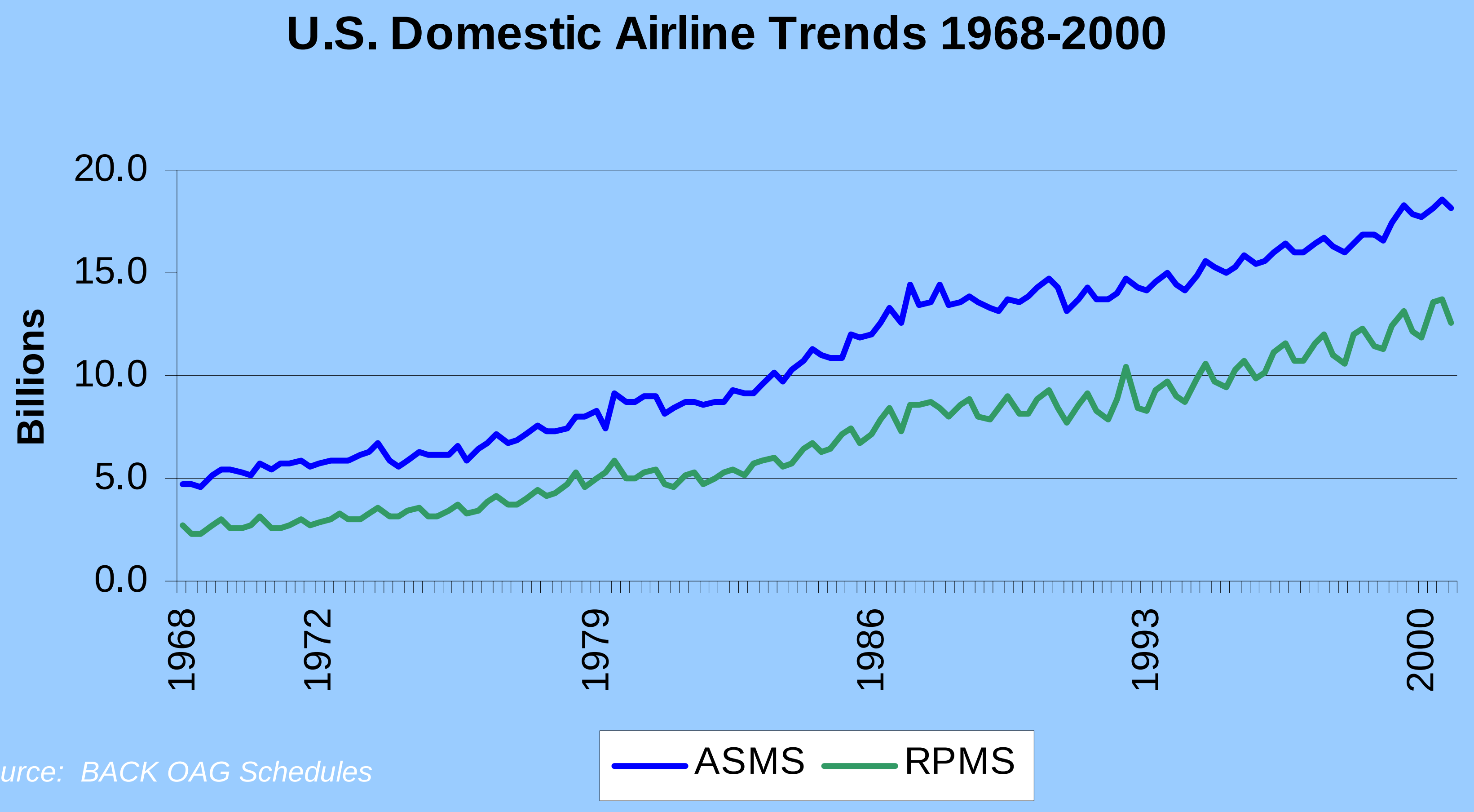
Since 9-11

By
Darryl Jenkins
George Washington University

The Airline industry

- Cyclical and seasonal
- High fixed costs
- A robust economy is an airline's best friend
- Pricing issues
- Capacity
- Labor
- Long term structural problems
- New entrants
- Smaller communities
- Future considerations

