bmi

20:20

A review of 20 years of deregulation in European aviation

Issued to mark the 20th anniversary
of bmi's Heathrow to Amsterdam service


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Foreword

On 29 June 1986 bmi flight BD101 took off from London Heathrow, bound for Schiphol Airport, Amsterdam. This flight represented an important milestone in European aviation.

It marked continued expansion of bmi's route network and was also the first major cross-border scheduled service for the airline from Heathrow.

But BD101's significance went further; it represented the first scheduled flight between Heathrow and a major European city by any independent airline. Until that date only the respective national airlines, or so-called 'flag carriers', were able to operate cross-border scheduled services on major routes.

The 119 passengers on BD101 were in the vanguard of a revolution in travel, in business and in culture. Every new flight between European markets delivers jobs, trade and tourism. And no-one can doubt that the air travel boom of the last two decades has had massively beneficial effects to the way Britain interacts with the rest of Europe – and Britons interact with other Europeans.

Whilst the last 20 years have shown great leaps in the level of value and choice for customers following deregulation we should now look forward to see what the next 20 years have in store for consumers, airports and the aviation industry and how the industry will change and develop over that time.

You will see in this report that during the past two decades, bmi has continued to fight for the consumer and to lead the industry in value, service and innovation.

As a result I believe that there is no-one better placed to comment on the impact of this historic milestone. We also feel well placed to provide an analysis of some of the trends that will develop over the next 20 years – and what these could mean for airlines and for the travel passenger.

I hope you enjoy the bmi 20:20 report. Few would have dared predict 20 years ago that air travel today would have become such a standard part of our lives; it will be interesting to see the impact of another 20 years of progress.

Sir Michael Bishop
Chairman

Take off

bmi until 1986

Since its creation in 1938, bmi has been an airline that has constantly challenged the market and its regulators to bring its award-winning level of service and value to new markets.

bmi began life in 1938 as Air Schools Ltd, specialising in RAF pilot training. In 1949 the company became known as Derby Aviation, diversifying operations to include passenger and cargo charter services. In the 1950s and 1960s, Derby Airways, as it was then known, established itself as a pioneer of the rapidly growing package-holiday flights industry.

The company became known as British Midland Airways in 1964 and moved to the newly opened East Midlands Airport in 1965.

During the 1970s British Midland Airways further expanded domestic and international passenger services, including long haul destinations. In 1974 British Midland Airways Leasing – for 'instant airlines' – was created, leasing a variety of long and short haul aircraft types to 25 worldwide carriers, providing a highly successful service and earning the company the Queen's Award for Export Achievement.

In 1979, the company celebrated a landmark when more than one million passengers were carried for the first time in a single year. Then in the early 1980s bmi led a challenge against the national flag carrier, British Airways, on the UK trunk routes – Heathrow to Glasgow, to Edinburgh and to Belfast. Before 1981, only British Airways flew on these routes. Following a high-profile advertising campaign, bmi was granted the right to fly between Heathrow and Glasgow and, later, Heathrow and Edinburgh.

The new services had an immediate and dramatic effect. The most important result was a major boost to the size of the markets. From a total of approximately 1.5 million passengers prior to competition, the market jumped considerably – and by the end of the decade, bmi alone was carrying as many people as the whole market had been in 1982. As passenger numbers grew significantly over the first five years, fares fell and the business class fares on these routes became some of the lowest in Europe.

A pattern was thus established, which flowed through to the second phase of competition at Heathrow, beginning in the mid 1980s. This time the battleground was Europe – and the increasing deregulation of short haul European routes, culminating in complete EU deregulation.

The deregulation process

The European deregulation process was a slow one. Those pushing for an open skies agreement across Europe were up against strong resistance from the national 'flag carriers'. These carriers argued that:

- the market was just not big enough for more carriers to operate;
- national flag carriers would find it impossible to adapt to a more open trading environment, putting jobs and air services under threat;
- essential but uneconomic services could be lost as carriers turned their focus to profitable routes;
- new entrants would focus on major trunk routes, leaving regional services underdeveloped;
- tough competition would place pressure on airlines to cut corners in matters of safety and security, while removing control over traffic rights would make it more difficult for the authorities to enforce standards.

