# Testimony of Jamie N. Baker
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**Before The Committee on Commerce, Science & Transportation**
**United States Senate**
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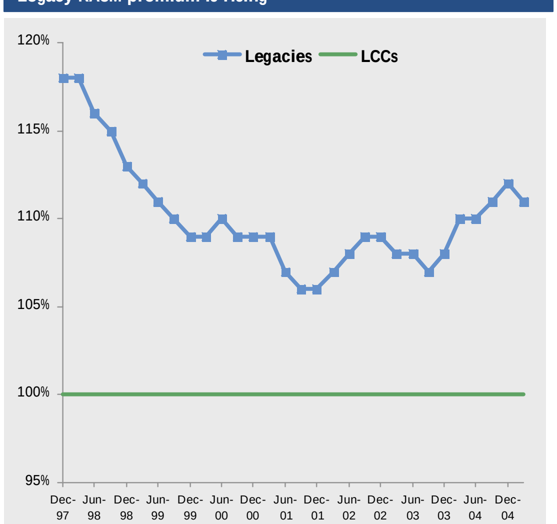
Chairman Burns and Members of the Committee, thank you for inviting me to speak this morning. My name is Jamie Baker, I am the U.S. Airline equity analyst at J.P. Morgan. I would like to provide the Committee with an overview on the U.S. airline industry, its ongoing efforts at recovery, and how the pension issue and other factors will continue to impact this recovery. I will also focus certain comments on the remaining legacy airline defined benefit plan sponsors, AMR Corp, Continental Airlines, Delta Air Lines, and Northwest Airlines. Please note that my testimony and statements are my personal views and do not represent the official position of J.P. Morgan.

## Fuel is masking fundamental recovery

Unfortunately for the airlines, fuel costs are masking a fundamental recovery that is well underway. Were an industry cockpit to exist, we would suggest all non-fuel gauges would be reading into the green, the first such instance since September 11th, 2001. For example, ex-fuel unit costs haven't been this low since 1997, and they are expected to head lower still. Airfares and revenue are both continuing to rise, with no apparent offset on demand. Capacity, while still increasing domestically, is rising at a slower growth rate than feared, with the majority of that growth coming from low-cost carriers. In fact, if fuel were not an issue, both American and Continental would have just concluded their most profitable second quarters in their history. While it is not our intent to suggest that legacy carriers can fully-match the efficiency and cost competitiveness of their smaller, low-cost carrier competitors, the chasm between the two sub-sectors is continuing to diminish.

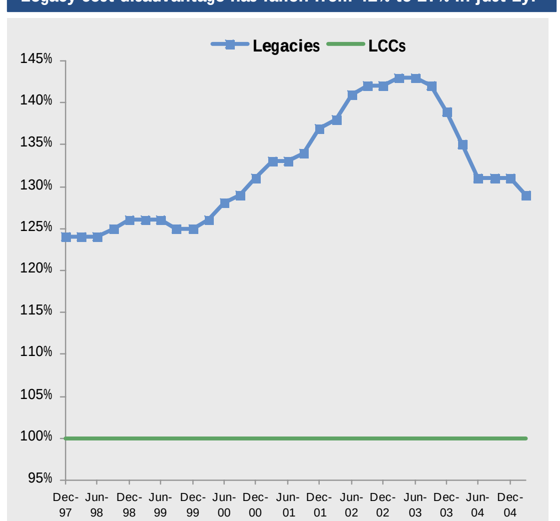
Exhibit I: Legacy RASM premium rising, cost disadvantage falling

**Legacy RASM premium is rising**




Source: Company reports and JPMorgan estimates.

