Fortune returns to the US market

Following five years of huge losses, US carriers are feeling the benefit of their cost reduction & restructuring programmes. USAirways achieved the highest operating margin of any major carrier in the second quarter.

The majority of major US airlines have finally returned to respectable levels of operational profitability, despite fuel prices reaching a record high of $2.00-2.30 per US Gallon (USG). Airlines recorded some of their best operating margins in the second quarter of 2006 since the terrorist attacks of September 2001. The four largest low-cost carriers in the US have also seen their financial performance improve.

Delta Airlines, Northwest, American, Alaska, Continental, United and USAirways (now including America West) all reported respectable operating margins *(see table, page 6)*. Moreover, all of these airlines are predicted to report positive operating margins for the whole of 2006 and 2007, even though the record high fuel price is expected to persist until the end of 2006 and then reduce only slightly during the following year.

The improved operating performance of the US majors has followed a similar pattern for each carrier. The main factors behind this return to profit are: improved passenger demand that has strengthened fares and yields; higher load factors; and cost reductions. Higher passenger demand and yields have benefited all US airlines.

Most airlines have succeeded in reducing their costs, and this trend has managed to offset the rise in fuel prices that has continued throughout 2005 and the first half of 2006. The average price of fuel paid by US majors was $1.20-1.30 per USG during 2004, but this increased to $1.75-1.80 during 2005. The price of oil rose substantially during April 2006 and recently reached a peak of $75-80 per barrel, resulting in a jet fuel price of $2.0-2.3 per USG. Oil has recently come down to about $70 per barrel, which is equal to a jet fuel price of about $1.85 per USG.

American Airlines

American was one of the first US majors to implement a cost reduction strategy after 2001, which has been largely achieved by keeping the airline's unit costs, excluding fuel, almost constant since 2004. American's total capacity also remained little changed in 2004 and 2005, and total available seat miles (ASMs) for 2006 are expected to be almost identical to 2004. This static capacity is also expected to be maintained throughout 2007.

American's experience of rising fuel costs is typical. Average fuel price was $1.21 in 2004 and equal to a total expenditure of $4.0 billion. Fuel price rose to $1.74 per USG in 2005, thereby taking total expenditure up to $5.7 billion. This $1.7 billion higher fuel bill accounted for most of the airline's $2 billion rise in costs from 2004 to 2005. American's traffic also increased by 6.3%, and was accompanied by higher load factors that resulted in higher unit revenues. The overall effect was for total revenue to increase marginally higher than costs, reducing the airline's operating loss to $94 million for the year. This was respectable given that the carrier was having to pay $1.7 billion more for fuel.

The same overall trend has continued in to 2006, with traffic, passenger load factor and yields all increasing. Traffic volume for the three months to June 2006 was up by 3.0% on the same period in 2005, and revenue was up by 12.5%. Costs were up by 8.2% and $420 million, with fuel itself 26.5% and $350 million higher than the year before. Overall, the airline generated an operating margin of $476 million, a margin of 8.0% of revenue.

Traffic will continue to be allowed to increase as capacity is held more or less constant for the rest of the year. Revenue is expected to reach $23.2 billion for the whole of 2006, with revenue passenger miles (RPMs) being about 8.6% higher than they were in 2004, and load factors increasing by 6.1 percentage points over the two-year period.

Despite maintaining constant capacity, annual costs are forecast to reach about $22.07 billion for 2006: $3.28 billion higher than for 2004. American is nevertheless forecast to generate an operating profit of $1.16 billion for the year: an operating margin of 5.0%.

The fuel price is forecast to be $2.18 per USG for 2006, compared to $1.21 per USG in 2004. This will result in American bearing an almost $3.0 billion higher fuel bill for 2006 compared to 2004. This higher fuel price accounts for virtually all of the carrier's overall cost increases over the past two years, with most other costs being held constant. This not only indicates how well American has managed to widen the gap between revenues and most costs, but also how strong its operating performance would be with lower fuel prices.