Eventually, after persistent lobbying by bmi and other independent airlines, the European Commission accepted the arguments put forward for liberalisation of the market and introduced its three-phase ten-year reform process.

Again, just as had happened on the trunk route services, fares fell following deregulation. bmi's new three-day executive fare brought savings of up to 25 per cent to business travellers and stimulated significant growth in passenger numbers.

As with previous battles for deregulation, bmi led the charge. Our first European service from Heathrow – to Amsterdam – launched in 1986. It was joined, over the next decade, by services to a majority of Europe's trunk routes – from Heathrow to major cities including Paris, Brussels, Dublin and many others.

"The greatest competition to national airlines... has come from BMA (British Midland Airways), which because of its presence at Heathrow was the only one of the new entrants able to launch new services from there and compete 'head to head' with the incumbents."

Source: CAA, Airline Competition in the Single European Market Report, November 1993

20 years on: the facts

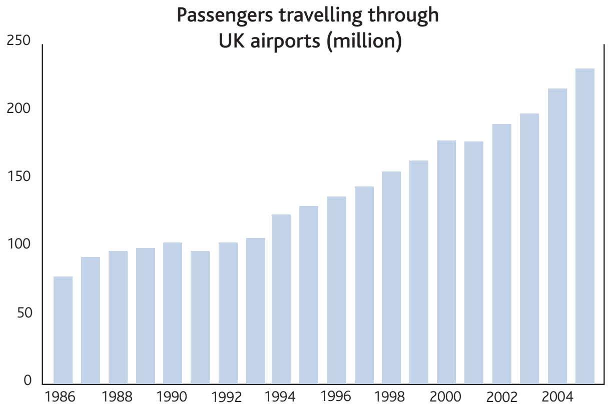
Overall growth

The European aviation market is virtually unrecognisable from the flag carrier-dominated skies of pre-1986. Air travellers have seen a massive increase in the number of airlines entering the market, competing on existing routes or launching completely new services.

The result has been a steady increase over the last 20 years in the number of passengers travelling by air. In 1986, 75 million passengers travelled through UK airports. This level has grown to more than 229 million passengers in 2005.

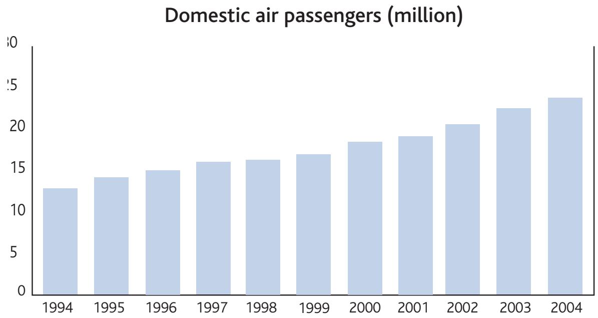
In 2005:

- there were 26 million passengers on UK domestic flights
- the number of passengers on flights to or from Europe totalled 129 million
- the proportion of passengers at UK airports flying on UK scheduled airlines reached 50.5 per cent, its highest level for the last 20 years

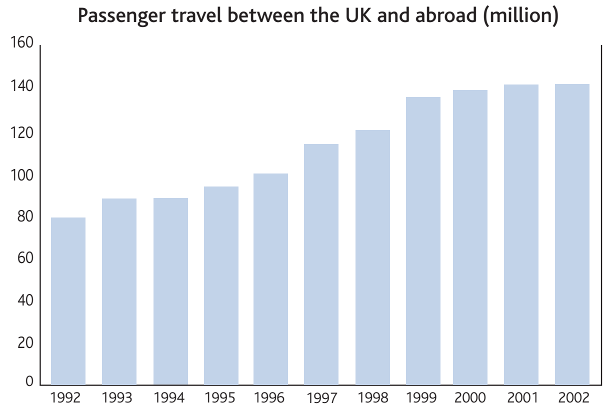


Source: Department for Transport, Transport Statistics for Great Britain, October 2005

As the number of passengers, airlines and routes has grown during the last 20 years a noticeable segmentation of the industry has taken place. Twenty years ago there was simply 'air travel'. That meant flying with a national flag carrier to a limited number of destinations. Today the UK market has low cost air travel, regional services, European short haul and international long haul travel and in most cases, a wide choice of carriers.



