

THOUGHTS ON THE US AVIATION INDUSTRY AIRLINE FLEET & NETWORK MANAGEMENT – July Issue

Years ago and lost in the wilds of Ireland, I met a farmer from whom to ask directions. “Limerick?” he said, “If I were you I wouldn’t start from here” I think the US aviation industry appreciates what he meant. More than three decades after facing the turmoil of deregulation and its aftermath of perpetual competition and being dragged to the edge of a financial abyss in 2002-4, it’s downsized, streamlined and squeezed to return to profit. No sooner has this seemingly impossible feat been achieved, when along comes a tidal wave of fuel price increases, combined with a weak economy, threatening to swamp most of the airline industry.

Without doubt, given a choice, the US airline industry would not ‘start from here’. Faced with high and increasing levels of debt, low cash reserves, aged fleets, a softening customer demand and an unenviable record for capital destruction, anywhere would be better than here.

Yet this is the only choice- to find a path when there appears to be no road back or forward, and no way to stand still. Just what are the choices?

Taking the long view

Despite the current level of crisis, it is worth a reassuring look at the long term fundamentals. Air travel is a critically important resource for the US economy, which is responsible for over US\$1,200billion of direct or indirect output, and around 9% of US jobs. Airlines and aviation suppliers that survive the current problems will be well placed to improve their business in the future. Domestic and international air networks provide massive and continuing competitive advantage for the US economy against other global competitors such as India and China.

While recent US aviation market growth has slowed in the light of both price increases and the deterioration of the travel experience, the US will remain for the next decade and beyond by far the biggest world aviation market. Future market growth will continue, driven by GDP growth. So what characteristics will ensure long term survival of airline suppliers to meet this market need?

First- the successes

Whatever the criticisms of the US Chapter 11 option, it has provided an umbrella for several of the majors to reinvent their businesses over the 2002-5 period. As a result of restructuring measures taken while under this protection, costs have been slashed, productivity increased and overall profitability restored. This success inevitably came at a price, both for staff who found their terms and conditions significantly eroded, the travelling public who found falling service levels, fuller planes and rising fares, and shareholders who found much of their investment destroyed. Passenger load factors on board many of the airline majors climbed to reach an average of 82% in 2007- an astonishing ten points higher than the apparent ‘peak’ load factor levels of year 2000. The system has never operated so efficiently, although the challenge now is how a system that has been squeezed to the limit over the last five years can now accommodate the further challenge of fuel prices doubling within a year.

The Unanswered issues

Despite the industry’s success in developing its survival skills, a number of key underlying issues have still not been resolved by the recent return to overall profitability of most US airlines. These issues seem set to continue to dog the industry until they are addressed.

- Regulatory framework and political interference

- Fleet age
- Consolidation

Airline deregulation opened up a new world of competition for domestic airlines in the US, but did not end the close interest of US legislators in air transport. The US airline share ownership limits effectively block any overseas capital interest, and do a very effective job in delaying the start up of new US based initiatives such as Virgin America. While various arguments from job protection to home security issues are advanced to support the current legislation, it does effectively prevent a desperately needed flow of capital to revitalise the industry. As US investors look at the startling record of capital destruction by the industry, there is not surprisingly a reluctance to make the same mistake again.

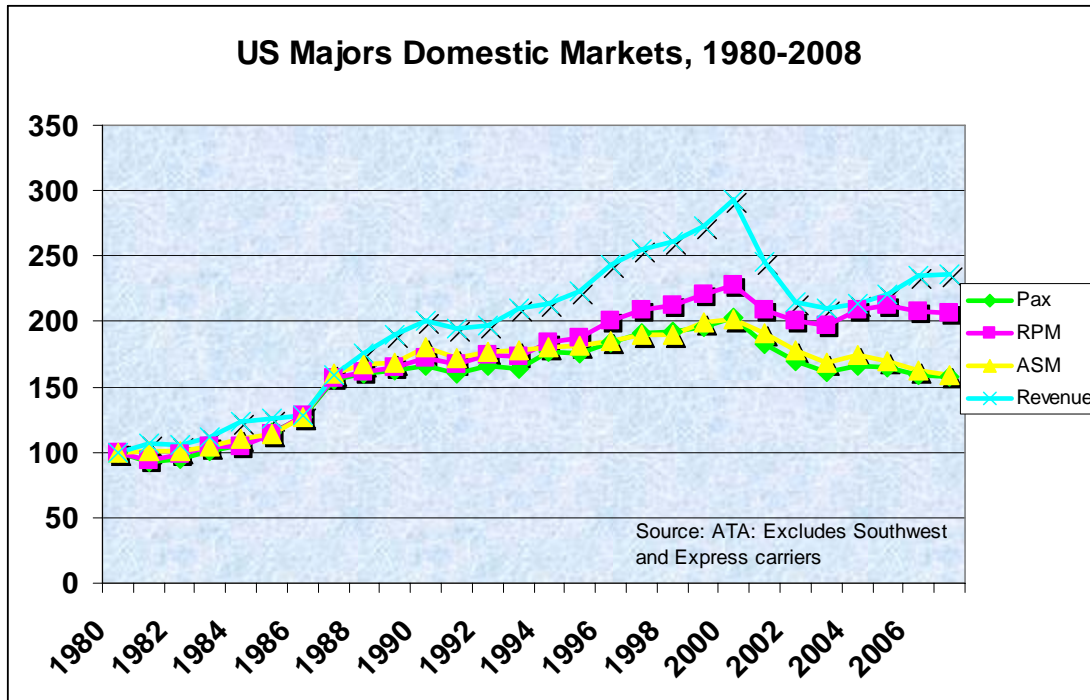
A capital inflow is particularly needed to renew the US major's fleet, which has become among the oldest in the world. It is estimated that the capital replacement cost for the US fleet over the next 10 years is USD110bn. With Northwest, Delta, American having around 50% of their fleet over 15 years old, US Airways 40% and United around 35%, fleet renewal to reduce fuel costs has become an imperative. A NW DC9 consumes twice as much fuel per seat as a modern narrowbody, and no amount of write down on the original asset appears to work at these fuel prices. On transatlantic services for example, airlines with the older fleet can be paying over USD15m more p.a. than their competitor for fuel in the same passenger markets. While the low cost airline model is often based on the latest fleet technology, the majors will find themselves increasingly competing with higher costs, older aircraft- and higher customer prices. This is not a formula for success. While it is admittedly unlikely that there would be a huge rush of potential investors if the US were to open up its aviation markets to broader competition on both the domestic and international front, the sheer size and scale of this market would always be likely attract investors. These could range from the stronger alliance partners such as LH, AF/KL and BA to the more ambitious and aspirational global players such as Emirates, Aeroflot or Air China. From a customer point of view the increased diversity would seem to be only a good thing, and for investors it would bring the reassurance of globally backed expert players that would be in the business for the long haul. Even for employment it seems that there would be few negatives, since domestic US services will always need US employees. However investors will be cautious and it is highly likely that the relentless reduction in real airline fares seen in the past three decades will start to tail off, since both the real costs of fuel and capital will now reflect the markets.

