Arab Air Carriers Organization Annual Report

39th ANNUAL GENERAL MEETING - KUWAIT 2006

21 - 23/11/2006

الجمعية العمومية التاسعة والثلاثين – الكويت ٢٠٠٦
39th AACO AGM - KUWAIT 2006

الاتحاد العربي للنقل الجوي
Arab Air Carriers Organization

AACO's Mission

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To promote cooperation amongst Arab airlines, and to serve their common interests through service excellence.

AACO's Objective

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To invest in the synergy of interaction between members through establishment of joint projects.

To promote the highest safety standards, providing a framework for a better economic environment for airline operations.

To promote high standards of consumer driven services, and high quality cost effective framework for human resources development.

Members of the Executive Committee

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Sheikh Talal Mubarak Abdulla Al- Ahmed Al-Sabah
President of AACO

Mr. Mohamad A. El-Hout
Chairman of the Executive Committee

Mr. Mohamad A. El-Hout, Chairman & Director General MIDDLE EAST AIRLINES
Eng. Khaled Al Mulhim, Director General SAUDI ARABIAN AIRLINES
Eng. Atef Abdelhamid, Chairman of the Holding Company EGYPTAIR
Eng. Samer Majali, Vice Chairman of the Board, President & CEO ROYAL JORDANIAN
Sheikh Talal Mubarak Abdulla Al-Ahmed Al-Sabah, Chairman and Managing Director KUWAIT AIRWAYS
Capt. Sabri Saad Shadi, Chairman AFRIQIYAH AIRWAYS
Capt. Abdulkalek Saleh AL-Kadi, Chairman YEMEN AIRWAYS

Contents

The Arab air transport market continues its **momentous growth** in spite of the various elements that negatively influence this sector in our region. Not only is the Arab region wealthy with human, natural and geographic resources that propel the growth of air transport, it is also, unfortunately, the **reservoir to most** of today's **conflict zones**. On one hand, the Arab geographic position, oil resources, and varied attraction points bolster sizeable growth in air transport. On the other hand, other factors undermine a stable and solid growth, namely the continued Israeli occupation of Palestine and the drawn-out Arab-Israeli conflict, the situation in Iraq, Sudan, Somalia, and the surrounding regions. Those factors amalgamate with the Arab World's share of terrorism, an example of which occurred the summer of 2006.

The Arab air transport market needs a **booster shot** in two major domains: **Freedom of Market Access and Airline Ownership.** In spite of the Arab Civil Aviation Council "ACAC"'s program to gradually open skies on bilateral basis, and the adoption of 12 Arab states of multilateral accords to free air transport, we cannot presume that this sector is out of the excessive regulatory control. It is necessary that any decision to open skies should come hand in hand with regulations and laws that guarantee **equal opportunity** on the economic level; otherwise, we would end up with undesirable upshots. The procedures and regulations that need to be put in place are prevention of **capacity dumping**, and **the rationalization of governmental support** to airlines into capitalization input, instead of the operational subsidy.

In the domain of **ownership and control**, the Arab world anticipates two major developments. First is the start of active measures to **privatize airlines** - or at least part of them in line with national agendas. The second is to allow **foreign investment** within a legal framework that guarantees conformity of the air transport sector with the strategic direction of Arab states, especially under the current circumstances.

AACO has called on ACAC and the Arab Ministerial Councils to study a legal framework that prepares the Arab world to an emulation of the

"European Right of Establishment," which was an introductory step towards converting the European common market from a political motion into an economic reality.

Our annual report this year contains a wealth of statistical data that highlights a clear trend of growth in Passenger and Cargo traffic over the last few years. I would like to draw particular attention to the following points:

- **Most of the growth is concentrated in the Arabian Peninsula** and at a small number of AACO members. Therefore, the high-level growth rates of those members should not camouflage the more or less normal growth of the rest of AACO member airlines.

- The largest travel region in the **Arab travel market** is within the Arab world, specifically within the Arabian Peninsula, and between the peninsula and the Arabian Levant.

- Traffic to **Sub-Saharan Africa, Asia**, and **Australia** is the **highest** growing, and will predictably maintain that ranking in the future.

- Traffic to **Europe indicates weak growth**, and needs special stimulus by deriving benefit from what the Arab World has to offer to Europeans in terms of the distinguished tourist attractions, and the importance of the European tourism market as the source of the largest exporting tourist sector in terms of expenditure. In this field, AACO's work with ACAC towards a Euro-Arab agreement to liberalize air transport may incite sufficient market stimulus, of course subject to the prevailing environment.

- The **Arab fleet** is expected to reach 900 aircraft in 2015, up from the present 600. In view of the projected traffic growth until that year, the Arab air transport market, as well as the markets where Arab airlines operate, will comprise over **350 million** passengers. The improved service level of AACO members and their continued pressure on cost, pursuit of new marketing strategies, and new capacity will not fall beyond the airlines' ability to maximize their market share.

A persistent element airlines have to face is the **continuous increase in costs** that fall out of direct airline control. **Fuel cost** again constitutes **30%** of operational costs in 2006, a record high since 1980. Despite the relative decline in the price of crude oil the end of summer 2006, there is no expectation of a return to the 1990s low prices. Taxes, charges, and other **"creative"** means of imposing new **levies** on air transport add a considerable burden to the consumer and to boosting the competitiveness of alternative transport methods at the expense of aviation. In the Arab world, taxes and ticket charges are among the highest in the world, almost equivalent to the ticket price on **some short sectors**, at a time when governments are calling for higher Arab tourism. These governments should be more in line with the call to **reduce taxes and charges, especially on short sectors**.

Distribution costs remain on top of the interests of member airlines; AACO is working with its partners – Computer Reservations Systems, Global Distribution Systems, Payment Gateways and others to arrive at the best future models to sustain the constructive cooperation between those systems and AACO members.

On the marketing level, this year has seen two major developments: **Arabesk Group** has been formed by 7 members, with an objective to boost the marketing positioning through cooperation, schedule planning, and codesharing. The second step was the accession of Royal Jordanian to **Oneworld** Alliance, and Middle East Airlines to **Sky Team** as an associate member. Both airlines are members of the Arabesk Group.

AACO, throughout last year has given even more attention to **safety**. AACO bylaws were amended last year. **IOSA** certification became a prerequisite for any new member to accede to AACO. AACO has also worked with ACAC to adopt an ACAC resolution calling on member states to adopt **IOSA as a prerequisite for granting operational rights** or airline license.

AACO's work in the **joint projects** domain has expanded. The number of trainees in AACO's **Regional Training Center** in Amman broke the 10,000 - trainee record in less than 10 years. The Joint Fuel-Purchasing project now comprises 17 members and covers 500 airports around the world. We have also negotiated with providers to implement **electronic ticketing**, and have arrived at the best scenario proposals to be adopted by members. The basic challenge is **how to do away with obstacles that impede interlining** among airlines around the world, in addition to **connecting Ground Services with different Departure Control Systems**; an important challenge to the whole air transport industry, especially that we are only 13 months away from the market ejection of paper tickets.

AACO continued to deal with joint **ground handling** contracts and other related major issues like the developments at Heathrow airport. We have also expanded the **Marketing Information Data Tapes** to include new services that bolster the planning and marketing capabilities of members.

This year was marked with the launch of **"Transarabia" among six member airlines**. We also refocused our efforts on the technical field –having held a **high level Arab Technical Forum** in Doha-Qatar, attended by several partners and members.

AACO's **Committees** are the backbone of our work; AACO **has revamped the Committees' structure** towards focusing work based on specialization. AACO remains committed to provide the best data source on air transport in the Arab Region, through its wide range of electronic and printed publications.

This year was marked with an unusual event that must be mentioned in this year's roundup. While the Secretariat General's work was scheduled during summer to finish several tasks, the **Israeli attack on Lebanon** occurred on July 13, 2006. Work did not stop. **AACO Secretariat General's staff** demonstrated great courage and dedication that enabled us to accomplish our programs without any delay, within to the originally scheduled timeframes. No doubt, the **support** we received from **AACO's President, the Chairman and Members of the Executive Committee, CEOs** and **Executives** on all levels during that period were the primary motivation for completing the work – first and foremost.

To all of them, and **to our partners in the International and Regional Organizations and Industry partners**, we express our gratitude for their support and backing at the most difficult of times.

Abdul Wahab Teffaha

Secretary General

Arab Air Transport

Regulatory Environment

The Arab Civil Aviation Council is pressing for **the gradual liberalization of air transport** between Arab states, aiming at liberalizing Fifth Freedom by 2007 on bilateral basis. The third phase had already been launched. It involves the liberalization of Third and Fourth Freedoms for scheduled air transport, to move from the 40% -60% capacity split between the parties of the bilateral towards lifting all imposed restrictions at the fourth phase, while asserting the principle of equal opportunities and non-discrimination. In addition, **ACAC adopted** an agreement at a ministerial level **for a multilateral Arab accord to liberalize air transport**: 12 Arab states signed the accord and 4 ratified it, while 5 states are in the process of ratification. This accord needs the ratification of 5 states to come into effect. It comprises crucial protocols on monopoly, capacity dumping, and governmental subsidy. Those protocols are an integral part of the accord because the actual implementation depends on the presence of laws that regulate doing business according to these protocols.

It remains that the national policy of each of the Arab states is the **determinant of the extent of liberalization** in that state and other related issues. In view of that, the airspace liberalization varies from one state to another. States like Lebanon, UAE, Bahrain, and Oman have adopted open skies policies. Seventeen open skies agreements were signed between ACAC states namely: Bahrain, Jordan, Lebanon, Morocco, Oman, Qatar, Syria, UAE, Egypt, and Saudi Arabia. On the other hand, some Arab states have implemented the liberalization on third and fourth freedoms. At the same time, many major Arab states are at the early stages of liberalization.

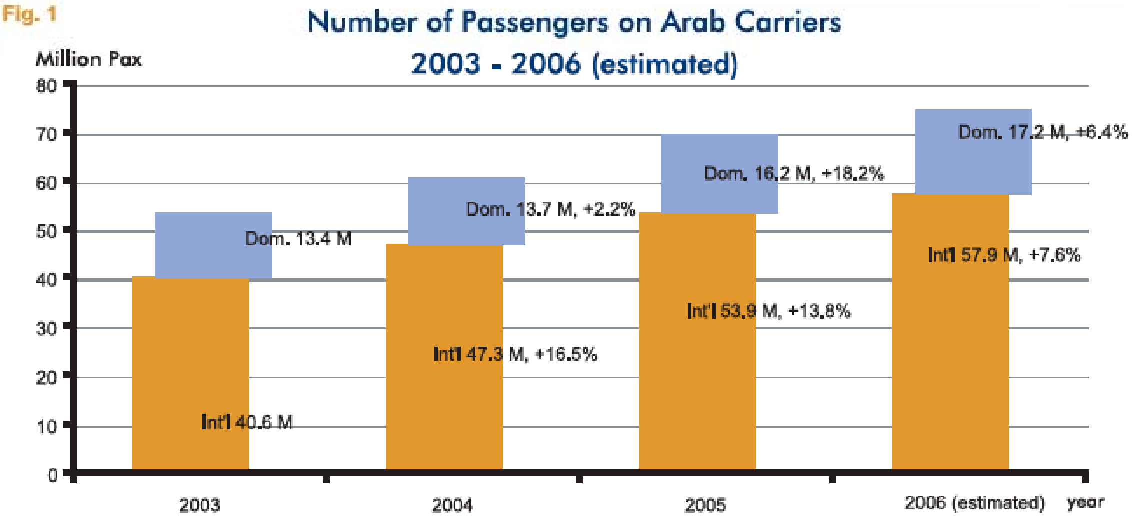
On the other hand, the privatization of airlines is progressing in some Arab countries. To date, no full privatization was concluded for an airline in the Arab world. Royal Jordanian, Saudi Arabian Airlines, and Tunis Air have completed some stages towards planned or actual sale of units associated with air transport. In turn, Egypt Air and Royal Air Maroc have concluded measures towards restructuring in preparation for partial or complete privatization depending on the decisions of their respective governments. Part of Middle East Airlines was to be introduced into the Lebanese Stock Markets but that procedure was delayed because of the Israeli war on Lebanon.