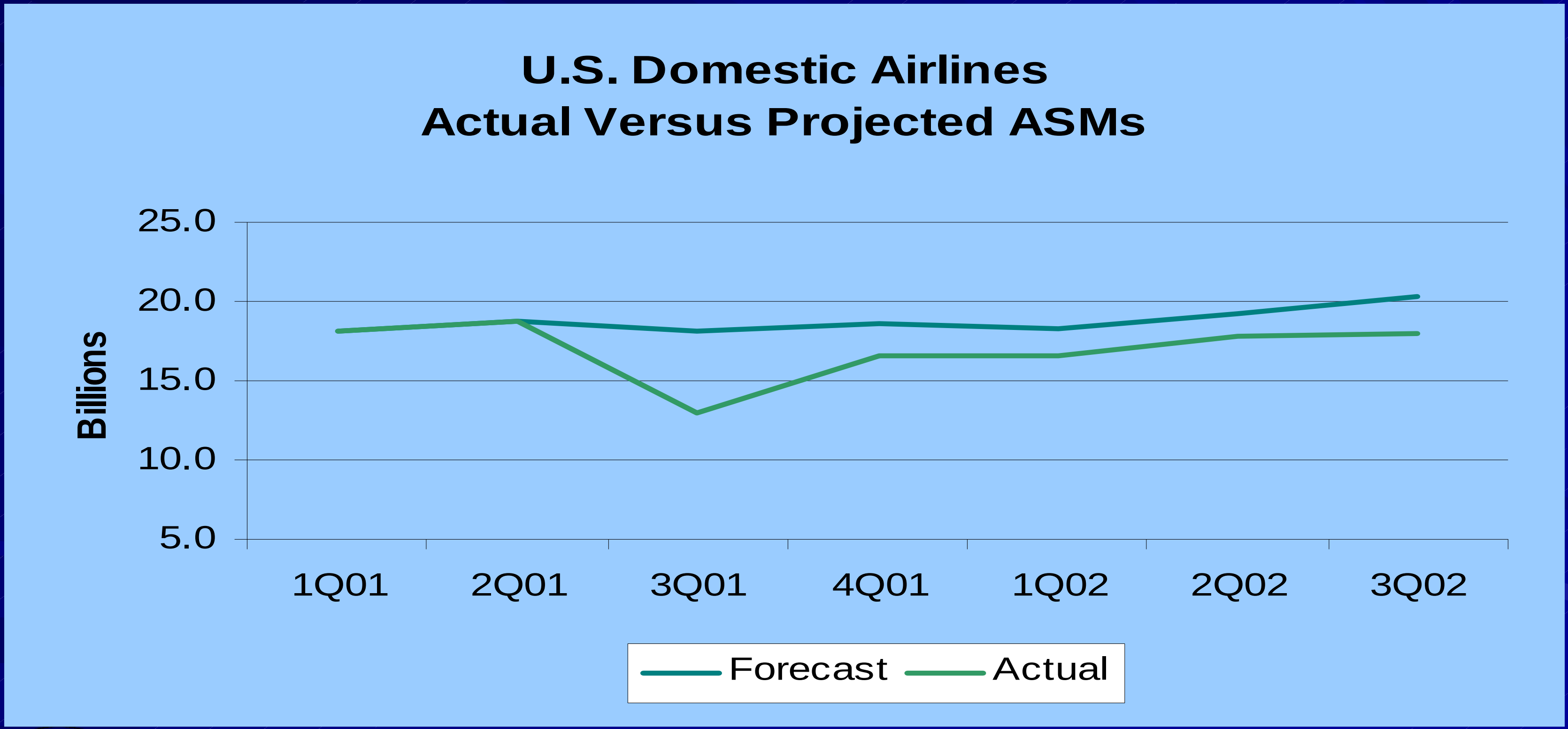
Cyclical and seasonal



Source: BACK OAG Schedules

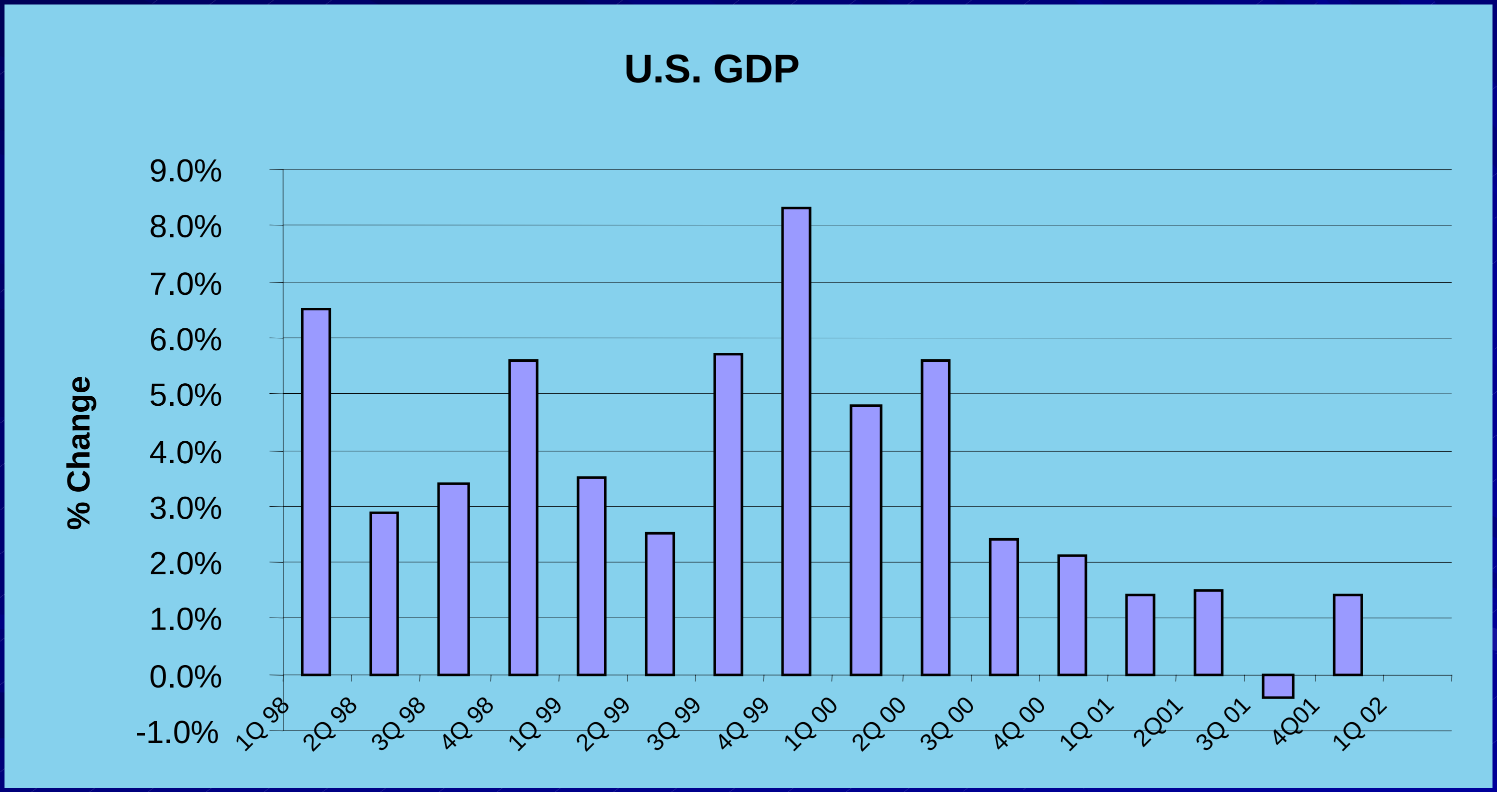
Capacity

- Capacity levels returning to typical recession levels



Capacity

- U.S. economy was headed into recession before 9-11



High fixed costs

- What percent of a major carrier’s operating costs are fixed?
- During a very good year (1998), how many passengers’ fares per flight went to the bottom line?