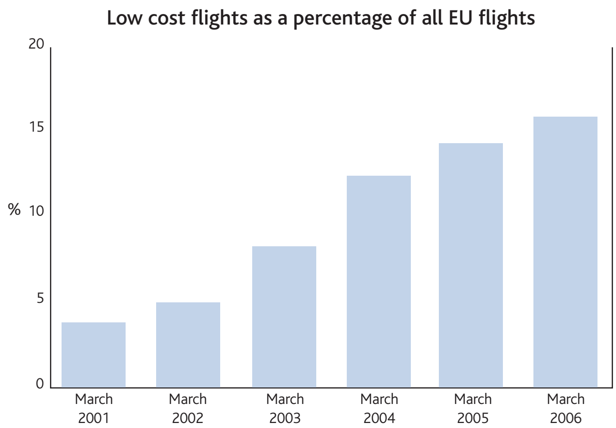
Source: Department for Transport, Transport Statistics for Great Britain, October 2005



Source: Civil Aviation Authority, UK Airline Statistics 2003

Growth in low cost travel

One of the most significant developments in the last decade has been the emergence of low cost air travel. Low cost business models have bought air travel within easy reach of millions of people in a relatively short space of time.



Source: OAG, European Low Cost Carriers White Paper, March 2006

bmi growth

The development of bmi's operations has mirrored that of the UK airline industry as a whole over the last two decades. Since its first flight to Amsterdam, bmi has increased both the number of routes it operates and the number of passengers it carries.

The growth of bmi has cemented its position as one of the UK's leading scheduled carriers. bmi is now the second-largest scheduled carrier at Heathrow with 11.2 per cent of slots. Overall the group serves 105 routes and last year carried 10.5 million passengers.

As well as operating its core mainline service bmi has been at the forefront of developing new business offerings to meet customer demands.

bmi regional

To cater for the demand of niche domestic routes, bmi launched bmi regional. Based in Aberdeen the airline operates 14 Embraer jets on routes where demand does not warrant a mainline service.

bmibaby

In March 2002 bmi group launched its own no-frills service, bmibaby. It has since grown to become one of the UK's largest low cost airlines. It operates out of Nottingham East Midlands, Manchester, Birmingham International, Cardiff and Durham Tees Valley airports. bmibaby has set itself apart from the low cost competition through provision of additional services such as free travel for infants, free checked baggage allowance and pre-assigned seating. bmibaby was voted 'best no-frills airline 2005' for the third consecutive year by the Telegraph Travel Awards.

bmi group of companies	2005
Routes served	105
Aircraft operating	60
Revenue passenger kilometers	9,325 million
Passengers	10.5 million

The lifestyle of travel

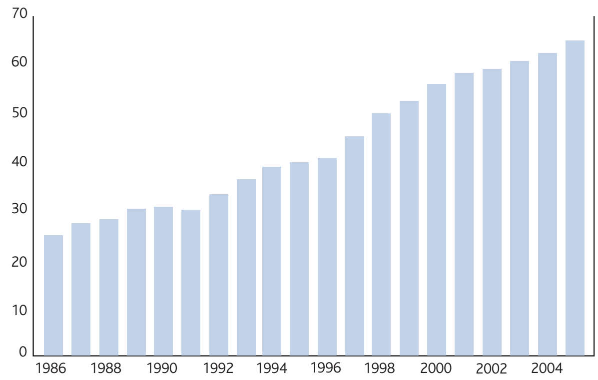
The growth in air travel has not just benefited airlines and the tourism industry. It has also led to a fundamental shift in the social make-up of the UK and has had a profound effect on the way people live their lives.

Brought on by the birth of the low cost model, air travel has become accessible to the masses in the UK and abroad.

The impact has been significant. In the last 20 years, tourism in and out of the UK has grown dramatically as more and more people are taking foreign holidays. In 2001 alone, more than 50 per cent of the UK population flew at least once. Secondly, there has been an upward trend in the number of people owning second homes abroad. Today, children are growing up with a European and international outlook and are learning more foreign languages to ensure they are best placed for a world of interdependence with other countries.

As air travel continues to become cheaper and more convenient, and the destinations on offer become more accessible, the lifestyle of Britons will continue to broaden which in turn will drive further demand for air travel.

