The US major carriers have collectively reduced their annual operating costs by $15 billion. They expect to make further cuts to take this to $25 billion. Although yields and unit revenues are strengthening, oil and fuel prices are high, and the industry is predicted to make a loss of $1-2 billion.

Are the US majors making headway?

Staggering since 2000 from repeated blows to their business models, the US major carriers have nevertheless managed to stay afloat, partly by cutting billions of dollars of expenses. Despite their successes in the labour arena, their jet fuel costs have grown alarmingly and it is likely that they will remain high. Have the US majors already done enough to ensure their survival, or do they need to do more?

Financial position

It is a stark fact that in the five years to the end of 2005, the major US airlines accumulated a combined net loss of $43 billion. In 2005, a year for which they had originally had strong hopes, they added a $10 billion combined net deficit to the $32 billion-plus net loss they had accumulated at the end of 2004.

At one point or another in 2005, four of the seven largest US airlines were operating under the protection of Chapter 11 bankruptcy. A fifth, smaller carrier, ATA Airlines, also kept operating only by the grace of the bankruptcy court (the airline completed its bankruptcy reorganisation at the end of February 2006). Two of the largest US legacy carriers, Delta and Northwest, will remain under Chapter 11 protection until at least 2007.

Although US Airways emerged from bankruptcy in the last quarter of 2005 to merge with America West to form a new, potentially huge low-cost carrier, many industry insiders are sceptical about their chances of success.

United Airlines, which completed its reorganisation in February 2006, has based its expectations of future profitability on the premise that crude oil prices will settle down to $55 or less a barrel. With crude oil exceeding averages of $65 a barrel in the early months of 2006, and experts forecasting that oil prices will pass the $70 per barrel mark, and remain high throughout the foreseeable future, United's new business plan looks rather optimistic.

Signs of hope

The legacy majors' future has been extremely bleak for the past five years, and they still face great uncertainty. There are some hopeful signs, however. Analysts at J P Morgan noted that in September 2005 the legacy carriers achieved a rolling 12-month combined operating profit of $15 billion. They achieved this after succeeding in cutting what the US Air Transport Association (ATA) estimated was the same amount in annual costs. By the end of 2005, the US airline industry had recorded a $22 billion operating profit, which excluded fuel costs, however. Including fuel costs, the analysts' calculations showed that the US airline industry posted an operating loss of $1.8 billion in 2005.

This may not sound encouraging, but it is important to note that while the ATA member carriers made a combined $10 billion net loss in 2005 (including $4 billion in interest costs to service their accumulated debts), John Heimlich, the ATA Chief Economist, says that US airlines' fuel bill increased by $10 billion last year. Had jet fuel prices not averaged over $72 a barrel throughout the year, shooting up briefly to a peak of more than $130 on the hurricane-ravaged Gulf Coast, but had stayed the same as the $50 average in 2004, the US airline industry might have broken even on a net basis.

A break-even net performance in 2005 would have been an astonishing achievement, given the legacy network carriers' massive debt burdens. Including off-balance-sheet debt and mainly capitalised aircraft operating lease rentals, US airlines were in debt by more than $100 billion by the third quarter of 2005, $29 billion more than in 2000, Heimlich says. The two biggest majors, American and Delta, each had over $20 billion of debts on a capitalised basis, and Northwest nearly as much. Even bankruptcy-reorganised United retained about $14 billion of debt, if capitalised lease rentals are included.

Achievements

However, by the end of 2005 the seven largest US network carriers, American, United, Delta, Northwest, Continental, US Airways and America West (these last two not yet combined into one), had cut their operating cost disadvantage against Southwest Airlines from 6 cents to 2, according to BACK Aviation Solutions' chief operating officer, Michael Allen (The comparison is not adjusted for stage length).

The major carriers have made $15 billion in cost reductions, with United, once the most bloated of the seven, slashing $7 billion all by itself. This was enough to bring down their average cost per available seat mile (CASM) from 14 cents to 10, even taking into account their hugely increased fuel costs in 2005.

Bill McKnight, a senior vice-president at transportation consultancy SH&E, believes that there is still plenty more cost-cutting activity to come from the legacy majors. Delta is seeking $3 billion of additional cost cuts, over $2 billion of which its chief executive officer, Gerald Grinstein, says have already been assured now that Delta is under Chapter 11 protection. Northwest is demanding $1.4 billion more in concessions from its workforce and creditors. Meanwhile, American and Continental are seeking new reductions, and the merged America West and US Airways are shedding staff as they cut nearly 15% of their domestic capacity. A further trimming "in the $5-

The US majors have collectively reduced their annual operating costs by $15 billion. United, which remained in Chapter 11 bankruptcy protection for more than two years, contributed to $7 billion of this reduction.