**Legacy cost disadvantage has fallen from 42% to 27% in just 1yr**



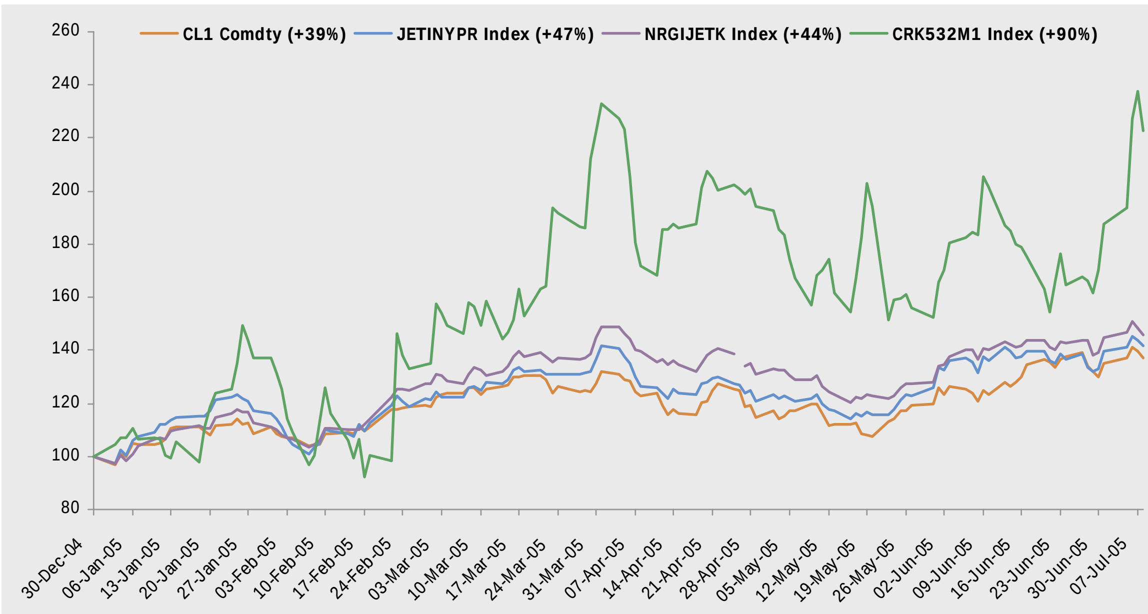

Source: Company reports and JPMorgan estimates.

**But fuel is a reality, and legacy airlines don't fly gliders**
Regrettably, stripping out fuel expense is but a mere analytical exercise. Jet kerosene prices have actually risen by a greater degree than raw crude, in part given the shortage of refinery capacity. Year-to-date, jet kerosene has risen 44% vs. a 39% increase in the price of crude.

Despite nearly a dozen, mostly successful efforts at raising fares in 2005, we estimate that merely $7 per barrel of crude agony has managed to be offset, leaving the effective price of that commodity still well above historic norms. While carriers will likely continue pressing fares higher this year and beyond, each successive fare increase is expected to generate a diminishing return, given the price-sensitivity of demand.