UK residents trips abroad (million)



Source: National Office of Statistics, International Passenger Survey, November 2005

"As far as the UK is concerned tourism represents an important part of GDP and a significant source of employment, both directly and indirectly, because of the spill over into other industries – one in every 10 jobs is related to travel & tourism. The UK must not sit on its laurels but must instead be prepared for new emerging markets and growing world competition among destinations."

Source: David Michels, World Travel and Tourism Council, May 2005

Air travel today: some of the major issues

Open skies

It is clear for all to see that deregulation has brought more passengers and more routes. Unfortunately, due to the vested interests of a few, deregulation of the largest market in the world – London Heathrow to the United States of America – has yet to become a reality.

More than 2.7 million passengers travelled on scheduled airlines between London Heathrow and New York in 2004, making it by far the most important inter-continental market in the world.

The importance of allowing this market to operate freely is plain for all to see.

Yet despite this, just four airlines are allowed to operate on Heathrow - US routes. The result is that a virtual monopoly exists on the routes, depriving the travelling public of greater choice, greater value and greater flexibility when they are flying between these countries. 'Rip-off Britain' still remains.

As we did on the domestic and European routes in the 1980s, bmi has for many years campaigned for a fully liberalised air market between Heathrow and the United States. Many times we have been told we were close to a resolution, only for it to fail to materialise. At present there does appear to be a chance of an agreement in the near future. bmi calls on all parties to work towards a deal that will benefit UK and US travellers, as well as the economies in both countries.

Airport and airspace capacity

The UK aviation market has always been one of the largest in the world, with London Heathrow holding the claim to be the world's busiest international airport for many years. Heathrow has been the crucial aviation 'staging post' between the United States, Europe and the Far East.

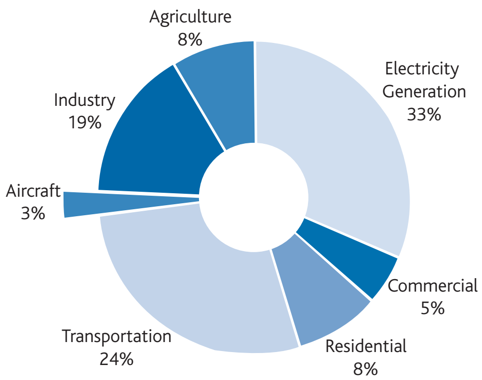
That claim has been under threat for some time as others have heavily invested in airport capacity. Countries such as France, Germany, Japan and Thailand have built new runways or additional terminal facilities in the last five years. The UK has responded with a new terminal at London Heathrow and plans for expansion at other airports are being considered.

However, if air traffic rises to 401 million passengers a year by 2020 as expected, this will not be enough. What is needed at London Heathrow is a third runway. This can only be achieved through continued heavy investment and a fundamental shift in the planning restrictions, so that new facilities can be built quickly – the 10-year process of building Terminal 5 cannot happen again. To meet the forecast demand Government, regulators and airport owners need to recognise the importance of adequate capacity. Otherwise there is a real risk that the UK could slip further down the league table and lose out to other airports around the world.

"By the end of this year, we would hope to have a signed, sealed and delivered air transport agreement that would... be applied by the two sides at the start of the next summer traffic season on March 25 2007"

Source: John Byerly, US State Department, March 2006

Aviation's share - Causes of US Greenhouse Gas Emissions



Source: The Economist, June 2006

"Our vision for 2020 and beyond is the UK aviation industry meeting the needs of society for air travel and transport, while removing or minimising any negative impacts on the local and global environment and maximising its contribution to the UK economy."

Source: Sustainable Aviation – A Strategy Towards Sustainable Development in UK Aviation, June 2005

The environment

It is recognised that the issue of the environment is an important one that needs to be taken seriously. Everyone has a responsibility to look at ways of reducing their personal footprint on the environment. This includes UK citizens, the Government, regulators, businesses and airlines.

bmi is committed to looking for ways to reduce its impact on the environment. Aviation has an outstanding record of investing to reduce environmental impacts. The result is that today's jets are typically 20dB quieter than those 30 years ago, while fuel consumption has improved by about 20 per cent since 1990. Through more efficient use of fuels and aircraft and new initiatives such as carbon trading, the UK aviation industry can play its part. However, CO_2 emissions caused by aviation are a small proportion of the overall CO_2 emission level. In the world's largest aviation market, the US, it accounts for just three per cent of emissions, with surface transport making up 22 per cent. It is therefore not just up to airlines to solve the challenges that we face.