$10 billion range is clearly not hard to do," says McKnight.

Source of cost reductions

So by the end of 2006, the US legacy network carriers may have succeeded in cutting more than $25 billion of costs in just six years - $10 billion in addition to the reductions made by the end of 2005. Where have the cuts been made? "For a start, the majors have created some efficiencies by revamping their hub operations," says McKnight. "Although there is 'clear evidence' that large hub carriers have significant revenue advantages over point-to-point airlines, the way the network airlines operated their hubs in the past made them quite inefficient in cost terms." The majors began fixing things by 'de-peaking' their hub flight-banks to improve aircraft utilisation, and pilot and cabin crew productivity.

Previously, aircraft arriving early in a flight bank waited around for dozens of other connecting flights to arrive, and all outbound flights in a bank departed from their gates within a short space of time. In addition to reducing aircraft and crew utilisation by extending downtimes, this practice created ramp, runway and airspace congestion and meant that aircraft were unnecessarily burning endless gallons of fuel during long taxis. Allen says that American led the de-peaking effort after recognising in June 2002 that its business model had become fundamentally flawed. American restructured its hub operations at Dallas/Fort Worth and Chicago O'Hare and dissolved the St Louis hub operation that it had inherited when taking over TWA.

"With improved aircraft utilisation fewer aircraft were needed, thereby reducing the majors' rental and capital costs," says McKnight. "At the same time the US majors outsourced revenue accounting, reservations and maintenance functions. Reservations became more automated as a result of internet booking, while the adoption of e-ticketing slashed travel agents' commissions, did away with the costs associated with paper tickets, and created staffing efficiencies in the airport terminal. Outsourcing of maintenance activities has also become common among the majors in recent

years, with Delta the latest to take the plunge. After senior managers and flightcrew, aircraft engineers and mechanics are the US network carriers' highest-paid employees.

Capacity reductions

Another significant source of cost reduction and revenue enhancement has been the US network airlines' moves to cut domestic seat capacity. Allen says that of the seven big network carriers, only Continental actually increased its domestic capacity in 2005, by 3-4%. The rest reduced their US domestic capacity from their mainline operations. Some, like Delta, reduced their capacity by double-digit percentages, and also transferred domestic routes and schedules to their regional partners.

Most of the majors have transferred spare domestic mainline capacity to shorter-haul international routes. Chapter 11-protected Northwest and Delta have also parked many older narrowbody aircraft. Northwest also chose to reject its leases on a sizeable number of A319s and A320s nearing major maintenance checks.

Vaughn Cordle, chief executive officer of Virginia-based economic consultancy AirlineForecasts, and a 777 captain and chartered financial analyst, notes that October 2005 represented a 'turning point' when, for the first time since mid-2003, total US domestic capacity fell. November and December 2005 saw the trend continue, and Cordle expects the majors to withdraw a further 5% of their domestic network capacity in 2006. Although domestic yields continued to fall in 2005, and ended the year 20% lower than they were in 2000, higher load factors and consistently increasing fares combined to improve unit revenue per available seat mile (RASM) by as much as 6.5% for the ATA member carriers. "Towards the end of 2005 the core network carriers saw their RASM levels climbing at double-digit percentages," says BACK's Allen.

Regional affiliates

A further source of cost savings available to the US network carriers should lie in re-negotiating the fee-per-departure agreements under which they contract capacity from their regional airline partners. "These deals have been so lucrative to the regionals that, in the US industry downturn following September 11th, these carriers became the most profitable in the country. However, United's success in contracting Mesa to provide United Express with capacity at an 8% operating margin, instead of the near-20% that was previously the norm, set the bar at a new level for all other agreements between major network carriers and their regional affiliates," says Cordle.

The results of United's success have included: Northwest's affiliate Mesaba Airlines filing for bankruptcy; Atlantic Coast Airlines fleeing the United Express stable to try its luck as a low-cost carrier with Independence Air, and subsequently ceasing operations; and Continental taking back 69 Embraer RJs from ExpressJet and telling its partner to cut its margins.

Further developments are likely and may lead to regional carriers parking large numbers of formerly profitable but suddenly uneconomic 35- to 50-seat regional jets. A tentative agreement in

Delta has made a reduction of several $ billion in its annual costs, but is seeking to cut costs by a further $3 billion. Delta recently negotiated a reduction of $280 million per year in salaries with its pilots union.