Exhibit II: Crack spreads have risen faster than crude prices ytd

**Relative change in oil (CL1 Comdty), jet fuel (JETINYPR, NRGIJETK) and crack spread (CRK532M1) ytd 2005**

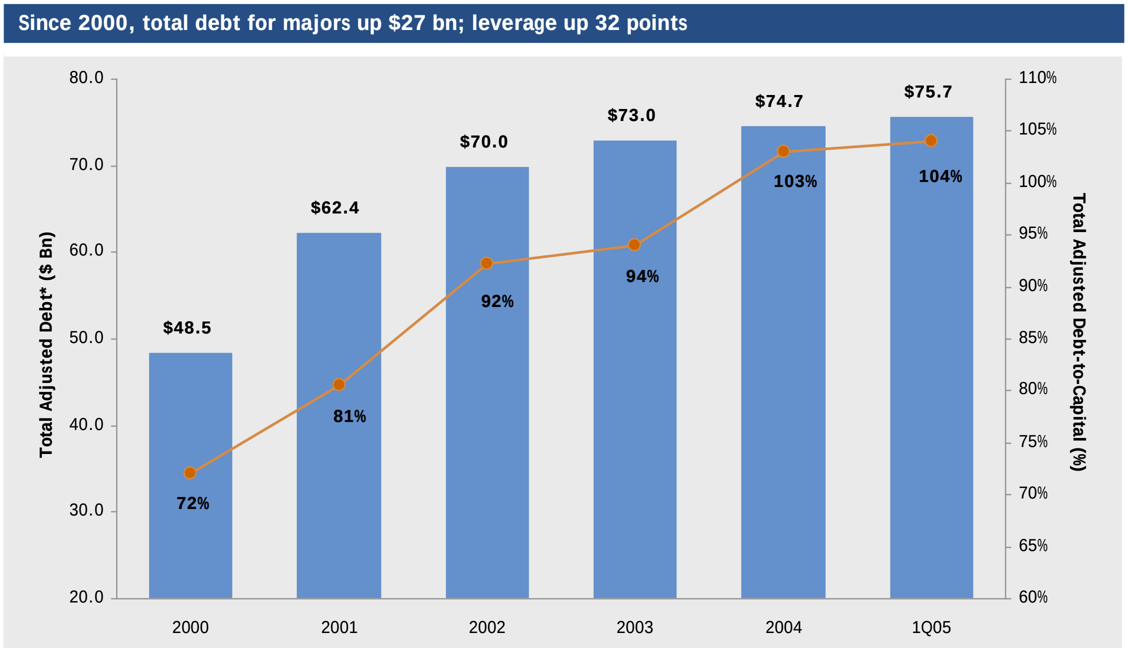



Source: Bloomberg and JPMorgan.

**Liquidity is under pressure**
Legacy airline liquidity is expected to decline significantly in 2005. We estimate that Delta and Northwest will each burn through more than $1 billion this year, inclusive of the capital raised year-to-date, unless assuming cash reserves can somehow be replenished.

The industry's ability to go deeper into debt, while seemingly inexhaustible, does appear to be rapidly diminishing. Since 2000, U.S. Airlines have borrowed more than $27 billion, and have witnessed substantial declines in their credit ratings. And while legacy airlines have been turning to non-traditional lenders, such as hedge funds and the manufacturers, the ability to further tap these resources is unlikely, unless pension reform can positively impact their credit standings.

# Exhibit III: Industry added >$27 billion in debt since 2000




*Total balance sheet debt plus operating leases capitalized at 8x rent (annualized for 1Q05) for AAI, ALK, AWA, AMR, CAL, DAL, JBLU, NWAC, and LUV.
Source: Company reports and JPMorgan.

# Exhibit IV: Base case YE05 airline liquidity snapshot

| MAINLINE ASSUMPTIONS | AMR | CAL | DAL | NWAC |
|---|---|---|---|---|
| RPMs (M) | 135,673 | 72,128 | 106,599 | 76,953 |
| *yr/yr % chg* | *4.2%* | *9.7%* | *8.5%* | *5.0%* |
| ASMs (M) | 178,509 | 89,919 | 137,929 | 94,424 |
| *yr/yr % chg* | *2.6%* | *6.2%* | *6.1%* | *3.3%* |
| Load Factor | 76.0% | 80.2% | 77.3% | 81.5% |
| *yr/yr % chg* | *1.2%* | *2.6%* | *1.7%* | *1.3%* |
| Yield | 11.70¢ | 11.25¢ | 10.74¢ | 11.40¢ |
| *yr/yr % chg* | *1.3%* | *-0.2%* | *-3.0%* | *-0.9%* |
| Mainline RASM | 8.89¢ | 9.03¢ | 8.30¢ | 9.29¢ |
| *yr/yr % chg* | *3.0%* | *3.1%* | *-0.8%* | *0.7%* |
| Mainline CASM | 9.82¢ | 9.85¢ | 9.43¢ | 10.87¢ |
| *yr/yr % chg* | *1.0%* | *3.9%* | *-7.9%* | *5.4%* |
| Mainline CASM ex-fuel | 7.34¢ | 7.46¢ | 7.06¢ | 8.25¢ |
| *yr/yr % chg* | *-3.7%* | *-2.6%* | *-15.8%* | *0.9%* |
| Fuel Cost/gal. | $1.501 | $1.569 | $1.474 | $1.471 |

| INCOME STATEMENT ($Mn) | AMR | CAL | DAL | NWAC |
|---|---|---|---|---|
| **Total Revenue** | **$19,847** | **$10,804** | **$15,831** | **$11,929** |
| *yr/yr % chg* | *6.4%* | *10.9%* | *5.5%* | *5.8%* |
| **EBIT** | **$102** | **$4** | **($766)** | **($686)** |
| *yr/yr % chg* | *NM* | *NM* | *-48.0%* | *204.7%* |
| **EBITDA** | **$1,282** | **$396** | **$492** | **($158)** |
| *yr/yr % chg* | *10.6%* | *22%* | *303.3%* | *NM* |
| **EBITDAR** | **$1,917** | **$1,121** | **$1,203** | **$628** |
| *yr/yr % chg* | *8.4%* | *15%* | *293.8%* | *-40.7%* |
| **Net Income** | **(682)** | **(263)** | **(1,824)** | **(1,293)** |
| **EPS** | **($4.23)** | **($3.93)** | **($12.94)** | **($14.86)** |