Finally the subject of airline consolidation has come up repeatedly- in the words of one commentator as 'the only option'. While the idea of achieving economies of scale through airline merger is theoretically attractive, the reality seems quite the opposite. Merging two financially desperate airlines seems more likely to create a third desperate airline than it is a surging new business model for the industry. The last decades are littered with the case stories of US airline consolidations that failed or were ineffective. How the merger of Delta and NW fleets to create a new behemoth with over 450 aircraft over 15 years old will create efficiencies is certainly not clear to us. A major stumbling block will always be staff acceptance, and time and again the internal effort required on such matters has usually undermined a great proportion of the benefits that might have been achieved. It seems that the challenges on this front, combined with lukewarm signals from legislators have put such mergers on the back burner for now. However in the case of Continental Airlines there may be an exception which is well placed to negotiate from a position of strength, and thus makes it an interesting consolidation target

Choosing the right tactics

A common call among the US Airlines has been that there is 'too much capacity'. With the US airline industry headed for a loss this year if fuel prices continue at current levels, it is tempting to agree. However a more appropriate comment may be that there is 'not enough capacity at the right price' for the market. Despite years of cost cutting and rationalisation the

US majors have unit costs per available seat mile (ASM) in the range 13c-16c in 2008. In contrast Jetblue and Southwest show operating costs in the range of 9c per ASM - more than a third lower, even with higher fuel prices. In relative terms this gives them a significant market advantage, which is further reinforced by the efficiency of their fleets and overall business models.



The market problems for the US majors are highlighted in the above graphic. Revenues have fallen since a peak in 2000, and passenger numbers are about the same level as in 1988. There has been a significant jump in load factors as the airlines have had to do 'more with less'. At the same time Southwest and other low cost airlines have managed to increase their business profitably on a lower cost base.

New World: Volume growth vs. profitable growth

The global airline industry has achieved growth of around twice the rate of GDP through the simple expedient of economies of scale - greater efficiency, fuller planes, lower prices. Meanwhile key input costs such as fuel and aircraft costs fell in real terms, and customer appetite for increased aviation services grew significantly. The US market has been the first to experience all these elements from deregulation through to market maturity and perhaps supplies some indicators to the watching world as to what can be in store for the aviation industry overall. In the new US world of stagnating GDP and traffic growth rates and a partial decoupling of traffic growth from GDP, two routes to airline success seem possible. The first is through the low cost model, which is likely to continue its expansion through the simple expedient of having the lowest price. For those airlines with higher costs the new focus will have to be on 'shrinking in to profitability' - a tactic employed successfully by British Airways in many sectors in recent years. The result will be that routes and flights that lose money will increasingly be dropped, and clearly with projections of capacity reductions of around 10% for summer 2008 this is already becoming a reality.

The further sting in the tail of the fuel price for many majors is that the economics of the regional jet aircraft used by many of them to provide hub feed is now very much under threat. Even with the latest regional jets operating costs per seat have risen dramatically, and some stark choices are going to have to be made as to whether to cut service or revert to ATR

operation. This is a further factor that will weaken the hub and spoke model, but could also potentially drive a renegotiation of scope clauses with pilots. Desperate times will call for desperate measures.

So if we had to sum up the various factors, what would we say?

- Apart from safety and security oversight, it is surely time for the legislators to stop interfering in the airline sector- either directly or indirectly.
- The fuel price crisis focuses more than ever on the right business model for markets, and the need to restore profitability again
- Fleet replacement is a problem which will not go away, and a life cycle costing of options reinforces this.
- The industry needs to plan for the worst, since that appears to be what has constantly surprised it in the past. But in every market there are winners and losers, and choosing the right business model for the right market is key.

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