A way advocated by many to discourage CO_2 emissions by airlines has been to introduce an aviation tax. bmi strongly rejects the arguments for such a tax. Firstly, airlines using UK airports already pay the equivalent of an environment tax; the air passenger duty raises almost £1 billion each year for the Exchequer. This is equivalent to one-and-a-half times the carbon cost of the flights leaving UK airports. Despite it being categorised by the Government as an environmental tax, the income is not used to address environmental impacts. Therefore any further taxation will be excessive, unfair and inappropriate. It will have a detrimental effect on UK air travel and will lead to UK airlines finding it difficult to compete against foreign airlines operating without such a heavy burden.

The aviation industry will concentrate its efforts on reducing its footprint on the environment. Everyone else must do the same.

The next 20: looking forward

So what will be the main trends of the next 20 years? How will the industry change and develop over that time?

Over the following few pages, we lay out a series of views of the future. Taken from the unique perspective of bmi, they do not try to replicate the work of IATA or other trade bodies, nor of the aircraft manufacturers or others who regularly predict the future size or shape of the market.

Rather, what they seek to do is apply the statistics and the views of those and other organisations, to lay out bmi's analysis of trends that will develop over the next 20 years – and what these could mean for airlines and for the passenger.

We believe ten key trends will have an impact over the coming two decades.

"By 2020, even by conservative estimates, we will have twice as much traffic as we have today."

Source: John Hayhurst, Boeing, June 2003

1 Growth is here to stay

Almost all commentators agree that growth will continue; despite the air travel boom of the last 20 years, there is no sign of any plateau appearing in the shape of the market.

The UK Department for Transport estimates passenger numbers – which rose from four million in 1954 to a record 229 million in 2005 – will reach 401 million passengers a year by 2020. Airbus and Boeing predict global passenger growth rates of between 4.8 per cent and 5.4 per cent per annum over that period, with Airbus suggesting a doubling of flight frequencies on routes, coupled with a 20 per cent growth in average seats per aircraft.

Those figures are against a backdrop of a predicted global economic growth rate of 2.9 per cent per annum over that period. Air travel will continue to outperform the global economy.

Strong growth will continue even in the UK and Europe, despite the maturity of the markets. There are a number of factors behind that growth – and implications for the industry.

"The objective... should be to create a smooth transition from the bilateral aviation agreements to an international multilateral framework which would allow airlines to meet increasing demand for global travel, freight flows and tourism requirements in a viable and sustainable manner."

Source: AEA Action Plan 2004-2009, February 2005

2 Deregulation is the real key driver

The primary driver behind air travel growth is of course consumer demand. But the historical quirks of the airline industry mean there is huge pent-up consumer demand waiting to be released – so one of the key drivers over the next 20 years will be deregulation.

Deregulation in the UK, and then in Europe, has led to massive growth in air travel. Today, we are already starting to see the impact of new moves – deregulation between India and the UK in 2005 immediately led to an increase of 58 flights a week, for example.

Within the next 20 years, we expect major liberalising steps in key global markets. The transatlantic market will – at last – be opened up, stimulating even more growth in what is already one of the world's largest markets.

But we will also see greater deregulation between Europe and the major developing economies of the world – as they recognise the major impacts on GDP that new air connections bring.

"After a period of decline, the long haul market is set to return to growth, driven by the continued rise in the UK economy, a strong pound and more adventurous British holidaymakers. With the pound and euro so strong, many long haul destinations have also become better value for money than comparable short haul destinations."

Source: Mintel, Long Haul Report, February 2005

"Strong growth in passenger traffic has been a characteristic of the low-cost sector over the last 10 years, and this is expected to continue. Growth rates of around 40 per cent over the period 1999-2004 are expected to continue for at least two more years. Whilst these will not be sustained in the long term, the outlook remains bright for the sector as a whole."

Source: Mintel, Airlines Report, June 2005

3 The long haul market will be a major beneficiary

A great deal of growth will focus on long haul travel, thanks to the opportunities offered by deregulation and the appetite for new destinations amongst UK and European travellers.