High fixed costs

- Depending on the carrier, fixed costs range from 60 to 70 percent of total operating costs.

High fixed costs

- Only one passenger's fare per flight goes to the bottom line.

High fixed costs

- Given the nature of fixed costs, the only short term method of reducing costs is to cut capacity, but losses will continue and will be large since lease costs remain even when the planes are parked.

High fixed costs

- High load factors will not bring about profitability, but they will minimize losses.

A robust economy is an airline’s best friend

- Business travelers’ income elasticity is 1.35 when annual GDP growth is between 2 and 3.5.
- Above 3.5 percent GDP growth, income elasticity nears 2.0 for business travelers.
- The income elasticity of demand for leisure travel is always higher than that for business.

A robust economy is an airline's best friend

- Historically, GDP has also been positively related to business fares, and less so to leisure fares.
- It is very difficult to raise leisure fares except when loads are above 70 percent and GDP growth rates are above 3.5 percent.

Pricing issues

- During the current downturn, walk-up fares have not decreased.
- Leisure fares have gone down significantly, though the decrease varies by market.

Pricing issues

- Why haven’t walk up fares gone down?
  - Fears of price wars.
  - Fears of losing revenue.
  - A general lack of knowledge of income elasticities.

Pricing issues

- What is the pricing outlook if GDP gains some steam this year?

