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May 7, 2008 Industry Update

USA
Airlines

Airlines

Presentation to Senate Aviation Subcommittee

- On May 7, Ray Neidl presented to the Senate Committee on Commerce, Science and Transportation Aviation Subcommittee on airline mergers and the state of the industry.
- The commercial aviation industry is becoming more global, whereby larger and financially stronger players will eventually dominate. This is already happening in the European Union (EU) which is treating the area as one market enabling its airlines to consolidate and become more efficient. The rapidly growing Asian economies welcome outside investment to help support and drive growth for their airlines.
- U.S. network airlines will find it tougher to compete in a more global and efficiently run industry unless they are allowed to gain market mass, obtain further cost efficiencies and increase their ability to enhance revenue generation so that they will attract capital investment. Although foreign carriers are not able to compete in the U.S. domestic market, network carriers are facing increasingly aggressive competition from low-cost carriers in this sector, thereby effectively squeezing network carriers from both sides.
- Mergers will not solve all of the industry problems. In fact, airline mergers in the past have proved to be relatively expensive and inefficient in the initial years. There is a major risk that there could be widespread disruptions in service if more than one merger is being implemented at the same time.
- However, properly planned and implemented, especially with the cooperation of the employees, mergers could produce stronger and more competitive entities long-term. Stronger airlines would not only be beneficial but are a necessity to properly serve travelers and give job assurance to employees, to say nothing of attracting strategic investors.

The industry has done a commendable job in rationalizing capacity and reducing non-fuel costs since 9/11. Employees have contributed by easing work rules and accepting reduced compensation while airline managements have thoroughly reviewed their systems to increase efficiencies. More can be done but there are limitations. As oil prices exceed $110 a barrel, something has to be done to further rationalize the overall structure of the industry. Without a major rationalization of capacity, slim profit margins will disappear, which will make it difficult for U.S. network carriers to modernize their fleets to stay competitive with foreign airlines that have been rapidly upgrading their fleets with new technology-driven, cost-efficient aircraft. This will hurt U.S. network carriers in the long run and ultimately have a negative effect on aircraft manufacturers and their many suppliers across the U.S. and worldwide.

Summary of Testimony May 7

As the industry moves towards globalization through trans-border mergers, foreign carriers will become tougher competitors for U.S. based network airlines. They are gaining market mass and are structuring themselves to gain in financial strength. Size in many cases also can mean stronger pricing ability since a broader scope of services can be offered in the international arena.

U.S. network carriers are facing pressure from start-up low-cost airlines

Domestic markets are currently closed to these growing foreign giants but the U.S. network carriers are facing pressure in these markets from start-up low-cost airlines that have newer more efficient fleets, a lower wage cost structure and greater flexibility in adjusting their operations. They can cherry pick the best routes.

Since 9/11, the U.S. network airlines have done a commendable job in restructuring themselves to be more competitive but in light of $110+ a barrel oil prices, future progress will now be limited. The workers have given all they can and though further restructuring can be done, all the easy fruit has been picked.

We have too many airlines offering too many seat miles

With exit barriers high as a result of U.S. bankruptcy law and entry relatively easy through deregulation, the U.S. airline industry has reached the point where we have too many airlines offering too many seat miles where the costs cannot be recovered through pricing as the multitude of airlines fight for market share to preserve their systems and obtain a certain market mass and service footprint. Because of strict anti-trust laws, airlines cannot coordinate operations or pricing even through their partnership agreements.

Excess capacity and competition has led to weak operating margins and profitability even in the upper part of the economic cycle. With fuel costs skyrocketing, the industry is now due for a major fall again as we enter the down part of the cycle, whether it is this year or sometime further down the road. Weak profitability and balance sheets will lead to a crisis at some point.

The industry will have to restructure one way or the other

The industry will have to restructure one way or the other, either through the relatively organized regulatory oversight of mergers or in the more risky and disorganized guise of bankruptcy, which may lead to certain airlines having to liquidate. It probably would be better for all parties concerned, the consumer, employees and investors to go with the former rather than the latter.

Industry consolidation that leads to larger carriers will not solve the industry problems by itself and mergers pose their own set of challenges and problems, particularly in the labor area. However, to remain competitive in an industry that is becoming more international and globalized, greater market mass and financial strength will be needed by the U.S. network airlines. Part of the market mass requirement is being met currently through worldwide alliances but that is not the same as the same airline being able to control the passenger for the whole trip.

Besides greater market mass, the two other benefits of consolidation would be cost cutting and revenue enhancement

Besides greater market mass, the two other benefits of consolidation would be cost cutting and revenue enhancement. To cut costs, marginal operations and smaller expensive hub operations would have to be evaluated as to their viability which will have an affect on communities they currently serve. However, if service is justified, other airlines or niche carriers would move in if the hub was abandoned. If not economical to serve certain small communities but service was deemed essential, it would be up to public entities such as local, state or national government to subsidize the service and not the airlines and their investors. These situations should be rare, however, since a host of lower cost airlines could probably profitably service these areas. The other benefit would be revenue enhancement. The first thing that comes to mind is higher ticket prices if there are fewer competitors. Higher ticket prices are needed and justified. With over $110 a barrel oil, the consumer is not paying their way and airlines cannot continue to subsidize them. However, revenue enhancement would also include the additional revenues that larger carriers could generate through a greater scope of services offered.

A major risk with multiple consolidations going on at the same time is that there could be widespread service problems initially as integration takes place. It has been demonstrated in past mergers that major service disruptions are possible, if not probable, in the initial stages of the complex integration process. If there were two major mergers taking place at the same time, the problem would be compounded over the nation's commercial aviation system.

Bottom line, as much as we do not want to hear this, airlines are not meeting their cost of capital or in fact their operating costs despite the major efforts by the carriers to control costs and increase efficiencies. Fuel, largely non-controllable in the short-term, is knocking out hard-won benefits and at some point fresh capital going into money-losing propositions will dry up.

Conclusion

The industry in its current fragmented form cannot sustain profitability

There are major doubts if the industry can remain viable over the economic cycle with oil over $110 a barrel if there are not major structural changes. The industry in its current fragmented form cannot sustain profitability under these circumstances. Through consolidation, the industry will be in a better position to rationalize capacity, further cut costs and enhance revenues since they will better be able to price their product at economical levels to earn a return on capital. Without profits the industry will ultimately have to shrink. A more efficient industry will be beneficial not only to investors and attract capital but will give employees job security and ultimately be beneficial to customers since profitable airlines will better be able to serve the consumer.

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