We expect two clear trends to emerge.

First, over 20 years we will see the development of real competition on the long haul 'trunk routes' of the world – routes between primary airports of main cities which are today served only by the two national carriers of the countries concerned. In the same way that Heathrow-Amsterdam's opening-up in 1986 can be seen as a forerunner of structural change within the short haul sector, the opening-up of Heathrow-Mumbai, for example, is a harbinger of new developments in the long haul sector.

Within the next two decades, we would expect to see deregulation – and growing competition – on a good proportion of the larger long haul routes.

Second, and again mirroring the development of the short haul market over the last 20 years, there will be real growth in point-to-point long haul connections between what are today regarded as secondary cities. Today, such connections are often made because it is all that regulations allow – look at bmi's routes from Manchester to the US, for example. But in future, the growing appetite for travel and the improved economics of new aircraft will lead to more 'regional' connections.

4 ...but there is still room for growth in the short haul model

It is tempting to assume that the massive growth of the last 20 years in European short haul travel should reach some sort of a plateau in the next 20 years. We don't believe that to be the case.

UK Department of Transport statistics, for example, suggest a slight slowing of growth in international short haul travel in comparison to long haul markets – but they still predict between 55 per cent and 91 per cent growth between 2005 and 2020.

Where will this growth come from?

We believe there is still significant room for expansion in the point-to-point market, for what are today regarded as low cost carriers (although please see the section overleaf for views on how this sector will develop).

The expansion of Europe's borders has opened up new routes for many carriers already. And the US model shows us that the appetite for air travel can continue to grow for many years.

There is also the opportunity for some more growth on what are regarded as trunk routes – between major airports – but this really does depend upon airport capacity. A congested airport such as Heathrow risks seeing a gradual shift in the balance of short and long haul services if its lack of slots forces airlines to switch to higher value routes only.

"The global economy depends on networks – be it telecommunications or transport, on the ground or in the air. Europe's network airlines are indispensable for the smooth and efficient functioning of global trade and understanding between peoples."

Source: AEA Action Plan 2004-2009, February 2005

5 Networks and point-to-point

The rise of the low cost market, coupled with the current capacity limits on major airports, suggests a focus on point-to-point growth in the future – and to a large extent we believe this to be the case. We are already seeing this trend developing in long haul travel too, as noted previously.

However, networks will continue to play an important role, particularly for the business traveller, for whom frequency and availability become critical factors.

"Full service airlines throughout Europe are being forced to react to the growing power of low cost carriers by adapting their business models."

Source: OAG, European Low-Cost Carriers White Paper, March 2006

6 The death of the low cost carrier

There is absolutely no doubt that low-cost air travel is here to stay – but the low-cost sector may not be so differentiated in the future.

Why? Because in a real sense, every short haul airline has become a low cost carrier over the last few years. Driven by the competitive pressures of the new airline and increasingly demanding customer expectations, almost every airline has been able to re-invent its operating and commercial procedures – and deliver travel at similar fares to the 'low cost' carriers.

Increasingly, the only differences in fares paid by passengers on a route will come down to a mix of 'traditional factors' which apply to all airlines – the time of day, the time of year and so on – and more overt positioning of 'new' factors, such as the cost of the airport from which you are flying.

"The launch of the 'superjumbos', the Airbus A380 and Boeing's Dreamliner will radically alter the industry further. The new double-decker Airbus is envisioned to bring a whole new level of comfort to airline passengers, whilst the Dreamliner will get passengers to destinations more quickly than ever before."

Source: Mintel, Airlines Report, June 2005

7 Larger – and smaller – aircraft

Just a few weeks before the publication of this report, Heathrow welcomed its first A380. It is clear that the introduction of these larger aircraft will have a substantial impact, especially on congested airports (one of the reasons we continue to see strong growth of network passengers – the A380s will very quickly be delivering thousands of extra travellers every day to Heathrow, not all of whom will have London as their final destination).

But outside of these trunk routes and congested airports, we also expect continued growth in the smaller aircraft sector. Management of capacity is becoming an increasingly skilled – and important – task at every airline, and more smaller aircraft can be a far better starting point than fewer larger aircraft.