AACO Members Operations

Year after year, **the Arab air transport** is proving its leading posture in growth in the world by exceeding average industry growth rates. The **Revenue Passenger Kilometer (RPK) numbers** in 2005 **increased by** 13.4% compared to 2004, and 147% compared to 1995. On the other hand, industry growth was 9.8% in 2005 compared to 2004, and 49% in 2005 compared to 1995. The total number of passengers who flew AACO members in 2005 reached 70.1 million passengers, 12.1% growth over 2004.

It is expected that the number of international passengers on Arab airlines in 2006 will increase by 7.6%, and domestic passengers to grow by 6.4% for the same year, bringing the total number of passengers on Arab airlines to 75.1 million passengers in 2006.

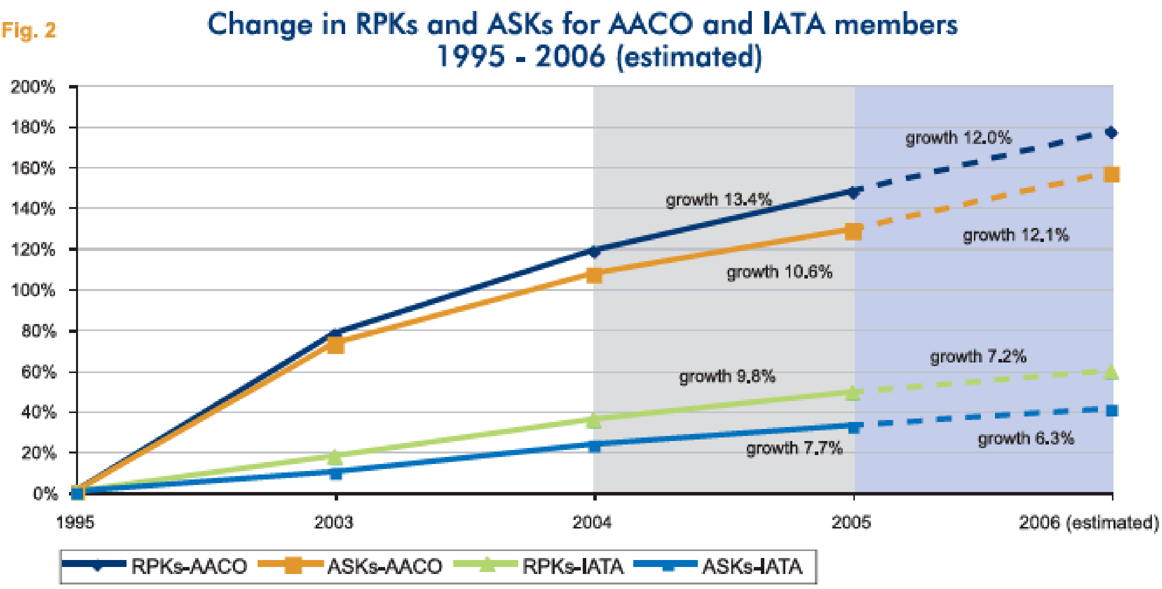
Fig. 1



Source: AACO

It is also expected that the RPKs on Arab airlines will increase by 12% in 2006 over 2005, while the industry growth is expected at 7.2% for the same period. However, the 12.1% expected increase in capacity on offer in 2006 is a pressing element on the economies of operations – slightly lowering load factors on Arab Airlines. In return, the global industry is expected to successfully improve its load factors in view of the 6.3% capacity growth in 2006.

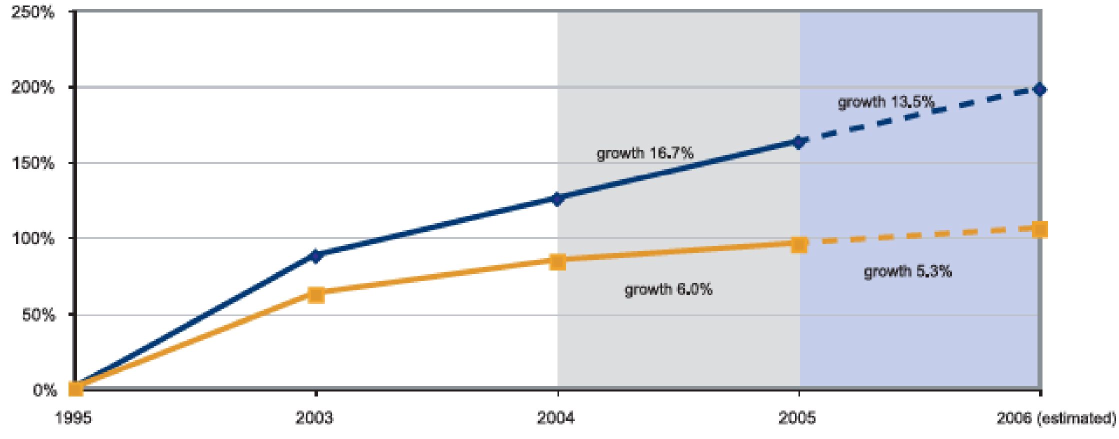
Fig. 2



Source: AACO, IATA

Arab airlines increased their focus on **cargo**. They registered a 16.7% growth in Revenue Tonne Kilometers (RTKs) of 2005 over 2004, and 163% in 2005 over 1995. Global growth in 2005 was 6%, and 95% for the same periods respectively. **Cargo traffic** is expected **to increase** on Arab airlines by 13.5% against 5.3% global growth predictions.

Fig. 3 Cargo Traffic Growth for AACO and IATA Members 1995 - 2006 (estimated)

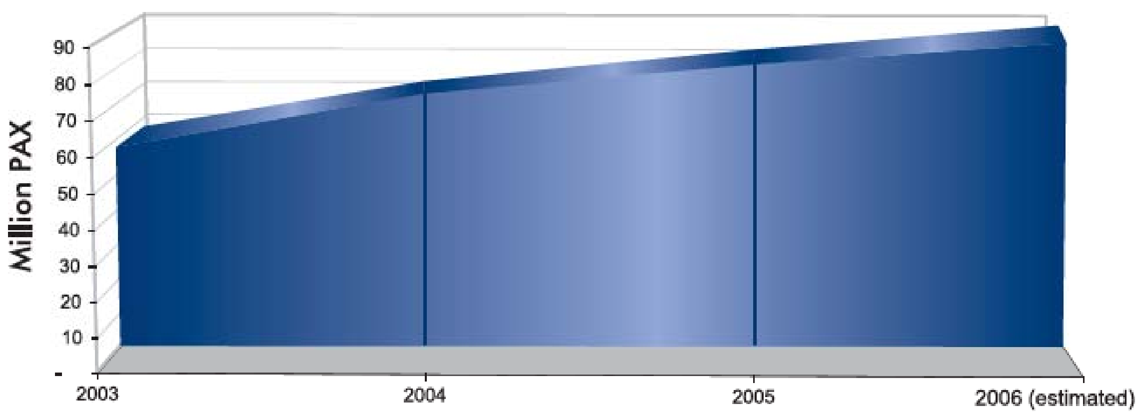


Source: AACO, IATA

Passenger Traffic by Regional Destinations

The total number of passengers in the Arab travel market is expected to reach around 86.7 million passengers by the end of 2006, an increase of 6.3% over 2005.

Fig. 4 Passenger Traffic and Estimated Growth for the Arab Market 2003 - 2006 (estimated)



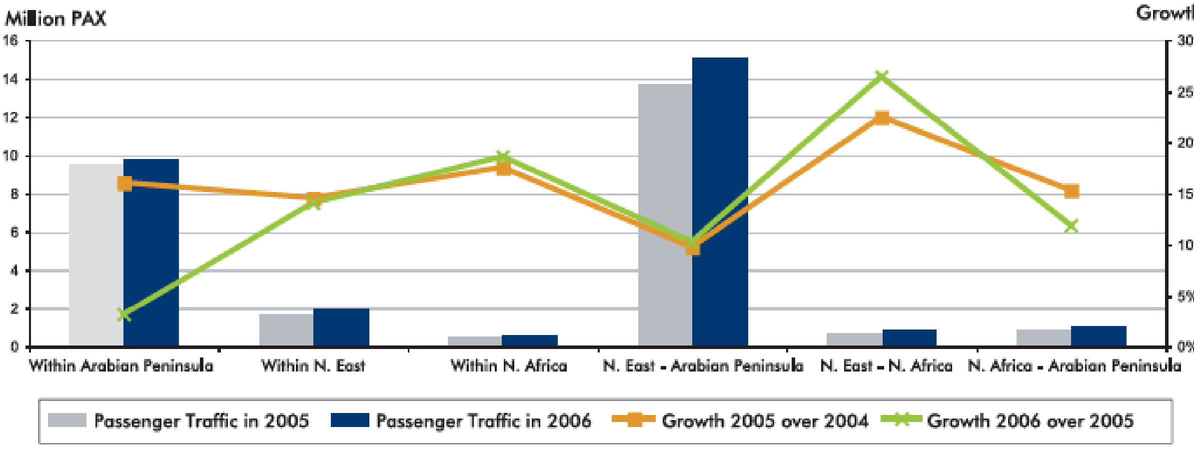
Source: AACO

Arab Market by Regional Destinations

The number of passengers of the Arab world measured by regional destinations reveals **large growth** of 12.1% over 2004. Growth between the various sub regions of the Arab world exceeded 10%. This growth is expected to reach 6.3% in 2006 over 2005.

Fig. 5

Intra-Arab World Sub-Regional Passenger Traffic and Change 2005 Compared to 2004 and Estimation of 2006 compared to 2005

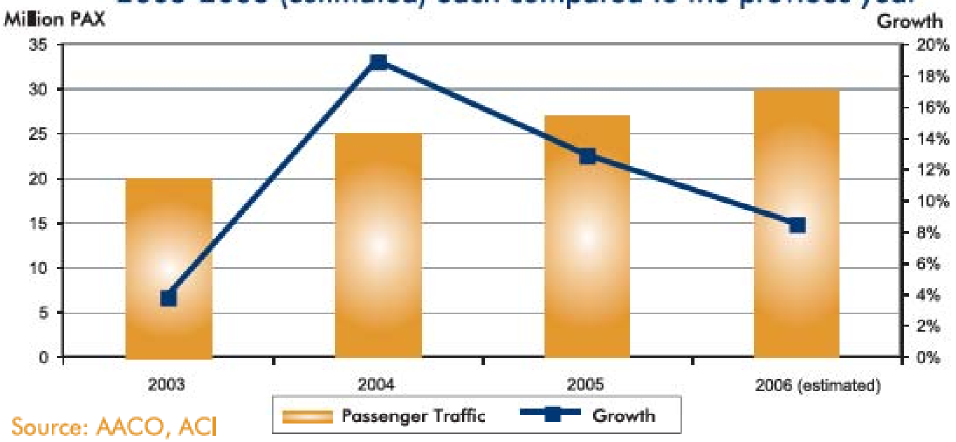


Source: AACO, ACI

Passenger traffic **within the Arab World** registered **12.8% growth** compared to 2004. This growth is expected at 8.4% over 2005.