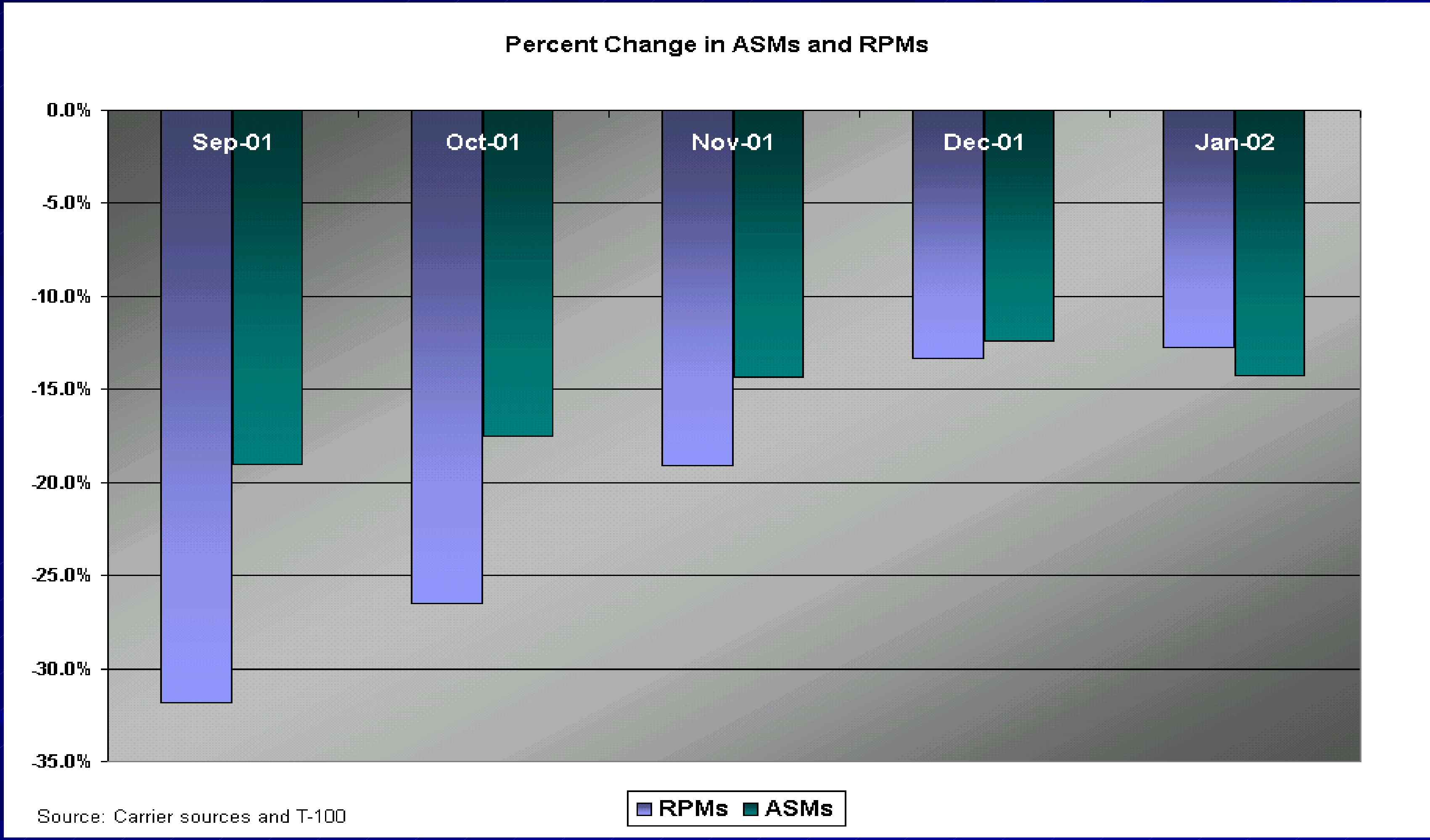
Pricing Issues

- With walk-up fares at all-time highs, will they increase even more?
  – It will be very difficult to get fare increases in the premium fare classes.
  – However, if capacity is reduced, then the revenue picture will improve greatly.

Capacity

- Airlines initially cut capacity drastically.
- This was followed by a policy of encouraging a return to travel.
- As load factors have increased, we see a decline in the year-over-year level of capacity cuts.