"Economic pressures will continue to highlight the advantages for carriers to join one of the main alliances in order to consolidate flights, co-ordinate marketing activities and combine sales offices amongst others. At the same time, mergers and acquisitions will become more common, similar to that of Air France and KLM."

Source: Mintel, Airlines Report, June 2005

9 Alliances and mergers

The airline industry remains unusual in its low level of merger activity to date – a result of the strategic importance historically given to airlines by national governments. The growth of the airline alliances, such as Star Alliance, came about as a solution to this problem – and has created networks that reach around the globe.

As ownership rules are relaxed, we are going to see the development – through merger – of airlines which are truly global: having multiple hubs in more than than one continent. The process has already started in Europe and will accelerate in other jurisdictions.

"Airports will need to build new capacity to meet the expected doubling of passenger and cargo traffic over the next 12 to 15 years."

Source: Airports Council International, ACI Survey, April 2006

8 The right kind of airport expansion

Airports will have to expand; there is no doubt. The demand for air travel requires substantial investment in new facilities throughout Europe and the world.

Such expansion must happen with all due respect to environmental and social factors, and bmi has always fully supported sustainable development of facilities.

Yet we do see a very real risk of the UK losing its pre-eminent position in aviation if the right type of investment is not made.

Heathrow is the world's leading international airport – but many others are snapping at its heels. Unless significant investment in the new terminal, and runways continues, the UK's leading airport will lose out to other European airports in the race for new passengers.

"Many airline analysts have predicted that the growth of the low-cost sector will result in a commensurate decline in national "flag-carrier" services"

Source: Aerospace America, February 2003

10 The development of airline brands

An allied element of future development is the shifting perception of airline brands. The low cost revolution has shifted, fundamentally, the ties that people have to the 'national' brand of the flag carrier of the country. People who 20 years ago would never imagine flying with anything other than the flag carrier – because to do so would mean using the 'foreign' carrier – now select between a score of options when flying.

This lessening of national ties is a good thing for competition and will continue to develop over the next 20 years.

Conclusion

The 20:20 report gives an outline view of the last and the next 20 years of aviation sector development and air travel in the UK and abroad.

bmi does not claim to have led the process of deregulation over the last two decades. However, we were one of the main protagonists of a drive for deregulation that led to an increase in choice, value and service for air travellers during the 1980s and 1990s.

Without our actions, greater competition would have arrived – but it would have been later and, we like to think, without the same unique character.

We are proud of the role we have played

If one lesson is to be taken from the last 20 years, it is that deregulation has delivered real growth. Growth in air travel, growth in tourism and ultimately a growth in the economies of those countries that took part in the deregulation process. Air travel alone is not a cause of growth – but air travel is the lifeblood of the modern economy.

If deregulation was the driving issue of the last 20 years, what will be the issue for the next two decades?

As our 10 key trends show, we believe it will not be about full cost versus low service, or about primary versus secondary airports, or even flag carriers versus independent airlines. Instead it will be about the balance of the mix of these that is achieved.

This mix, which will give the air traveller the choice and value he or she deserves, will only be possible if competition in the UK, in Europe and in countries around the world is allowed to flourish.

By allowing competition to grow without constraints from national governments, regulators and from the vested interests of a few, it will ensure that all airlines are able to operate on a level playing field.

And so, therefore, the key driver of the next 20 years will mirror the last 20. Deregulation must continue, opening up new routes to the competition that the customer wants.

Finally, if air travel is the lifeblood of the modern economy, airports are the arteries. We cannot allow our major airports to become clogged, or the impact will be severe. It would be pointless allowing more competition but then having no capacity in the market to deliver it.

If airlines are allowed to operate and compete in a truly free aviation market, governments, airlines and most importantly the consumer will be the ultimate winners over the next 20 years.

"The de-regulation process in Europe, which is really one of liberalisation, has effectively brought significant advantages to the European consumers in terms of choice, better service and lower fares, thereby contributing to enhanced air transport competitiveness. ...(The) continuation of the liberalisation process is a key factor for making European air transport successful globally."

Source: Ulrich Schulte-Strathaus, Secretary General AEA, June 2006 www.flybmi.com

Report drafted, designed and produced by Four Communications plc www.fourcommunications.com