Fig. 6

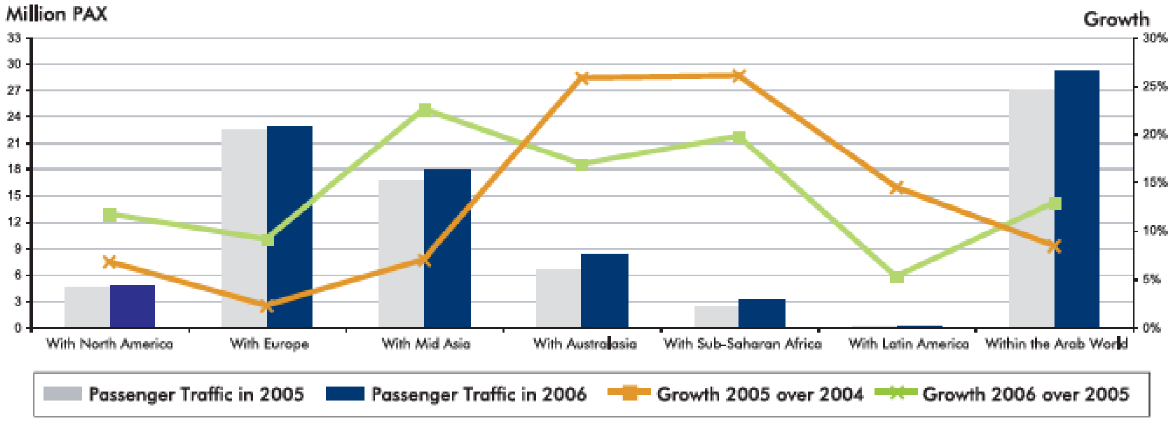
Regional Arab Market Passenger Traffic & Change 2003-2006 (estimated) each compared to the previous year



Source: AACO, ACI

Fig. 7

Worldwide Regional Passenger Traffic and Change
2005 Compared to 2004 and Estimation of 2006 compared to 2005



Source: AACO, ACI

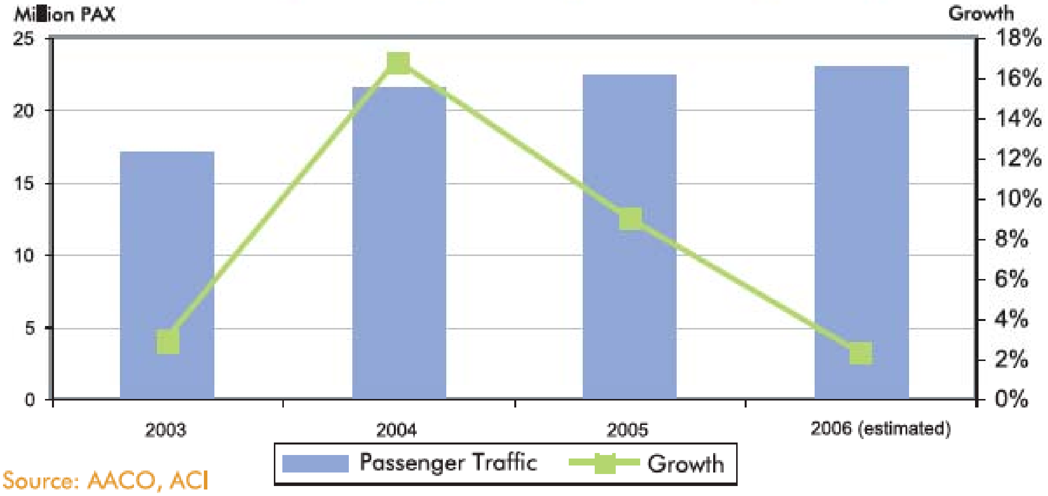
Regional traffic flows between the Arab world and the rest of the world regions were as below:

With Europe:

In 2005, **growth was 9%** over 2004, and is expected at 2.6% in 2006 over 2005.

Fig. 8

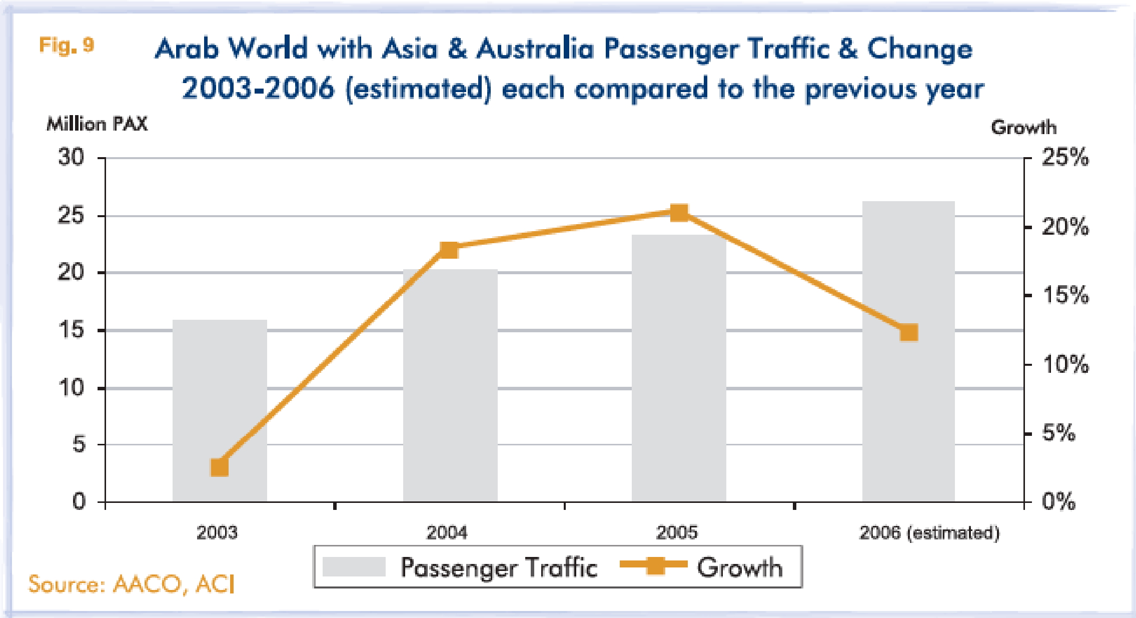
Arab World with Europe Passenger Traffic & Change
2003 - 2006 (estimated) each compared to the previous year



Source: AACO, ACI

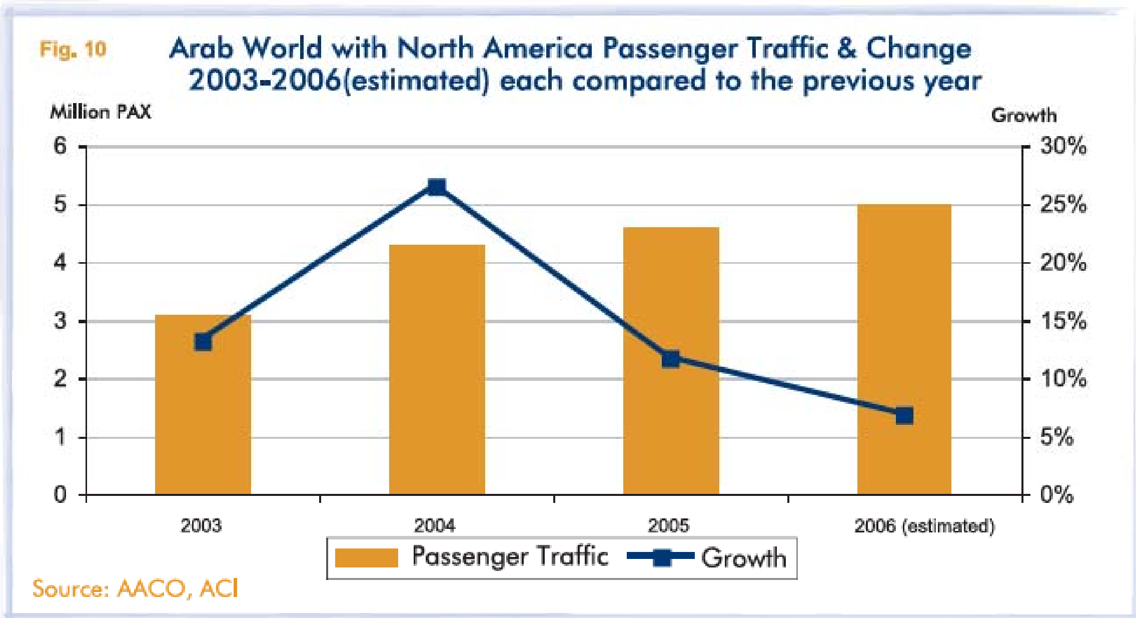
With Asia and Australia:

Passenger traffic registered **21% growth** in 2005 over 2004. Growth is expected at 12.3% in 2006 over 2005.



With North America:

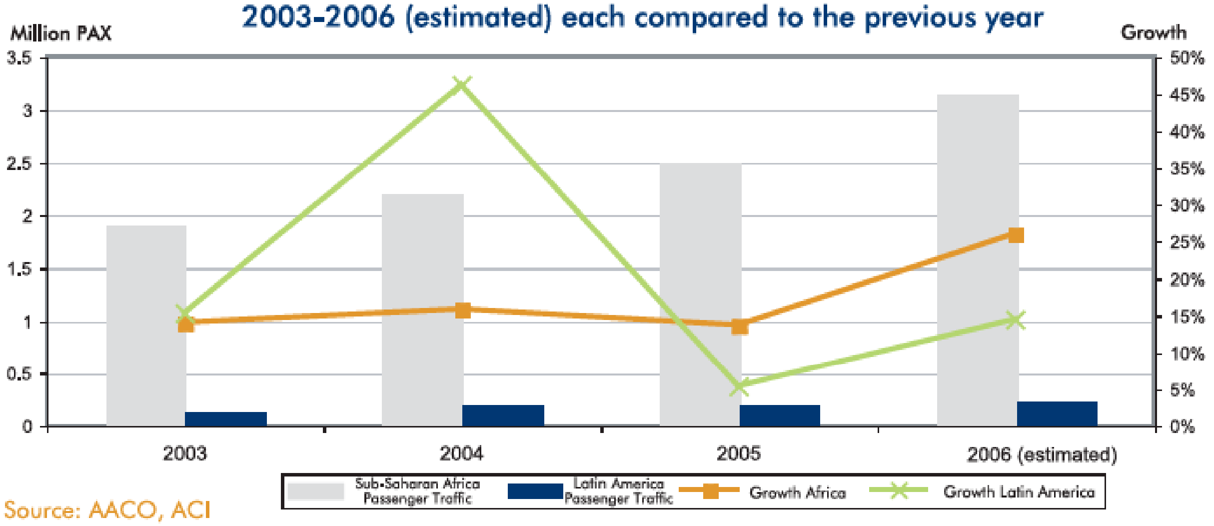
Passenger traffic grew at 11.7% in 2005 over 2004. Growth is expected at 6.9% in 2006 over 2005.



With Sub-Saharan Africa and Latin America:

Passenger traffic **grew at** 13% in 2005 over 2004. Growth is expected at 25.1% in 2006 over 2005. Growth of traffic to Sub-Saharan Africa is the fastest growing among the entire world's regional traffic with the Arab world.