| CASH FLOW ITEMS ($Mn) | AMR | CAL | DAL | NWAC |
|---|---|---|---|---|
| Beginning unrestricted cash | $2,929 | $1,409 | $1,799 | $2,459 |
| **Net Income (Loss)** | **($682)** | **($263)** | **($1,824)** | **($1,293)** |
| + Depreciation & amortization | 1,180 | 392 | 1,258 | 528 |
| +/- Working capital | 0 | 0 | 0 | 0 |
| + I/S Pension expense | 390 | 235 | 700 | 500 |
| - Cash pension expense | (310) | (136) | (450) | (420) |
| **Net operating cash flow** | **$578** | **$228** | **($316)** | **($685)** |
| - Non-aircraft capex | (400) | (175) | (375) | (100) |
| - Aircraft capex | (460) | (45) | (570) | (400) |
| + Aircraft back-up financing | 345 | 20 | 563 | 300 |
| - Debt & capital lease payments | (807) | (688) | (758) | (601) |
| + Debt issued | 0 | 425 | 675 | 291 |
| + Asset sales | 0 | 23 | 200 | 160 |
| +/- Other | 350 | 300 | 0 | 0 |
| **Ending unrestricted cash** | **$2,535** | **$1,497** | **$1,218** | **$1,425** |

Source: JPMorgan estimates and company reports.

**AMR**
- We assume AMR raises incremental $350 mn in capital in '05 although not necessary

**CAL**
- We assume CAL would need to raise an incremental $300 mn in capital in '05 to reach mgt.'s $1.5 bn YE05 target
- $425 mn of debt issued includes $75 mn of OnePass and $350 mn of Air Mike deal in 2Q05.

**DAL**
- $875 mn of capital raised in '05 includes $295 mn of Amex draw in 1Q05, estimated $300 mn GE second lien in 2Q05, estimated $80 mn other debt raised in 3Q05 and estimated $200 mn asset proceeds in 3Q05

**NWAC**
- Estimated $450 mn of capital raised in '05 debt issued includes $118 mn Pinnacle note in 1Q05, $101 mn Tokyo real estate deal in 2Q05 and estimated $160 mn from asset sales.

**Our bankruptcy probabilities are largely shared by the market**
By looking at credit market implied cumulative default probabilities (a more accurate analysis, in our opinion, than relying on equity values), the market ascribes between a 55% and 59% probability that Northwest and Delta will file bankruptcy within the next 12 months. Implied one-year risk for American and Continental, arguably two better-positioned carriers, is significantly lower, though their implied bankruptcy probability over the next four years remains in the mid-to-high 50% range.

Exhibit V: Credit Market Implied Cumulative Default Probabilities

**Cumulative Default Probability Before Time Period Expires**

| | 1-year | 2-years | 3-years | 4-years | 5-years | 7-years | 10-years |
|---|---|---|---|---|---|---|---|
| AMR | 12.5% | 29.1% | 45.2% | 57.1% | 61.1% | 69.9% | 80.0% |
| CAL | 14.6% | 30.5% | 44.4% | 54.9% | 64.6% | 72.3% | 82.0% |
| DAL | 59.0% | 75.6% | 80.1% | 85.0% | 87.8% | 93.9% | 97.8% |
| NWAC | 54.7% | 71.1% | 73.8% | 80.8% | 84.0% | 91.8% | 96.6% |

