REGIONAL AVIATION INSIGHT
ACMI – THE FUTURE OF EUROPEAN REGIONAL CARRIERS?

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At the European Regions Airline Association (ERA) annual general assembly held in Athens in October, under the shadow of the Acropolis airline CEOs, lessors, manufacturers, technical service providers and lawyers gathered to talk about the state of the industry.

In this report, Angus von Schoenberg, founding partner at The Sharpwings, analyses the emerging trends towards the US style capacity purchase operations by European regional carriers.

Can ACMI contracts deliver the affordability and flexibility that regional carriers seek to underpin their operations?

Traditional ACMI carriers & new comers changing business model

Among ERA's member airlines, a strong emerging trend over the last year is the acceleration of the transformation of some carriers' business models into wet lease capacity providers. **The Sharpwings** believes this trend still has some distance to go, but is unlikely to reach the same level of penetration as in North America.

Some smaller operators such as UK based Titan Airways or Denmark's Danish Air Transport have been active in the Aircraft, Crew, Maintenance and Insurance (ACMI) leasing market for many years, but such carriers have traditionally focused on short-term, often ad hoc, requirements to cover, for example, unscheduled maintenance events, industrial action or certain peak time requirements. These **traditional ACMI carriers have largely kept their business model of supplying the short-term ad hoc market where higher rates can be achieved**. This also includes special mission contracts ranging from supporting natural resources companies to transporting sports teams on charter arrangements.

In recent years, **some carriers have begun to develop long-term ACMI contracts** either as a **diversification strategy** from their normal scheduled services **or** increasingly **seeking to develop ACMI contracts as their main core business**.

Long-term ACMI contracts are prevalent in North America where many of the regional operators provide capacity to legacy network carriers under a capacity purchase agreement (CPA), which are often for **long periods that can exceed ten years**. Operators such as Skywest, Republic and Jazz fly for majors on this basis. Increasingly, European carriers are adopting a similar business model to fly for larger airlines, a main difference being that **no major European airline has yet committed to such an agreement for as long as ten years**.

Of the major European airlines, SAS has been a leader in contracting capacity on this basis. Initially, capacity was provided by Cimber and Jettime on CRJs and ATRs, but neither of these operators continue today principally because their contract rates were too high for SAS to generate a return, and the providers themselves were not able to generate positive results either. Undeterred, SAS have continued with a similar strategy and have now contracted with Cityjet to provide capacity on CRJ900s, and with Estonia's Nordica to provide ATRs.

Cityjet is an example of an ERA member airline that has completely changed its business model from that of a scheduled airline to becoming principally an ACMI provider. Apart from its sole remaining scheduled route between Dublin and London City, its fleet of 17 CRJ900s now operates for SAS. In addition, three of its Sukhoi SSJ100s now operate on behalf of Brussels Airlines under an ACMI agreement and some of its remaining RJ85s provide capacity for KLM. The remaining aircraft operate in the charter market.

Nordica also operates most of its services on behalf of others. This includes a newly acquired fleet of five ATR72-600s for SAS and its CRJ900s that fly on behalf of LOT Polish. Another example is Adria, which has orientated itself to specialise in ACMI work for Austrian Airlines, Swiss and Luxair in recent times, using an expanded fleet of CRJ900s.

Other carriers operate a hybrid of scheduled and ACMI services. This includes Flybe in the UK, which designates this as white label flying. In the past Flybe has operated ATRs on behalf of Finnair and today it operates DHC8Q-400s on behalf of Brussels Airlines. Conversely, Flybe also leases in ACMI capacity from Stobart for its Southend operation; and Air Nostrum is expanding its business by providing ACMI capacity for smaller Latin American carriers in Paraguay and Argentina.

One of the themes in the growth of ACMI has been the success of operators from Baltic or Eastern European countries, who have been able to take advantage of their lower cost base for back office and administration. Only time will tell how long this advantage will continue and how other competitors in the ACMI space respond.

The Sharpwings' Viewpoint

The Sharpwings believes the benefits of **longer-term ACMI contract flying are finely balanced in a European context**. For those moving in this direction there are indeed some demonstrable benefits.

First, the risk of selling seats is passed to another party. This means that revenues are generated on a predictable fixed rate basis irrespective of how many passengers fly on any specific service. Secondly, the costs associated with the sale and distribution of seats is removed so that the airline not only reduces risk, but can dismantle a significant portion of its cost base.

Furthermore, since such ACMI contracts are almost always with larger legacy airlines to feed their hubs, less well known regional airlines can benefit from the perceived quality of a contract with a major airline. This can greatly assist their buying power with third party suppliers. For example, lessors and other financiers usually take great comfort from the contract with the major airlines. This either enables them to lease or finance suitable aircraft that the finance community would otherwise have not provided at all, or enables the regionals to achieve lower finance costs. Similar reasoning applies to other third party suppliers which can extend to more attractive maintenance costs, and better credit terms for other services.

However, **there are also some negative factors**. The biggest risk relates to contract termination.

Indeed, to date European major airlines have been unwilling to commit to contracts long enough to enable regionals to equip their operations in the most efficient manner. **A major benefit of the long-term US model is that operators can commit to long attractive financings on aircraft to match the term of the ACMI contracts**. In Europe where contract terms are much shorter, financing is, therefore, sub-optimal. If the regionals optimise their equipment finance terms without matching the length of the ACMI contract, they risk becoming stuck with expensive assets that are unable to generate revenue in the event that the underlying agreement with the major airline is terminated. Some carriers can mitigate this risk, but this is at best partial. As in North America, many of the European regionals diversify their ACMI portfolio by flying for multiple carriers and most are reluctant to completely dismantle their ability to offer scheduled services in case they need to quickly deploy surplus aircraft.

Summarising, **The Sharpwings** believes that for larger airlines looking to outsource regional operations in this way, there are more competitors and options for this wet-lease business than ever before. Regional carriers in Europe are increasingly keen to provide such capacity, but this brings different risks of dependence on the major airlines, which cannot be totally mitigated until the North American model can be fully implemented in Europe.

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