Fig. 11 Arab World with Sub-Saharan Africa and Latin America Traffic & Change 2003-2006 (estimated) each compared to the previous year

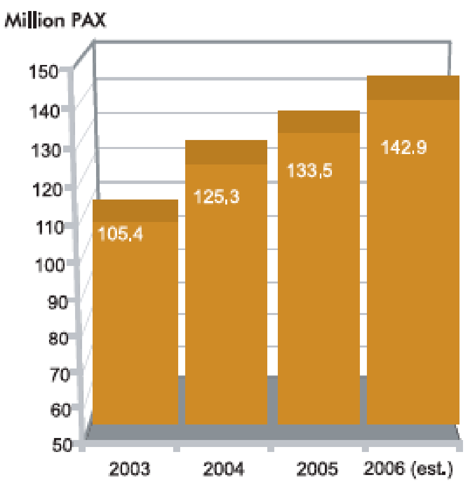


Source: AACO, ACI

Arab Airports Traffic

Passengers through Arab airports have increased by 6.6% in 2005 over 2004, having reached 133.5 million in 2005, and are expected to reach 142.9 million passengers by the end of 2006.

Fig. 12 Passenger Traffic in Arab Airports 2003 - 2006 (estimated)

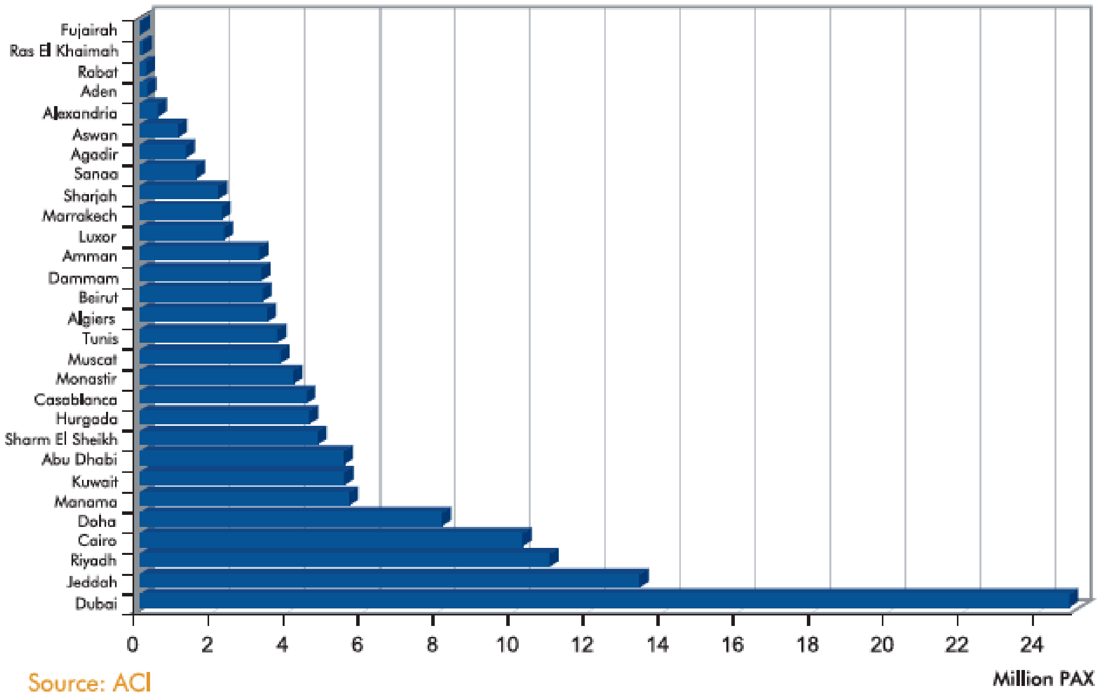


Source: AACO, ACI

Most Arab airports registered a healthy increase in passenger numbers in 2005 over 2004, led by Marrakech Airport in Morocco at 31.7% annual growth. Airports outside major cities are contributing to the increased growth rates of airport traffic, especially airports that attract tourist traffic.

Fig. 13

Passenger Numbers in Most Arab Airports
Year 2005

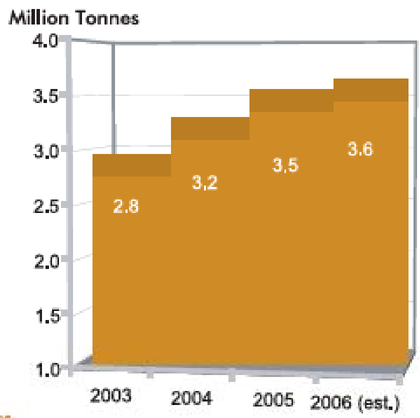


Source: ACI

Cargo traffic registered a significant increase of 8.2% in 2005, and is expected to grow by 2.4% in 2006.

Fig. 14

Cargo Traffic in Arab Airports
2003 - 2006 (estimated)

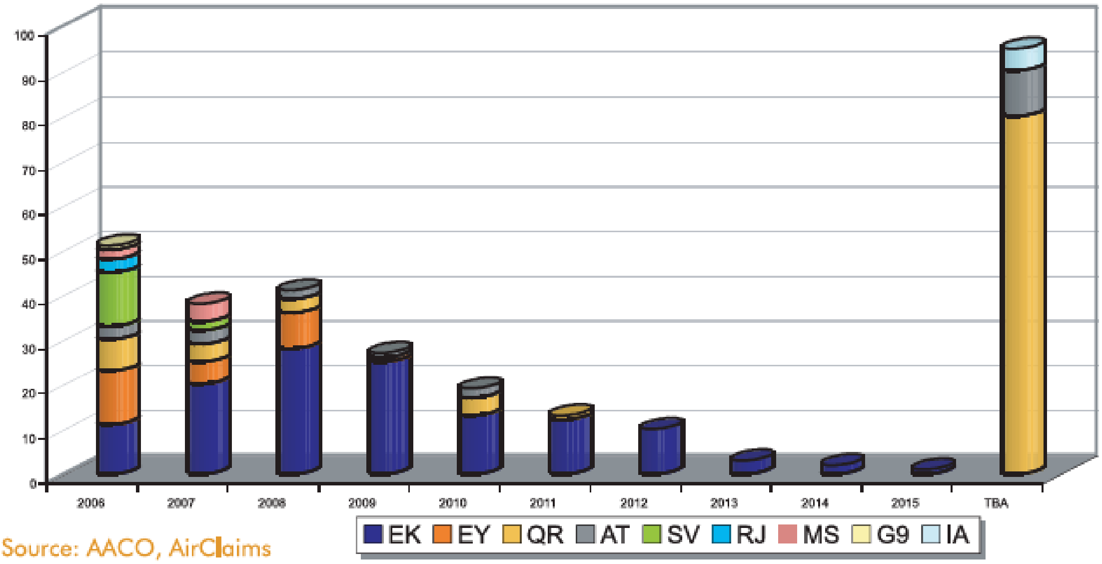


Source: AACO, ACI

Fleet

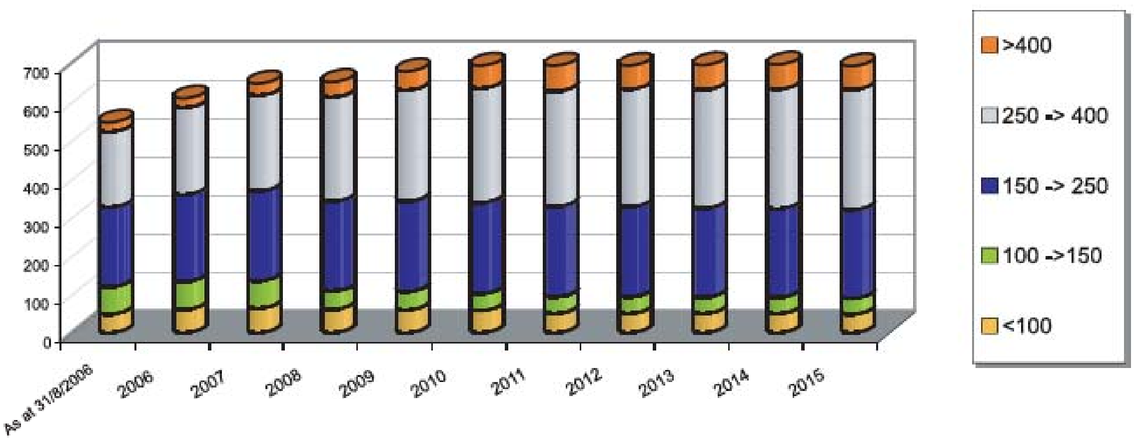
To meet the increasing demand on air transport services, Arab airlines are persistently expanding and renewing their fleet. In 2005, Arab airlines received 82 new aircraft, 28 for expansion, and 54 to replace aging models; 46 aircraft were wide-bodies, an indication of those airlines' ambition to expand their share of the international markets and on long haul routes. Arab airlines expect to receive 51 new aircraft in 2006.

Fig. 15 Number of New Aircraft Expected to Join the Arab Airlines' Fleet (As of 31/08/2006)



Source: AACO, AirClaims

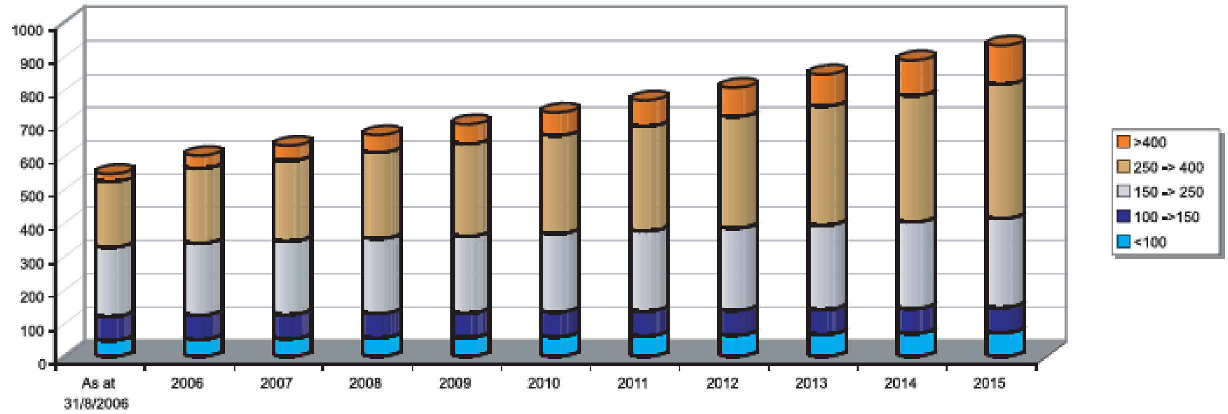
Fig. 16 Contracted Growth of Arab Fleet by Capacity Type and Estimation of aircraft retirement (2006 - 2015)



Source: ATI, AirClaims

Fig. 17

Estimated Growth of Arab Fleet by Capacity Type
2006 - 2015

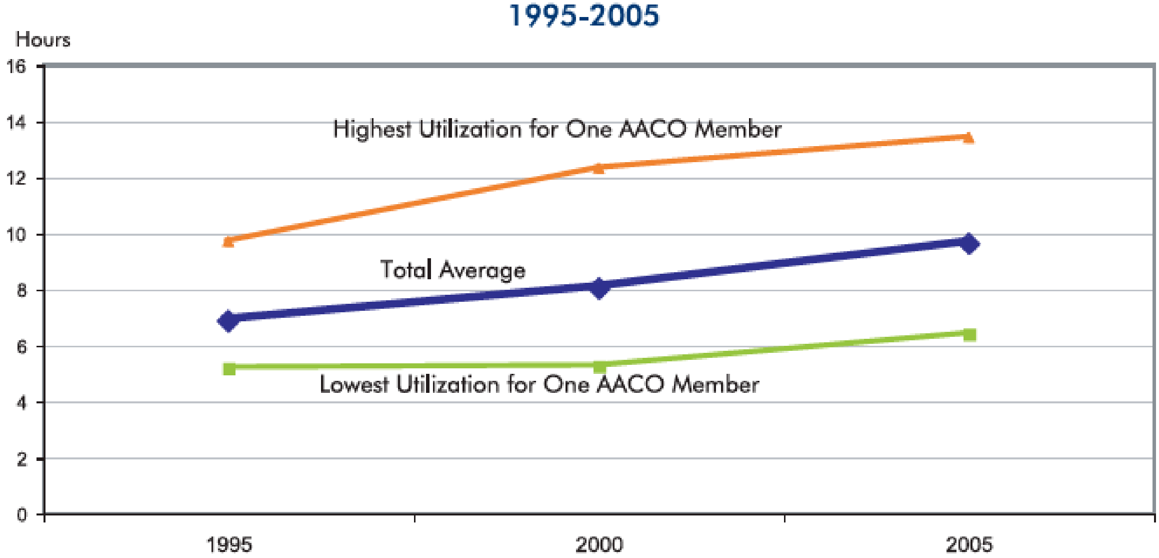


Souce: ATI, AirClaims

The **average daily utilization of members' aircraft in 2005 has increased**, signaling maximal utilization of the capital cost of the aircraft, in addition higher operations on long haul routes.