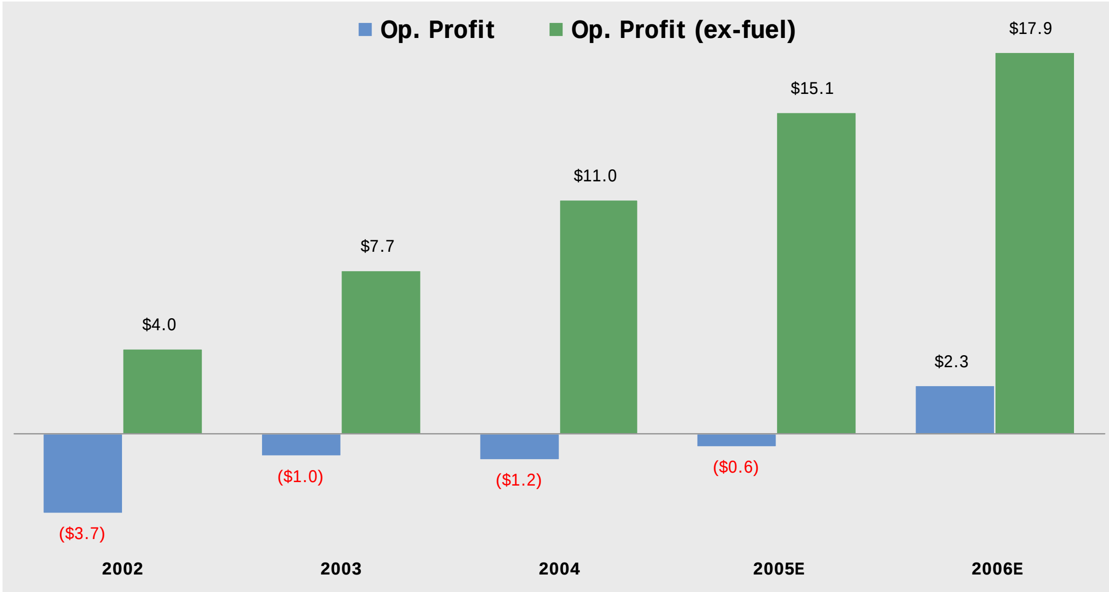
Source: JPMorgan, based on 8-July-05 credit default swap quotes assuming 10% recovery in bankruptcy

**Can the airlines raise additional capital?**
As of late, legacy airlines have been turning to non-traditional lenders. Delta has pre-sold frequent flier miles forward to American Express and tapped General Electric for a securitized loan. Continental recently sold miles forward as well and borrowed against its last major unencumbered assets (Air Micronesia, its Guam-based operation).

It remains to be seen whether or not other vendors and manufacturers are willing to invest further in their airline partners. Nevertheless, the proposed America West /US Airways capitalization includes proceeds from Airbus, hedge funds, traditional money managers, and an airline maintenance provider (Air Canada). Therefore, we can conclude that the legacy airlines could perhaps tap some of these same sources for additional liquidity, especially if pension reform positively impacts the credit standing of the legacy airlines.

Exhibit VI: Ex-fuel profitability should continue to rise quickly

**Industry operating profit ($ billions)**




Note: **Based on U.S. non-regional Equity Research coverage universe (ie. excludes UAL & UAIR).**
Source: Company reports and JPMorgan estimates.

**Will pension reform force additional legacy airline Chapter 11 filings?**
Under some pension reform proposals, the airlines that sponsor defined benefit plans will face incredibly onerous payments. Relative to the 2005 required minimum contribution of $450 million, Delta has disclosed that its projected minimum funding under the current rules will increase by 33% in 2006 to $600 million, by 111% in 2007 to $950 million, and by 255% in 2008 to $1.7 billion. For Northwest, they are estimating $800 million in 2006, and $1.7 billion in 2007.

For this reason, both Delta and Northwest are likely to seek Chapter 11, and follow the damaging precedent set by United Airlines in terminating its defined benefit plans. This unless a rapid decline in fuel costs or reform allowing for a longer-term amortization of deficits for sponsors agreeing to freeze DB plans comes into law, sometime within the next six months or so.

Continental is not as exposed to rising payments given the nature of the airline's defined benefit plan relative to Northwest and Delta. Nevertheless, the combination of the current oil price environment, current industry revenue, and higher required pension payments could force Continental to consider Chapter 11 as well in 2006.

AMR has enough liquidity-raising options and current liquidity to perhaps bridge the gap between today's environment and one where industry revenue and stock market improvement make required pension payments more manageable.

The issues surrounding credit balances and annual premiums, while important, are secondary to both the length of the amortization period and the interest rate to value liabilities in the cases of Delta and Northwest.