March 2006 between Northwest and its pilots for them to operate up to 90 51- to 76-seat jets in a new wholly-owned NWA subsidiary suggests that this is the probable future for existing regional carriers, such as Mesaba and Pinnacle, if they do not remain competitive when bidding for new contracts.

Labour cost reductions

These moves are linked closely to the majors' main cost-cutting activity: reducing labour costs. "In the 2001-2005 period the legacy network carriers laid off or furloughed over 160,000 employees," says Heimlich.

Labour cost reductions accounted for 70% of the $15 billion in savings that the US majors had achieved by the end of 2005. This reduction has come from staff lay-offs, productivity concessions, pension-plan and retirement-benefit freezes (or even rejections, by carriers in Chapter 11 bankruptcy), scope-clause changes, or straight wage cuts. Whereas labour costs represented up to 50% of the majors' entire cost bases in 2000 (when Delta was boasting that its pilots were the highest-paid in the industry, but the US stock market bubble was about to burst and domestic high-yield travel was on the verge of collapse), today, for example, labour accounts for just 20.7% of United's operating expenses. Before the big payrises awarded to pilots in the late 1990s, the norm had been around 35%.

"Delta paid its pilots an average of $209,000 a year in 2004 and its average total annual labour cost per pilot, including pension and retirement benefit costs, vacation time, training and miscellaneous costs, was $320,000," says Cordle. By 2005 Delta's renegotiation efforts had brought its average pilot salary down to $169,000. Delta recently negotiated further pilot salary cuts of $280 million as part of a further $1 billion labour cost reduction across its workforce. This will further reduce its average pilot salary.

United was paying its pilots an average of $200,000 a year before September 11th, but by 2004 its average pilot salary had declined to $129,000. Northwest, which was paying its pilots an average of $180,000 a year in 2004, wants to cut its average pay to $125,000 as it seeks to achieve $1.4 billion in additional cost cuts under Chapter 11 protection. America West's average pilot pay of $134,000 under its 2003 contract, and US Airways' $125,000 average in 2005, are now both below the $136,000 average that JetBlue pays its pilots.

Staff productivity

But staff productivity is important too. Recent J P Morgan figures show that at 3.2 cents, Southwest Airlines had the third highest labour costs per mainline ASM in the US industry in the third quarter of 2005, just below Northwest's 3.4 cents and American's 3.3 cents. However, by a number of measures, Southwest's workforce is more efficient than those of the legacy network carriers. Cordle notes that in 2000, when the industry average number of employees per aircraft was 110, Southwest's was 85 and United's was 170. Even though United has since obtained a massive productivity boost during its protracted Chapter 11 reorganisation to bring its employee-per-aircraft count down to 116 today, Southwest has now set the industry bar at 72.

"Southwest's network is also more efficient than all other US airlines' mainline networks," says Allen. The average number of domestic routes that Southwest operates per airport it serves is more than six and the figure for the next-highest carrier is fewer than three.

Net interest costs are another huge consideration: Southwest owns most of its aircraft and has little debt, while legacy majors lease most of their jets and have huge debt costs. Cordle notes that while the new US Airways' operating costs are about 30% higher than Southwest's, if net interest costs are taken into account US Airways' costs are actually 58% higher.

Employee pensions

The Chapter 11 bankruptcies of some US majors have helped the US airline industry make in-roads into another enormous area of labour cost: pension plans and retirement benefits. Traditionally, most US major airlines (except Alaska Airlines and Continental) offered entitled retired employees 'defined-benefit plans', under which each employee was entitled to receive a set level of pension payments. "However, the stock-market decline in the early 2000s caused investments in the majors' pension plans to lose much of their value, as a result of which the plans became under-funded," says Mark Kiefer, aviation consultant with economic and management consultancy CRA International. The struggling majors were unable to make either the top-up payments needed to fund these liabilities, or to fund their ongoing monthly employee contributions.

"By the end of 2004, the majors' pension plans were underfunded by $21.1 billion," says Kiefer. "A year before, their healthcare and other retirement benefit obligations on behalf of former employees had already grown to represent an additional $13.5 billion of liabilities. But the US government's Pension Benefit Guaranty Corporation (PBGC), which guarantees payments to a maximum of $45,000 a year to each employee belonging to failed pension plans owned by companies under Chapter 11 protection, had to take over United's pilot pension plan, which was about to collapse. Instead of the

Continental has one of the lowest unit costs and leanest cost structures of the US majors. Since 2001, it has consistently been one of the best performing major airlines.