Fig. 18

Average Aircraft Utilization for AACO Members
1995-2005



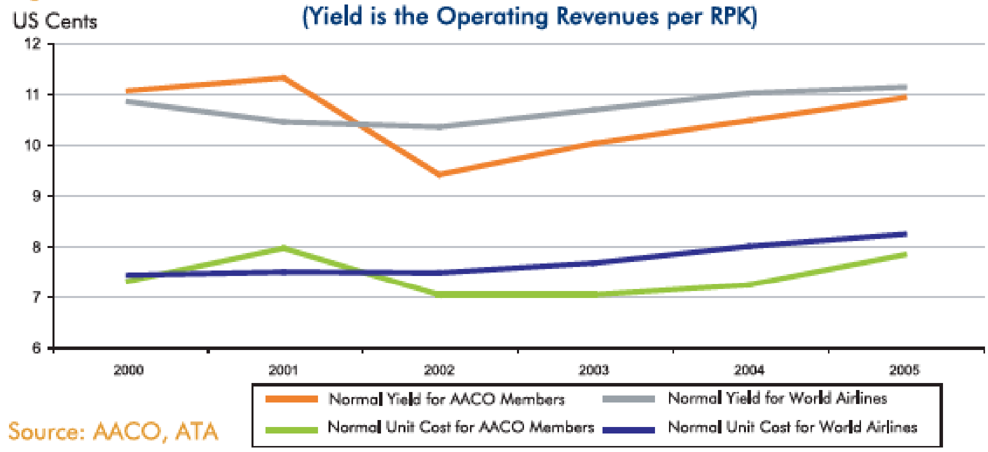
Source: AACO, IATA

Yield and Unit Cost

Yield

The current yield of Arab airlines continued to grow in 2005, registering 4.2% in 2005. This comes at a time when the average industry yield increased by 1.0% for the same year. This increase reflects a correction in the price of air transport, in part to accommodate the increase in cost, especially in the price of fuel. Nevertheless, this correction is not high enough to accommodate the full increase in cost because of the strong competitive pressures.

Fig. 19 Comparison of Yield and Unit Cost between AACO Members and World Airlines (Yield is the Operating Revenues per RPK)

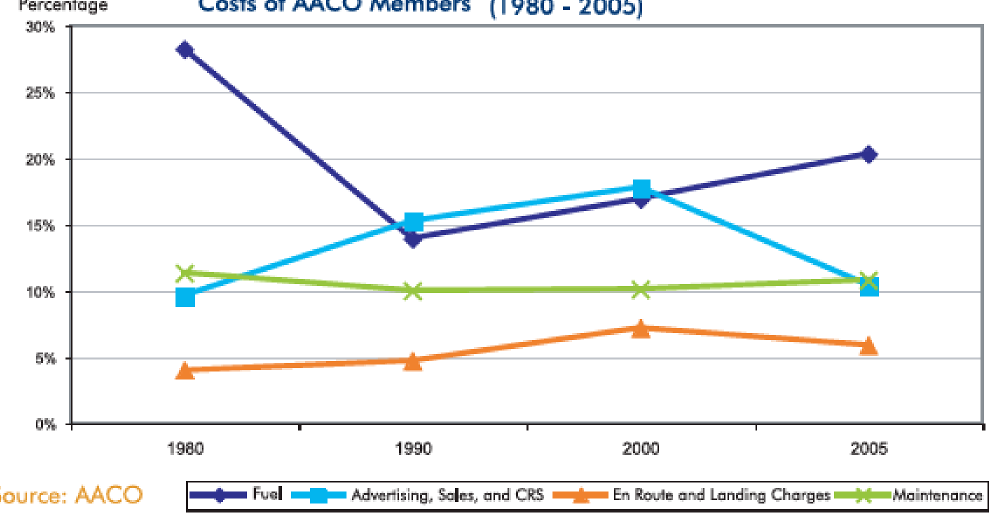


Source: AACO, ATA

Changing Costs

Despite the strong efforts to control and **rationalize costs** at Arab airlines, operating expenses are on the rise. Operating expenses **for ten member airlines** increased by 19.8%, leading to a loss in the operating results in spite of the 18.2% increase in operating revenue. **Fuel costs** still represent the largest part of the airline's cost at a level of **20.3%** of overall costs in 2005. Fuel costs increased 61% approximately compared to 2004. Historically, fuel costs for member airlines, and for all airlines around the world, represented 30% of operating costs, as indicated in Figure 20. The decline in oil prices, and the increase of ratios of other costs over the last decade brought down fuel cost to 14% of the overall expenses before the last price hike.

Fig. 20 Contribution of Some of the Operating Costs Components in the Total Operating Costs of AACO Members (1980 - 2005)



Source: AACO

Reducing Indirect Costs: Distribution

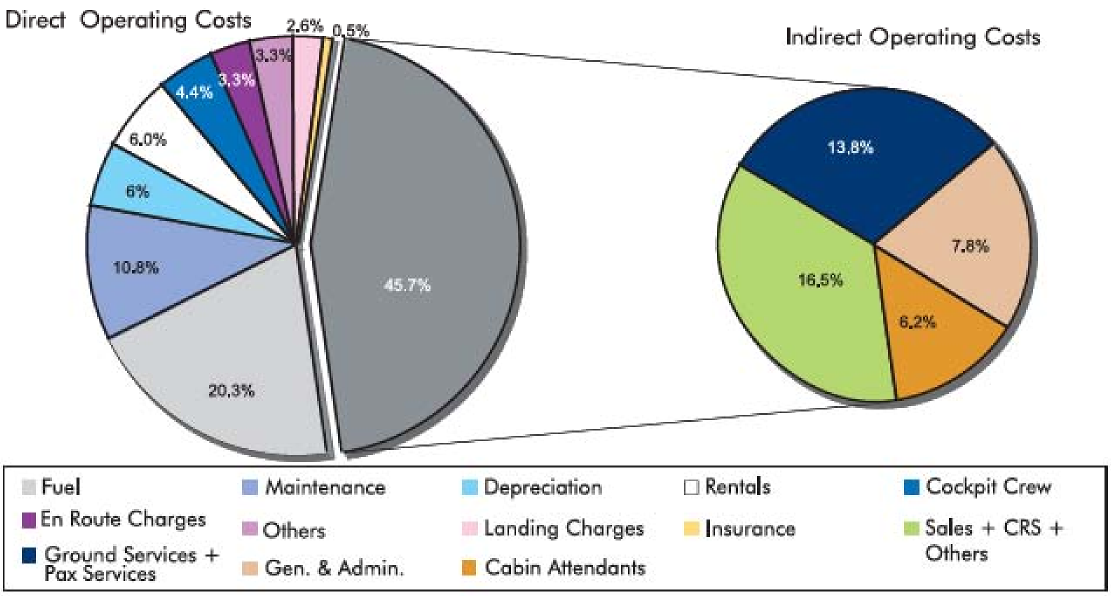
The cost of reservations and sales, especially distribution, remains on top of the challenges that face all airlines, and goes beyond to all service providers in the tourism industry, such as hotels and car rental companies. Tourism service providers are working on boosting direct sales to reduce those costs. Direct distribution has grown by 31% over 2001, largely because direct airline sales have increased by 63% over 2001. Today, direct sale comprise 49% and 51% for GDS, compared to 70% GDS sales in 2001, according to Forrester Research.

Airlines are devising several strategies to deal with high distributing costs. Boosting direct sales, whether through the airline's websites, improving sales processes at ATOs/CTO, and through growing sales through airline call centers, are not the only paths the airlines have undertaken to reduce those costs. Airlines are exploring new strategic prospects for distribution, following one or several of the following avenues, while at the same time paying attention not to harm sales volumes:

- Establish direct connectivity with travel agents and corporate accounts, bypassing GDSs.
- Cooperate with GDS New Entrants with specific travel agents within particular geographic areas.
- Devise substitute solutions to deal with travel agency commissions and credit card charges through financial incentives, depending on the size of returns and productivity of each particular agent.
- Revisit the relationship with Global Distribution Systems in terms of content, cost, or renewing the current contracts taking into account local, regional, and international market requirements.

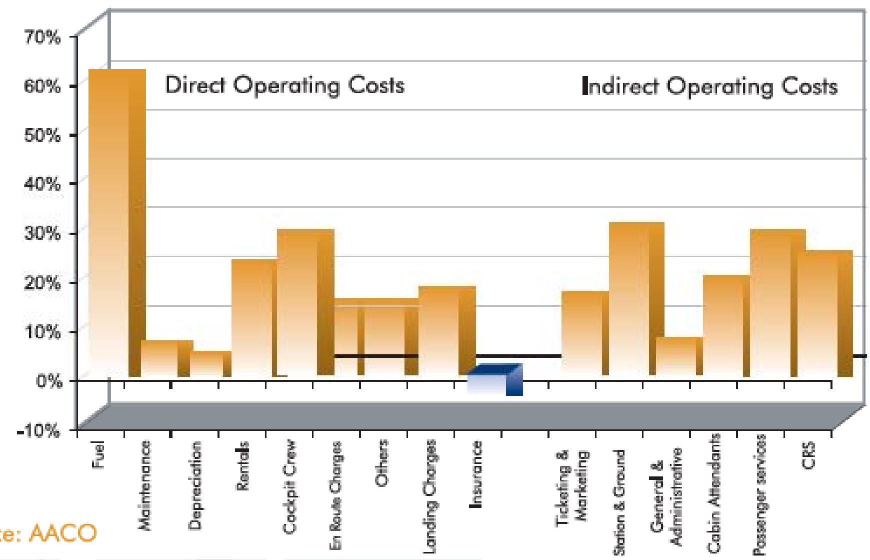
Fig. 21

Cost Distribution- Year 2005



Source: AACO

Fig. 22 **Cost Changes- Year 2005**

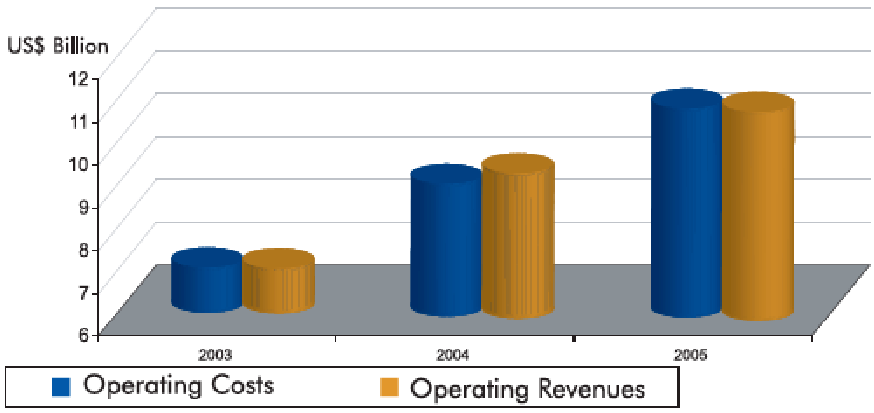


Source: AACO

Financial Results

Operating Revenues have increased alongside operating costs. Looking at the financial results of **seven Arab airlines** in Figure 23, we see that the operational returns increased by 17.2% to US$ 10.5 billion, while operational cost increased by 19.3% to US$ 10.62 billion, leading to approximately US$ 40 million operating loss for those airlines. Nonetheless, within that group, the highest operating profits were US$ 225 million for one airline, and the highest operating losses were US$ 232 million for another airline.

