
|-----------|-------|-------|---------------|-------|-------|-------------|-------|-------|-----------|-------|-------|---------------|-------|-------|
| 12/19     | 12/12 | 12/5  | 12/19         | 12/12 | 12/5  | 12/19       | 12/12 | 12/5  | 12/19     | 12/12 | 12/5  | 12/19         | 12/12 | 12/5  |
| 313.6     | 307.0 | 305.9 | 305.9         | 298.5 | 296.4 | 37.5        | 36.6  | 36.0  | 93.82     | 90.69 | 88.56 | 88.39         | 85.64 | 85.74 |
| Chicago   |       |       | Los Angeles   |       |       | Pacific NW  |       |       | CIF Japan |       |       | Singapore     |       |       |
| 12/19     | 12/12 | 12/5  | 12/19         | 12/12 | 12/5  | 12/19       | 12/12 | 12/5  | 12/19     | 12/12 | 12/5  | 12/19         | 12/12 | 12/5  |
| 90.26     | 91.38 | 88.73 | 99.45         | 98.95 | 102.3 | 98.80       | 98.95 | 101.4 | 39.2      | 38.6  | 38.1  | 38.0          | 37.4  | 36.9  |

## Futures/Differentials

Trend ?

| IPE Gasoil*        |       |       | NY Heating Oil    |       |       | WTI Crude            |        |        | Brent Crude |       |       | Rott Jet/IPE Gasoil |       |      |
|--------------------|-------|-------|-------------------|-------|-------|----------------------|--------|--------|-------------|-------|-------|---------------------|-------|------|
| 12/19              | 12/12 | 12/5  | 12/19             | 12/12 | 12/5  | 12/19                | 12/12  | 12/5   | 12/19       | 12/12 | 12/5  | 12/19               | 12/12 | 12/5 |
| 276.2              | 267.0 | 255.5 | 92.85             | 91.25 | 86.10 | 33.02                | 33.04  | 30.73  | 30.05       | 30.37 | 28.74 | 37.4                | 40.0  | 50.4 |
| NY Jet/Heating Oil |       |       | Gulf Jet/NY 2 Oil |       |       | Gulf/Los Angeles Jet |        |        |             |       |       |                     |       |      |
| 12/19              | 12/12 | 12/5  | 12/19             | 12/12 | 12/5  | 12/19                | 12/12  | 12/5   |             |       |       |                     |       |      |
| 0.73               | 1.66  | 3.10  | -4.87             | -3.53 | 0.34  | -11.06               | -13.31 | -16.56 |             |       |       |                     |       |      |

Key: U.S. weekly averages cents per gallon, WTI Crude, Asian jet in \$/barrel, Europe, Medd \$/Ton

Sources: Opus Jetfax, JFR

redesigned engine, another 8% of the reduction is due to better aerodynamics and lighter materials, and the final 4% is due to improved "cycling," the spokesperson said. "The whole airplane is smaller and able to package better," she added.

"In talking to airlines their number-one requirement was fuel efficiency," she said. "(Those talks) are what made us change from speed to efficiency." The spokesperson added that the 20% reduction in fuel burn translates into about a 10% reduction in operating costs for airlines.

While adoption of the Dreamliner by major airlines is far from a sure thing, the fuel efficiency is certainly attractive. American Airlines, for example, at about 3 billion gallons of fuel per year, could realize savings of up to \$480 million annually at a gallon price of 80 cents and a 20% reduction in fuel burn. Lufthansa, at 1.7 billion gallons of fuel consumed in 2002, would realize fuel cost savings of \$272 million.

### ASIG Awarded New Contracts

**Orlando...** ASIG has been awarded the contract to handle

Scandinavian Air System's ground handling, cabin cleaning and deicing at four US locations: Washington Dulles, Chicago O'Hare, Newark and Seattle-Tacoma airports. As a result, ASIG will establish a new operation at Washington Dulles and expand its line of services offered in Seattle. Separately, Virgin Atlantic awarded ASIG the contract to provide ground handling, cabin and deicing services at John F. Kennedy International Airport. Both contracts begin in February.