$120,000-plus a year the company's plan was supposed to have paid each United pilot, the PBGC guaranteed only $28,800, the maximum level it provides for anyone retiring at 60, the USA's mandatory pilot retirement age.

Kiefer says the PBGC is now badly underfunded and could not support even one more failed large pension plan. The United pilots' experience has persuaded employee groups at other US majors to agree freezes for defined-benefit pension plans. In the future, new employees may well receive no pensions or health benefits, while employee members of existing plans will receive smaller pension benefits under 'defined-contribution' plans that will replace the defined-benefit plans. Over time, the US majors' pension and retirement-benefit liabilities should decrease.

The future

In Cordle's opinion, 2006 will be the best year in the current business cycle for the US legacy airlines. Yields and RASM performance are strengthening as the airlines keep cutting domestic capacity. Fares are expected to improve by a further 5% or more this year after a 1.3% average increase in 2005. The scale of the US airlines' revenue problem, however, is shown by an ATA calculation indicating that average US airline fares last year were 18% below 2000 levels.

Meanwhile, the majors continue to cut labour and other costs. Another $10 billion of cuts appears achievable, as Delta sets about cutting another 9,000 jobs and Northwest furloughs another 1,400 flight attendants and 400 pilots. Some analysts say the US industry could see a $29 billion operating profit this year, although this excludes fuel costs. On a net basis, Heimlich estimates that the industry will lose $1-2 billion in 2006.

He is predicting an industry-wide net profit for the US airlines in 2007, although fuel costs remain a huge unknown. However, ATA's forecasts that jet fuel will average more than $70 a barrel in the US this year appear to be an accurate prediction, and Cordle says that there is clear evidence that throughout the foreseeable future jet fuel costs will remain at today's levels of around $72 a barrel, equivalent to more than $1.90 a US gallon, including taxes.

One key piece of evidence is that OPEC has fixed its wholesale basket-pricing for crude to the $45-55 per barrel range. By the time that crude reaches US refineries, transport and other costs have added another $5-7 per barrel, so it is costing even the oil companies as much as $62 a barrel. The US Department of Energy forecasts the average price of crude oil per barrel in the US will be $63 in 2006 and $70 in 2007, while in early 2006 the New York Mercantile Exchange 12-month futures curve showed crude staying at $66-$68 a barrel.

To the cost of crude oil must be added the 'crack spread' between crude and jet fuel: the cost of refining crude into Jet A1 and distributing the fuel by pipeline to airports, plus the oil companies' profit margins. Historically $5-8 per barrel, the US crack spread has recently reached $15, partly because no new US refinery capacity has been built since 1978 and Gulf capacity is still down. "The crack spread should decrease but will remain about 2.5 times higher than in the past," predicts Cordle. "It could get higher if the USA experiences further natural disasters or refinery accidents."

Heimlich says that should the US economy start slowing down later this year, as many economists now predict, slower GDP growth in 2007 would help bring jet fuel prices down. He expects ATA members to reduce domestic capacity by about 4% this year, given that their schedules for the first seven months of 2006 show domestic capacity down by 4.2%. However, it is clear to Cordle and Kiefer that even in the height of the upswing the majors are not making enough money to repay the huge debt loads that are costing them billions in interest. "A modest profit in the next few years is not good enough," says Kiefer. The US legacy carriers have to be able to repair their balance sheets and cover their capital costs to stay in business.

"This situation suggests that a second round of restructuring among the major US airlines will take place after this business cycle peaks. The longer the price of crude oil stays above $60, the more likely it is to happen," says Cordle. "The next round of restructuring, perhaps not far away, would involve liquidations or mergers between legacy network carriers." Cordle has performed detailed studies showing that the best combinations, from an overall business perspective, would be for United to merge with Continental, Delta with Northwest (they are already code-share partners) and American with Alaska, which are also existing code-share partners. Delta and Northwest have denied they are contemplating a merger. But Cordle says if they did propose a deal the political case for allowing it would be strong, since both carriers would meet the failing company doctrine required for the US government to allow an otherwise anti-competitive combination.

Kiefer believes that if the US majors fail to repair their balance sheets during the current upturn then the US government will be forced to allow foreign investors to take proportional shareholdings in US airlines higher than the 25% stake that the law now allows. Although many members of the US Congress are fighting hard to prevent a change in the rules, Kiefer feels that this is inevitable as the majors' balance sheets become ever more vulnerable to sudden upsets. For the US legacy network carriers the future may seem to be getting brighter, but dark clouds continue to gather overhead. AC