Fig. 23 **Comparison of Operating Revenues and Operating Costs for Some AACO Members (2003-2005)**



Source: AACO This graph includes the following Carriers: AH, AT, EK, GF, KU, ME, RJ, WY

Industry Issues

Safety

The global aviation system remains **generally safe**. However, over the year 2005, 35 fatal airline accidents have been recorded, resulting in 1059 fatalities and 44 ground fatalities. Although the number of accidents was significantly lower than the ten-year average (40), the number of fatalities was almost equal to the 1995-2004 ten year average. In 2004, cargo planes were a cause for concern with 13 crashes, whereas in 2005 the number remarkably dropped to 8.

In terms of aircraft manufacturers, statistics show that Antonov suffered the highest number of accidents for the third year in a row.

Generally, 18 Western Built aircraft crashed versus 17 from the formerly Eastern Block. Western built aircraft accidents involving fatalities were high and similar to last year due to meteorological factors as well as technical faults of aging aircraft.

Moreover, most of the accidents occurred in Africa, the continent with the highest accident rate of 13. The Democratic Republic of Congo witnessed the highest number of fatal accidents (4).

According to the IATA, the hull loss rate in 2005 continued its seven-year decline with a rate of 0.76 per million sectors flown. Fatalities increased as described earlier.

AACO member airlines have passed another clean year with 0 fatal accidents, thanks to the high safety standards being put into practice, supported by the IOSA project that AACO is facilitating. By 2007, all AACO members shall be accredited IATA's seal for safety and quality Excellence.

Besides the successful IOSA project, AACO is now looking forward to one of the most challenging safety initiatives: The Implementation of the **ICAO English Language Proficiency Requirements** by March 2008 for pilots and air traffic controllers. **AACO will make sure that an efficient program in terms of quality and cost** is arranged, with recognized assessment and training centers in the field to assist its members to meet the ICAO deadline.

Aviation Safety Priorities

Further cooperation between states is needed in order to enhance global safety standards. No doubt, sharing of information requires deeper involvement of the industry and the governmental authorities. The industry is rapidly expanding within the unclouded reality of resource limitations. Focus should be on the enhancements of safety oversight activities, safety awareness and training, identification of the Human Factors mistakes in terms of why and under which circumstances they were made, as well as proper maintenance of aircraft.

Aviation Security

Innovative technology and increased awareness remain the most two important factors in thwarting any attack or act of sabotage to the civil aviation industry. In fact, the challenge is to identify and manage the weak links of the industry since there is always someone smart enough to break through the system.

The incidents that occurred during the month of August 2006, which involved aircraft sabotage attempts in London using liquid explosives have raised the threat level in the UK and US, evidently proving that the civil aviation industry is not far from any future attacks similar to the ones that occurred on September 11, 2001.

The threat of liquid explosives will remain in place until strict measures are set clear to eliminate the dangers associated with such fatal and destructive tools.

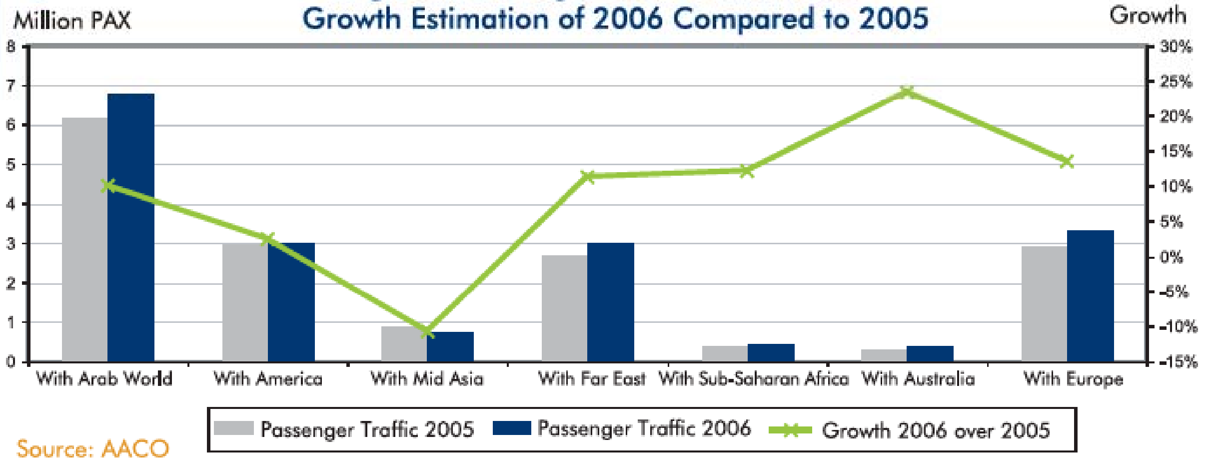
International cooperation, data exchange, implementing mutually acceptable measures and boosting innovative screening technology while focusing on cost efficiency and simplifying passenger travel will continue to be aviation security's top priorities.

Emerging Markets

Indian Market

Fig. 24

Regional Passenger Traffic in India and Growth Estimation of 2006 Compared to 2005



Source: AACO

India has 122 airports operated by Indian Airport Authority (AAI), including 11 international airports. Two-third of International passenger traffic moves across four airports: Mumbai, Delhi, Chennai, and Calcutta.

Air transport liberalization in India started in 2004. India has concluded bilateral air transport agreements with 100 countries to date, including 15 Arab countries, for full or partial liberalization of air transport services. Airlines from 52 states operate to India, among which 10 are Arab. Indian airlines operate direct or code-share agreements flights to 25 countries, including 6 Arab states.

The current civil aviation regulations allow foreigners to own 49% of Indian airlines, but blocks out any direct or indirect foreign ownership on part of a foreign airline.

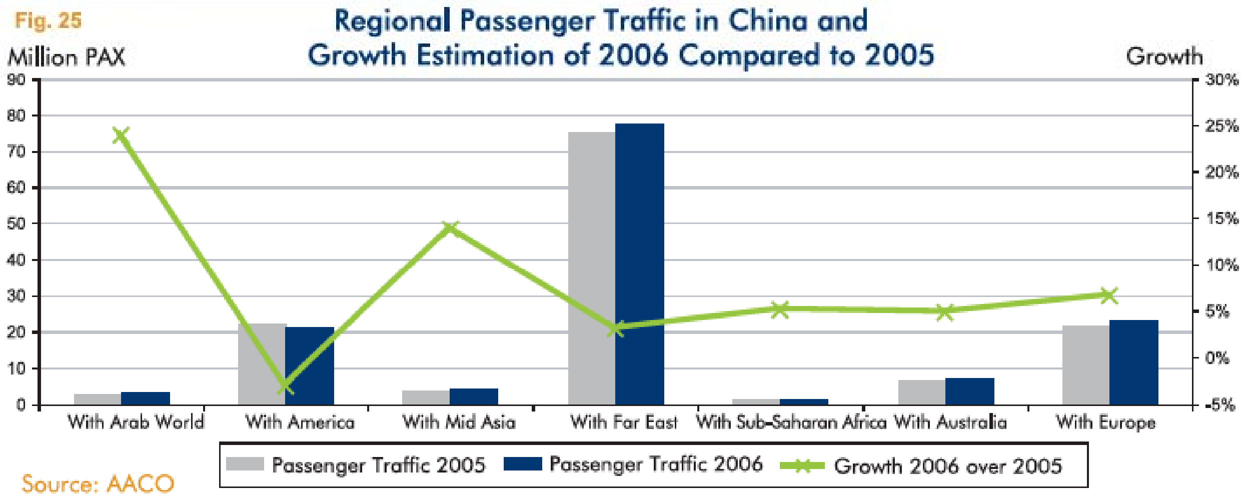
Forecast and Regulatory Environment

The Indian government is also working on a new civil aviation structure that would offer enduring support to the development of the aviation sector on the long run. The new policy revolves around the following:

- Increase direct foreign investments in Indian air transport services.
- Liberalize bilateral agreements and move towards "open skies."
- Encourage regional airlines to benefit from the growth of the air travel market.
- Encourage the creation of low cost airlines.
- Establish economic regulatory authorities for airports to determine charges and monitor airport performance.
- Restructure airports within the framework of Indian Airport authority.
- Put special standards in place to match demand with the increased offered capacity on the shorter run, especially in Delhi and Mumbai.

Chinese Market

Fig. 25



Source: AACO

Continuous Growth

The Chinese air transport market will grow into 142 million passengers in 2006 – 3.29% over 2005. Traffic between China and the Arab world came on top of the relative growth rates by 23.9%. China's largest market is with the Far East – counting 78 million passengers in 2006. **World Tourism Organization expects 100 million Chinese tourists by 2020.**

The People's Republic of China has emerged as a major player in the international economy over the last fifteen years, reflecting rapid economic and development growth. China registered a 7% economic growth rate over the previous 14 years. The Chinese Civil Aviation Authority expects a 15% year-on-year growth in Chinese air transport until 2020. In other words, China will grow into the world's largest Asian air transport market by that time.

Airline Industry Policies and Regulations

China is showing its intention and willingness to open its domestic and international markets to larger competition, whereby the Chinese civil aviation authorities intend to liberalize the Chinese air travel market over three stages, leading to a liberalization of 70% to 80% of China's air transport industry by 2010. The authority is also gradually liberalizing ticket pricing in a manner that gives the airlines more flexibility to determine prices in accordance with market demand. It also works on encouraging low cost carriers to boost their economic and tourist development for the middle classes.

Because of this policy, the Chinese civil aviation authority has concluded several air transport agreements of wider liberalization with third countries including Singapore, Thailand, Australia, USA, and others. In general, Cargo services precede passenger services as far as liberalization is concerned.

China is also working on liberalizing rules pertaining to foreign investment in the civil aviation section, but foreign investors are not allowed to fully own Chinese airports or airline companies.

This Chinese policy revamp goes hand in hand with major projects to develop airport structures and to adopt new technology to manage air transport traffic. China has built over 25 new airports since 1990. The number of airports now exceeds 200, and will reach 260 by 2015. Moreover, the Chinese government handed in the ownership and control of airports to regional and municipal authorities that have greater incentive to develop their regional air travel markets and to attract special funds to support those plans.

The Chinese civil aviation authorities anticipate that the Chinese airlines have to add 1800 aircraft to their fleet over the coming two decades, at that time China will be requiring new technology to manage air transport traffic, and to manage the Chinese future growth prospects.

Challenges Faced by the Chinese Air Transport Market

The Chinese civil aviation authorities have pinpointed the major challenges to develop a safe civil aviation market in China as follows:

- Improve safety and security systems and monitoring abilities.
- Larger expansion of infrastructure.
- Optimal use of air space.
- Better training of employees.
- Adapting airlines and airports to higher competitiveness.