For AMR, the interest rate assumption and premium payments are most critical given the company's and its workers' desire to maintain defined benefit plans rather than the freezing approach embraced by Delta and Northwest management.

UAL is AMR's largest competitor. Although UAL's replacement defined contribution plan costs are significant, I nonetheless am concerned that AMR (and other legacy majors) will be at a strategic disadvantage to UAL going forward because of UAL's successful elimination of its defined benefit plans.

**Multiple bankruptcies are by no means inevitable**
Legacy Chapter 11 filings, with their accompanying toll on workers and expected service declines to smaller communities, are not inevitable, in our opinion. Legacy airline managements would much prefer to avoid the process, and instead remain concentrated on the task at hand - further reducing their competitive disadvantage versus the more youthful and fit, those airlines that have sprung up since airline deregulation. Their ability to succeed, however, is largely predicated on favourable airline specific pension reform and/or sharply lower energy prices.

Should the government afford defined benefit sponsors the flexibility to stretch payments out over a period of several years, the sponsors must be forced to maintain fiscal discipline. Such discipline should include, though not be limited to, restrictions on the ability to repurchase stock, pay dividends, or offer increased defined benefits even if funded with cash.

Exhibit VII: Pension reform/stock market rally <u>needed</u> for legacy survival

**US major airlines operating profit/(loss), $Bn**

| | PBO | | | Fair Value of Plan Assets | | | PBO % Funded | | | Underfunded Amount | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| CAL | $2,863 | $2,362 | $2,059 | $1,281 | $1,280 | $866 | 44.7% | 54.3% | 42.1% | $1,582 | $1,079 | $1,193 |
| NWAC | $9,254 | $8,554 | $7,638 | $5,425 | $4,806 | $3,690 | 58.6% | 56.2% | 48.3% | $3,829 | $3,748 | $3,948 |
| AMR | $10,022 | $8,894 | $8,757 | $7,335 | $6,230 | $5,323 | 73.2% | 70.1% | 60.8% | $2,687 | $2,664 | $3,434 |
| DAL | $12,140 | $12,477 | $11,682 | $6,842 | $6,818 | $6,775 | 56.4% | 54.6% | 58.0% | $5,298 | $5,659 | $4,907 |
| UALAQ | $13,577 | $13,117 | $12,673 | $7,152 | $6,961 | $6,298 | 52.7% | 53.1% | 49.7% | $6,452 | $6,156 | $6,375 |

| | Discount Rate | | | Expected Rate of Return | | | Actual Plan Return | | | Minimum Payments* | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 | 2005 | 2006 | 2007 |
| CAL | 5.75% | 6.25% | 6.75% | 9.00% | 9.00% | 9.50% | 8.8% | 25.2% | -12.0% | $266 | $360 | $450 |
| NWAC | 5.90% | 6.75% | 7.50% | 9.50% | 9.50% | 10.50% | 15.0% | 28.2% | -12.5% | $420 | $800 | $1,700 |
| AMR[1] | 6.00% | 6.25% | 6.75% | 9.00% | 9.00% | 9.25% | 17.8% | 23.8% | -0.3% | $310 | $600 | $800 |
| DAL | 6.00% | 6.125% | 6.75% | 9.00% | 9.00% | 10.00% | 12.0% | 14.6% | -8.7% | $450 | $600 | $950 |
| UALAQ[2] | 5.84% | 6.25% | 6.75% | 9.00% | 9.00% | 9.75% | 12.1% | 22.2% | -9.3% | TBD | TBD | TBD |

* Without pension reform.
Source: JPMorgan and company reports.
1. AMR 2006/2007 minimum payments are estimated.
2. UAL's 401K/defined contribution costs are far from $0 and may total >$200 million per annum.

## Conclusion

If the proposed pension legislation <u>not</u> supported by the legacy airlines is passed into law, we agree with the market that near-term Chapter 11 filings become significantly more likely. Put differently, certain airlines are likely to pursue a United-type strategy, whereby the PBGC shortfall will increase and taxpayers and plan participants will suffer as a result. Alternatively, pension reform that does not result in onerous near-term deficit reduction contributions would likely materially diminish bankruptcy risk from non-fuel related issues, and otherwise allow carriers the chance to make good on promises already made to employees, while further protecting taxpayers and stakeholders in the process.

Thank you once again for allowing me to speak to you today.