Capacity

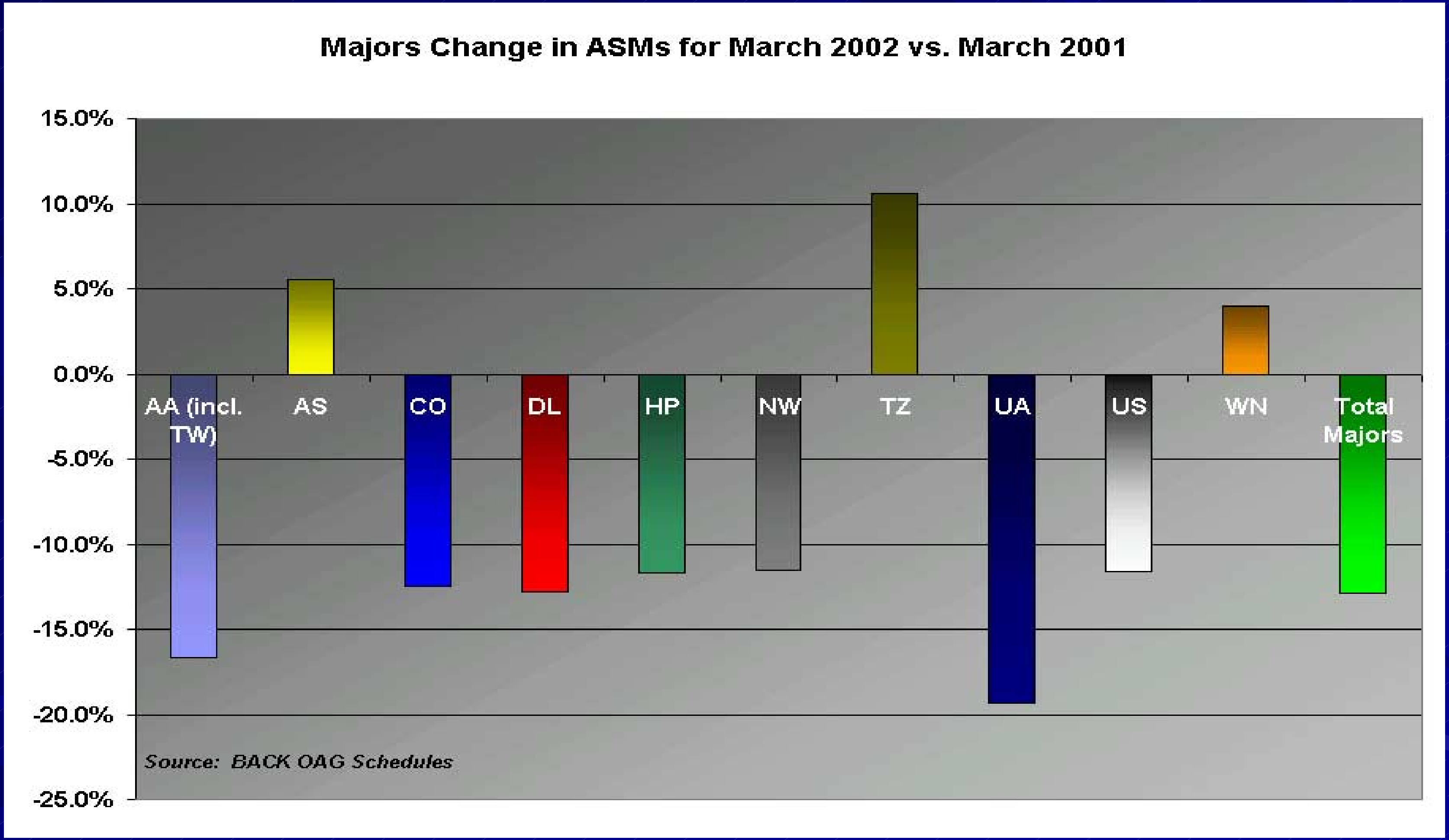


Percent Change in ASMs and RPMs
0.0%
-5.0%
-10.0%
-15.0%
-20.0%
-25.0%
-30.0%
-35.0%
Sep-01
Oct-01
Nov-01
Dec-01
Jan-02
RPMs
ASMs
Source: Carrier sources and T-100

Capacity

- Capacity decreases differ greatly among the majors.
  - American Trans Air and Southwest recorded year-over-year capacity increases beginning in October.
  - Alaska is also faring well.
  - United’s capacity cuts remain the deepest -- 19.3 percent lower than March of last year.

Capacity



Majors Change in ASMs for March 2002 vs. March 2001
15.0%
10.0%
5.0%
0.0%
-5.0%
-10.0%
-15.0%
-20.0%
-25.0%
AA (incl. TW)
AS
CO
DL
HP
NW
TZ
UA
US
WN
Total Majors
Source: BACK OAG Schedules

Capacity

- Low fare airlines' March ASMs reflect continued growth.
  - JetBlue is flying 51 percent more ASMs than in August 2001.
  - AirTran is up 12.1 percent.
  - Frontier has a moderate 1.5 percent gain.

Labor

- Pilot scope clauses are limiting RJ deployment and resulting in turboprop cuts
  – American parks three turboprops for every RJ delivered;
  – United parks one turboprop for every RJ delivered

Long-term structural problems

- The growing disparity between the cost structures of the low cost airlines and the network carriers.
- Within five years, Southwest will be the largest carrier of domestic passengers in the United States.
- AirTran, JetBlue and other well managed carriers will eat the major's lunch on the East Coast.

Long-term structural problems

- Did the industry make a major mistake by going to Congress for relief?
- All long-term pressure to restructure was postponed.

New entrants

- Scope clauses are the biggest incentive to new entrant carriers.
- In the past, new entrants followed the ValuJet model.
- JetBlue raised the standards for the type of aircraft used and management.
- Most of the Eastern and Pan Am retreads are gone forever.

New entrants

- There will probably be fewer new entrants than in the early 1990s, but they will be better financed and hopefully better managed.
- New entrants have most always forgotten smaller communities.

Smaller communities

- The biggest problem going into the next decade will be service to smaller communities.

Future considerations

- Operations
  - – Government and private perspective.

This presentation is available at

www.backaviation.com