Alliances

Following a period of preoccupation with cost related matters, airline boards are revisiting airline alliances from a strategic context once more. The most important example of this is the decision of the Japanese Airlines (JAL) to join Oneworld. JAL has been one of the few major airlines that operated independently.

As for future membership of alliance, it appears that China and India are the most important focal points for alliances at the time being. In China, Star Alliance pursued a two-track strategy by taking – in "Air China" and "Shanghai Airlines" to the alliance in 2007. On the other hand, "Sky Team," which includes Chinese airlines expects, the accession of "China Southern" by the end of 2007. In turn, One World that already has Cathay Pacific as an alliance member is looking into the addition of "Dragon Air" to the alliance once the Cathay Pacific takeover of Dragon Air is concluded.

For Indian airlines, it seems that this process represents an even bigger challenge to alliances. In spite of that, Star Alliance announced it is confident that an Indian airline would join the alliance during 2007.

Alliance expansion comes at a time when the airlines still await the open skies agreement between Europe and the United States; such an accord would remove various restrictions that are possibly obstructing closer cooperation and cross-Atlantic airline mergers.

On the Arab level, **two airlines have recently joined global alliances**. Middle East airlines joined as an associate member of Sky Team, and Royal Jordanian joined One World. Other Arab airlines have expressed their interest to join one of the alliances, and are in the process of evaluating such a move to choose the alliance that is best suited for those airlines' network and best interests.

It is worth mentioning that most Arab airlines follow the code share strategy to open local markets and to communicate with regional and international airlines. Arab airlines have concluded **24 codeshare agreements** in 2005 and 2006 among each other, or with non-Arab airlines, save the codeshares done within Arabesk.

Low Cost Carriers

The liberalization of air transport created the foundation for the emergence of new business models that were previously unknown to airlines. The liberalization of air transport in the United States in 1979 resulted in the emergence of Southwest Airlines. Southwest devised a new business model called "Low cost." More airlines adopted the same system, and the model expanded when airlines could market their products on individual levels, and less costs, with the proliferation of the internet.

Following the complete liberalization of air transport in Europe in 1997, this model started to spread in the continent with EasyJet and Ryan Air. Many airlines followed suit, and they managed to develop the market and to achieve significant traffic numbers.

This model has lately spread in Southeast Asia and Australia in conjunction with steps to liberalize air transport, especially market access.

In the Arab world, despite the incomplete process of air transport liberalization, the low cost model started to emerge with Air Arabia in Sharjah, Atlas Blue in Morocco, and lately Jazeera in Kuwait.

The most important characteristics of low cost carriers are the following:

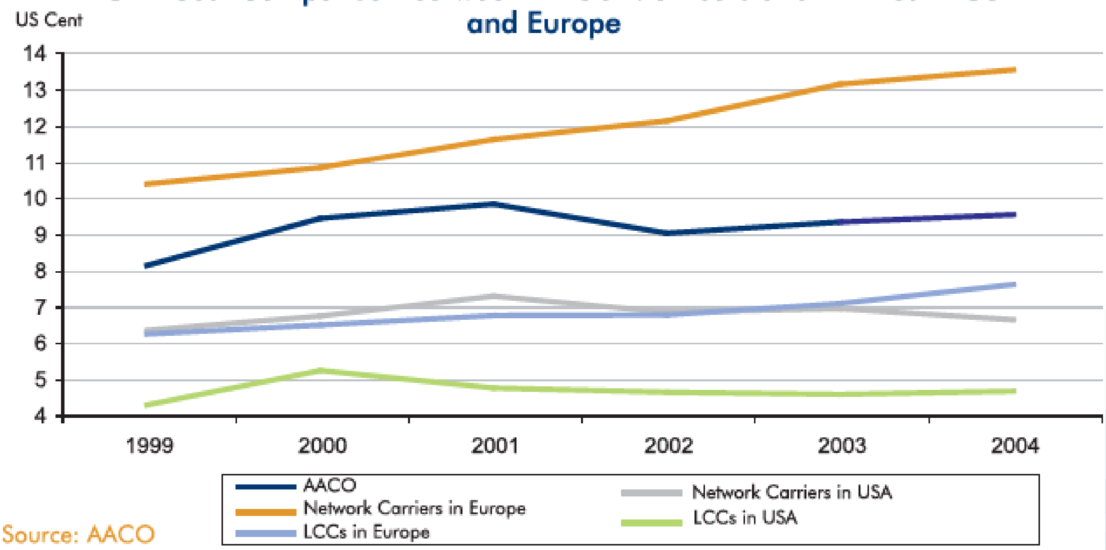
- Relatively high number of seats on the plane, which maximizes revenue.
- Point-to-point Operations, avoiding the complexities of intraline-interline traffic.
- Short to medium-haul flights, and the use of secondary airports.
- Focus on leisure and VFR travelers who are usually sensitive to prices.
- One class of service.
- No frills on some services, such as food on the plane.
- Focus on direct sales, particularly through the Internet.
- High aircraft utilization and short turnaround time.
- A single or two-type fleet, with preference for one type.

Figure 26 shows that the unit cost of Arab airlines falls between the unit costs of US airlines and European airlines. American airlines enjoy relatively lower costs due to lower fuel prices in the United States compared to other countries, including Arab countries. US airlines also have the benefit of about 60% lower user charges from their European counterparts. Moreover, they advantage from the increased use of direct sales techniques to avoid agency and distribution related costs, higher operational averages, focus on productive airline specialized employment, and outsourcing of none-core operations. The figure shows that the difference in unit costs between low-cost companies in the United States and network carriers in the same country does not exceed 2 cents - taking into account the recent restructuring of network carriers in the country. The margin between the European low cost and network carriers is much wider; low cost carriers in the continent focus on short-haul operations, and operate from secondary airports, or from separate terminals at large airports under differential conditions.

There are elements in this business model that are missing in the Arab region, wielding pressure on the cost structure of any airline that wishes to operate as such in the region. Our region is more like Europe in terms of geography; the expansion of low-cost carriers and achieving lower margins vis-à-vis network carriers requires liberalization of airspace, the availability of secondary airports, not withstanding the need to operate from more than one location to cover the geographically expansive Arab world. The last condition entails clearing the way for the establishment of airlines that are either partly or wholly owned by non-nationals.

Technology currently allows the reduction of the distribution cost margins between low-cost carriers and the network carriers. Direct sales and lower travel agency commission are becoming part of network airlines' strategy. The same applies to operating costs of the two business models. The remaining disparities that could give low cost carriers a cost advantage in the Arab world are the usage of secondary airport, lower or no ground handling requirements, higher aircraft utilization, and multiple bases of operation.

Fig. 26 Unit Cost Comparison between AACO Members and Airlines in USA and Europe



Source: AACO

Fuel

The higher **rise in global oil prices** created a heavy burden on airlines' costs. **In 2005**, it constituted **20.3% cost, 60.9% more than 2004**. Airlines paid US$ 63 billion for fuel in 2004, and increased to US$ 100 billion in 2005. The Arab airlines fuel bill amounts to US$ 3 billion. The cost of fuel for Arab airlines was about US$ 3 billion. Prices in 2006 indicate that fuel prices will continue their increase up until 2007. However, fuel **hedging programs** by some airlines helped alleviate the burden a little.

AACO's Fuel Purchasing program helps the Arab airlines achieve significant savings. They have saved more than US $20 million 2005.

Charges and Taxes

Charges and taxation represent a **significant burden** on both the airlines and consumers. **Landing charges represent 2.6% of airline cost**, and have increased by 16.6% in 2005 over 2004. **Overflying charges constitute 3.3%, and have increased by 14.1% over 2004**. Arab airlines also face government imposed fuel taxes and duties at international airports, especially American and German ones. Among the taxes and fees currently under deliberation, and that could be imposed on airlines is the tax on tickets to help developing countries. France launched this tax three years ago, and gained approval from 13 countries in 2006. Moreover, there are talks about the inclusion of the air transport industry under the European emissions exchange program by request of the Environment Council of the European Union. Lately, it received the support of the European Parliament to include airlines within the program; or in other words, impose taxes on jet fuel, and to increase them on domestic European routes.

On the other hand, taxes on tickets in the Arab World have increased this year. At certain short sectors, the taxes are almost equivalent to the cost of the ticket, thereby hindering the travel and granting an unfair preference to other competitive modes of transport.

International Regulatory Relations

Arab-European Talks

AACO and the Arab Civil Aviation Council initiated **several rounds of discussions with the European Commission** on the bilateral agreements between the EU and Arab states. The European Court of Justice ruled against the **national ownership** in existing bilateral agreements between any country in the EU and a third country. Accordingly, ACAC drafted the **collective Arab mechanism for negotiations with regional or sub-regional blocs** to negotiate collectively with the European counterpart. Thirteen Arab states signed the agreement, four countries have ratified it and two are **currently in the process of ratifying it. This agreement came into effect on June 15, 2006.**

Talks have begun between the Arab and European counterparts. The Arab side presented four points to the European Commission for negotiations:

First: that this phase becomes **part of a dialogue aimed at reaching a Euro-Arab aviation agreement**

according to the authorization granted by the Arab Ministers of Transport and Civil Aviation on the establishment of an Arab mechanism to negotiate with regional and sub-regional blocs.

Second: to **maintain operations at current levels** without change in operators, number of flights, or offered capacity except through negotiations between Arab and European countries on a bilateral level, or under the Euro-Arab aviation agreement.

Third: **not to allow operations** under the European airline ownership clause from **European countries that do not have a bilateral air transport agreement** with the Arab country concerned.

Fourth: to **allow Arab countries to appoint other Arab carriers** to operate on European routes on **codeshare basis** agreed with the Arab national carriers.

The European Commission agreed to deal with the Arab party as a single entity based on the jurisdiction granted by the Arab Ministers of Transport and Civil Aviation. The two parties agreed to maintain operations at their current levels, and not to change except through negotiations between Arab and European countries on the bilateral level or under the Euro-Arab aviation agreement.

The European Commission made clear that any European airline that begins operations from a European point to any Arab country across a European country that has an agreement with that Arab country is bound by the existing bilateral agreement between the two states.

With respect to code share agreements, the European commission announced that it will introduce the issue during the horizontal negotiations, since it does not have a mandate for this by the European Union Council of Ministers.

One of the most important outcomes of the talks between joint discussions is the pledge of the European Commission to apply the results of the Euro-Arab negotiations automatically to any bilateral agreement between the Arab authorities and the European Commission if the Arab side so wishes. In other words, to incorporate the results within bilateral agreement.

Regulatory Developments within the European Union

Developments in rules and regulations within the European Union may affect the operations of Arab airlines to Europe. The Secretariat General of AACO is following up on the latest developments below:

Slot Allocation: The European Commission is working on a new mechanism to determine slot allocations, including the exchange of slots without prejudice to ground for the rights.

Charges and Taxes on the aviation Industry: the subject is still under study. The commission will submit a proposal regarding the exchange emissions accord end of 2006.

Black List of Airlines Banned from Operating to the European Union: The current EC Regulation includes 180 airlines that have been prohibited from operating to the European Union. The Commission updates and publishes this list every three months to consumers in order to cede any responsibility. None of AACO members is affected by the ban.

SESAR: SESAR's definition phase was launched on 6-7 March 2006. The project's budget is 60 million euros for the first two years, and is centered on the laying grounds for a major plan to manage the European air space system more effectively by 2020.

European-American Relations

Euro-American talks to liberalize skies across the Atlantic

The air transport industry is awaiting the wrapping up of the **biggest open skies accord** in the history of the air transport industry between the European Union and the United States. This agreement will draw on a market of 750 million inhabitants and 26 states to become the largest liberalized air transport market. Negotiations between the European Commission and the USA started in June 2003 with a view to reaching an agreement on the liberalization of air transport across the Atlantic, and that lasted until mid-2004. Following a lull, negotiations between the European Union and the United States were revived in October 2005. At that time, the United States rejected the request of the European Union to award the right of Cabotage to European airlines operating within the United States, in addition to the American laws of airline ownership and control.

The parties agreed on the principle of liberalization of airspace, and started negotiations of the draft agreement. It was expected that the United States would review foreign ownership laws during the month of August 2006, and to announce the results before the Ministers of the European Union meeting scheduled in October 2006. The European Ministers were expected to vote on the proposal of the agreement on the liberalization of airspace across the Atlantic during their meeting.

Throughout the talks, Europeans and Americans were working to accomplish a **final agreement by the end of 2006.** Then came the American decision to postpone the review of restrictions on foreign ownership, and the European Union Ministers of may not vote on the proposal of the Convention in October 2006. Both parties are hopeful to reach an early final agreement, and to roll it out in summer 2007 as previously scheduled.

Passenger Information Record Transfer between the European Union and the United States

An agreement was reached two years ago for the transfer of Passenger Name Records information (PNR) from the European Union to boarder and custom control in the United States. It followed extensive negotiations between the European Commission and the United States on the development of a satisfactory legal framework for such an agreement. On March 30, 2006, European judges issued rulings to overturn the contracts that obligate European airlines to provide passengers' information to the United States authorities starting September 30, 2006, on the grounds of the European Parliament's concerns that the agreement violates laws that protect privacy.

Following that decision, the European Commission pledged to develop new measures by September 30, 2006 in cooperation with all parties concerned. The commission is working on concluding a preliminary agreement stretching until the month of November 2007, the date of expiry of the initial agreement that was overturned by the European judges. The European Parliament supports the idea of a short - term agreement, and the adoption of a new pact on November 2007, while emphasizing that the Parliament will be closely monitoring the short - term agreement negotiations.

Arab-American Relations

The USA is working on concluding open skies agreements with different countries, and has managed to date to conclude more than 76 open skies agreements. Seven agreements were signed with Arab countries: Jordan, Morocco, Qatar, United Arab Emirates, Bahrain, Oman, and Kuwait. In addition to open skies agreements on bilateral basis, the United States is a member of the multilateral convention on the liberalization of worldwide air transport known as MALIAT, which went into effect on December 21, 2001, and includes the Sultanate of Brunei, Chile, New Zealand, Samoa, Singapore, Tonga, in addition to the USA. The Cook Islands also joined to the convention recently in July 23, 2006.

Airport Ownership

The ownership and management of airports is undergoing a shift towards increased performance and higher competitiveness. This marks the need for larger investment programs to meet the forecasted growth in demand for air transport, especially in some regions that are undergoing rapid growth, such as Asia, India and the Arab region.

AACO's Work

Joint Projects

Regional Training Center

AACO Regional Training Center has maintained positive results during 2006 as in 2005, where it has achieved savings for the airlines valued over US$ 5 million. During the first 6 months in 2006, the center has contributed in savings for the airlines valued at **US$ 3.4 million**, having **held 80 training courses**, attended by 1,352 trainees from different Arab airlines. The courses tackled many industry issues, most importantly:

- IOSA
- Electronic Ticketing
- Human Resources

In addition to new courses on issues pertaining to cost reduction, enhancing fuel management, Simplifying the Business, some courses were conducted in French.

Moreover, the RTC has re-launched its website, to be more user friendly with a database containing all information needed about the services provided at the RTC.

Passenger Services Program

A number of developments warrant the Arab airlines to look into modern techniques flexible enough to function in a complex environment: **Cost Rationalization**, projected traffic growth, increasing passenger requirements, competitive market, **innovative strategies for distribution, the emergence of new distribution channels**, as well as adoption of the concept of **self-service tools**, customer centricity, improving the productivity and efficiency of operations and staff, are all issues encompassed by these developments.

Following the results of the consultancy study on the future of distribution and information systems in 2005, AACO's 38th AGM decided to establish a working group for passenger systems that would address four major topics:

1. **e-Ticketing Implementation**: especially interline e-Ticket.
   The team paid particular attention to this pressing issue because of the deadline set by IATA for the full application of the e-ticketing, after which travel agencies will not be able to issue paper tickets since paper tickets will not be processed by the BSP. A large proportion - exceeding 25% of Arab airlines passengers are interlining, mostly with major airlines. Hence, Arab airlines placed high importance on the **STB** project and its timeline.

2. Adopt **e-commerce** concept and encouraging its implementation within the Arab airlines.
   - Work with other association (B2B)

3. Look into the **new generation of passenger service systems -** (Reservation, Inventory, and Departure Control System). Most airlines still depend on older technology that lacks responsiveness to the rapidly changing industry requirements, or to new commercial practices. In addition comes the high cost of maintenance and development of the old systems.

4. Look into **future relations with Global Distribution Systems**, and explore the airlines' distribution strategy beyond 2008. That year marks the expiry of the existing distribution contracts between Arab airlines and the Global Distribution Systems.

Arabesk

Arabesk is a "network cooperation" alliance project gathering 7 Arab airlines; Gulf Air, Middle East Airlines, Royal Jordanian, Saudi Arabian Airlines, Yemen Airways, Tunis Air and Egypt Air. Arabesk is a regional cooperation amongst member airlines in AACO, these airlines optimize their schedules through Codeshares and Special Prorate Agreements, increase their revenues, achieve the optimal utilization of their aircraft and network, and provide better services for their customers, aiming at strengthening their competitive positioning by offering a wider network.

Arabesk Chief Executive Officers have formalized the establishment of the Arabesk Project by signing its Articles of Cooperation on 21 January 2006. AACO Secretariat General plays the administrative role in the project, while Sabre Consulting provides technical assistance.

Joint Fuel Purchasing

AACO Joint Fuel Purchasing project continued its progress during 2006; it now gathers 17 AACO member airlines. During 2006, the project achieved incremental savings for the airlines, in spite of the increasing fuel prices. AACO Joint Fuel Purchasing group announced 2 Tenders in 2006. Planned tenders during 2007 shall cover more than 500 airports worldwide.

The most important steps taken by the group during 2006 were:

1. A change in the negotiations criteria with the fuel suppliers worldwide, resulting in additional savings for the airlines.
2. Direct negotiations with Arab airports suppliers enabled the group to improve fuel prices at some Arab Airports.
3. AACO has subscribed to the daily Platts Bulletin for fuel prices worldwide.

The success of the work mechanism in the joint fuel purchasing program within AACO has set AACO's strategy in fuel purchasing as a worldwide reference.

Moreover, the Fuel Technical Committee within AACO continued to enhance technical specifications in aircraft fuel supplying, whereby the committee launched its **first issue of the "Fuel Quality Control Manual,"** aiming to guarantee the quality of Jet Aviation Fuel, and to maintain the safety of AACO member airlines and passengers. Also the Committee is working on the First edition of the "**Inspection Manual**" to be published in 2007.

Ground Handling

The Ground Handling Steering Board has successfully expanded the Ground Handling joint project amongst AACO member airlines over the years. The Steering Board signed a number of joint agreements in various airports since its establishment in 1999; in London with AFSL, in Athens with Swissport, in Rome with "DRH," in Frankfurt with Fraport and in Istanbul with "Havas."

The Board is seeking further expansion to cover more airports, in addition to following up on the latest developments in Heathrow airport pertaining to terminal allocation.

Joint Analysis of MIDT

AACO MIDT Joint Purchasing and Analysis Group gathers Gulf Air, Kuwait Airways, Middle East Airlines, Royal Jordanian, Saudi Arabian Airlines, Yemen Airways, and Egypt Air. These airlines benefit from the economies of scale achieved through a joint agreement for analyzing data offered by Sabre Airline Solutions, and launched in 2002 under AACO umbrella. MIDT is considered a comprehensive source for worldwide bookings, giving the participating carriers a competitive edge and in-depth analysis for data, contributing in better network management and enhancing the performance of travel agents.

During the first phase of the MIDT project, which started early 2003, the airlines worked on utilizing Market Information Data Tapes with the sales and marketing initiatives to increase their respective market shares and competitiveness. The second phase, expected to start in 2007 will witness an upgrade to the utilization of MIDT on the network level.

Joint Projects within AACO Technical Committee

Joint projects within AACO technical committee have kept momentum, most recently with the joint IOSA implementation project. AACO is still offering its support to airlines by requesting better proposals for renewing the auditing agreements in 2007 with the aim to obtain IATA's Safety stamp on all AACO member airlines.

The Secretariat General, through the work of the technical committee, will launch a number of future joint projects namely; joint purchase of aircraft engine oils, and common procurement of spare parts and tires. Moreover, the Secretariat General will closely follow up on the provision of member airlines with all the safety related developments from ICAO, including the English language proficiency levels for pilots and air traffic controllers. Accordingly, AACO will formulate a program to work together with its members to achieve the international passing level set by the program.

Special Multilateral Fares Agreement "Transarabia"

"Transarabia" is the new name of the special multilateral fares agreement amongst six Arab airlines starting from June 1, 2005. The airlines party to the Transarabia agreement are EgyptAir, Kuwait Airways, Middle East Airlines, Oman Air, Royal Jordanian, and Yemen Airways.

"Transarabia" agreement is applicable worldwide for the participating carriers on their sectors within Arab countries only, where the ticket should include a minimum of three coupons in economy class only.

International Relations

AACO has developed over the years various channels with worldwide parties with the purpose of defending the interests of its member airlines. AACO lobbies for the interests of member airlines with governmental and non-governmental bodies on aeropolitical and operational issues. AACO also maintains strong relations with organizations such as ACAC, ICAO, IATA, regional organizations, the EC, and the US DOT.

On the other hand, AACO has developed strong relations with various companies specialized in the air transport industry under the umbrella of AACO Industry Partners Program, which now brings together 40 industry partners. The Industry Partners program creates a mutually beneficial environment for both the airlines and the industry partners, whereby the industry partners support the training programs at the regional training center, while benefiting at the same time from a continuous dialogue with AACO member airlines through the various joint projects and AACO's forums.

Publications and Database Management

AACO follows up on the developments in air transport and has created a vast database in air transport in the region. Both industry developments and the databases are subject of a number of specialized publications covering:

- The most important developments in International and Arab air transport, mainly economic, regulatory, and operational news in **AACO Bimonthly Bulletin**.
- The results of AACO meetings and events, and the progress of AACO joint projects in the **Executive Bulletin**.

- Regional and International developments, and incidents relating to airlines' safety, in **Safe & Level**.
- Industry news published **daily** on AACO's website, and distributed **weekly** in AACO **Weekly Web News**.
- Air Traffic figures, market size, and capacity on - offer from Arab and foreign airlines in the Arab world, in AACO's monthly specialized bulletin, **Industry Pulse**.
- Detailed statistics about AACO member airlines operations, fleet, market size, the overall economic trends and its effect on the Arab travel and tourism industry, in the **AATS**.

Coordination Framework

AACO's coordination work revolves around joint forums and conferences on one hand, and joint projects on the other hand. On the forums' level, five standing committees function under AACO's umbrella covering the commercial, technical, training, and ground handling services, in addition to special forums for the Executives of the member airlines discussing future strategies and challenges facing the industry.

Working through another channel, AACO has established the joint work amongst its member airlines, whereby the joint projects enrich the cooperation amongst the airlines and result in overall benefits for them jointly. The joint projects also benefit AACO Industry Partners by establishing continuous dialogue between the partners and members. The joint projects vary according to the requirements of the member airlines.