Average fuel prices are forecast to decline marginally in 2007 to about $2.0 per USG, while American's traffic volume may decline by one or two per cent. Nevertheless, the airline is forecast to make a margin of $1.45 billion, equal to 6.2% of revenue. This is derived from total revenues of $23.3 billion and costs of $21.83 billion; with RPMs and size of operation just 0.5% higher than 2004. Fuel accounts for $6.45 billion of this forecast annual cost, and is $2.48 billion higher than 2004. Again, this illustrates the operating performance that American could expect if fuel prices were at 2002-2004 levels.

Continental Airlines

Continental is another carrier that has managed to keep its unit costs excluding fuel more or less constant since 2004. Unlike American, however, Continental has continued to add capacity over the past two years.

Continental was one of the first US majors to benefit from strengthening demand, and RPMs grew by 8.4% from 2004 to 2005. The airline has allowed traffic to continually outpace the rise in capacity, resulting in an increase in passenger load factor from 77.6% to 82.9%. Combined with higher yields, unit revenues have gradually increased and widened the gap between revenue and costs and allowed Continental to

US AIRLINES SECOND QUARTER 2006 OPERATING RESULTS

Airline	Alaska Air	American Airlines	Continental Airlines	United Airlines	USAirways
RPMs millions	4,626	36,857	20,633	30,743	16,148
ASMs millions	5,834	44,600	24,885	36,191	19,635
Load factor-%	79.3	82.6	82.9	84.9	82.2
Revenue $ million	873	5,975	3,507	5,113	3,191
Costs $ million	793	5,499	3,263	4,853	2,849
Fuel cost $ million	200	1,708	791	1,250	658
Operating profit $ million	80	476	244	260	342
Unit revenue (RASM)	12.18	11.82	11.56	11.74	12.28
Unit cost (CASM)	10.90	10.88	10.72	1.37	11.06

Airline	Air Tran	Frontier Airlines	JetBlue Airways	Southwest Airlines
RPMs millions	3,703	2,285	5,924	17,844
ASMs millions	4,739	2,789	7,202	22,844
Load factor-%	78.1	81.9	82.3	78.0
Revenue $ million	528	302	612	2,449
Costs $ million	474	291	565	2,047
Fuel cost $ million	175	90	192	491
Operating profit $ million	55	11	47	402
Unit revenue (RASM)	11.14	9.85	8.50	10.70
Unit cost (CASM)	9.99	9.40	7.85	8.83

generate an operating profit of $244 million for the second quarter of 2006. This compares to $199 million for the same period in 2005.

The improvement in operating performance comes despite an increase in total unit costs from 9.70 cents per ASM for the whole of 2004, to 10.15 cents for 2005 as a result of higher oil and fuel prices. Unit costs continued to rise in the first half of 2006 as oil prices continued to climb, and reached 10.72 cents per ASM. Average fuel cost for 2006 is expected to reach $2.14 per USG.

Despite this burden, unit revenues have increased at a higher rate, with the carrier's performance steadily improving. Continental reported an operating loss of $238 million for 2004, a loss of $39 million for 2005 and is forecast to generate a profit of $405 million for the whole of 2006. Traffic and revenue are expected to increase by similar rates in 2007, while capacity will also increase. The average fuel price is forecast to fall slightly to $2.00 per USG, while operating margin will increase to $525 million.

United Airlines

United only emerged from Chapter 11 bankruptcy protection in 2005, having been in this state since December 2002 for a record period of about three years.

The airline has clearly managed to benefit from its restructuring, with unit costs, excluding fuel, falling by 23.1% from 2004 to 2005. The airline held its capacity constant over the same period, while its annual salary cost dropped by about $1 billion, or 20%. Aircraft rental costs also decreased by $133 million, but costs relating to regional affiliates increased by $470 million. Overall, costs excluding fuel fell by $588 million to $13.6 billion from 2004 to 2005. Fuel costs rose, however, by $1.1 billion to $4.03 billion. United therefore suffered an overall increase in its annual costs of $500 million as a result of surging fuel prices. Traffic remained constant from 2004 to 2005, while revenue rose by 7.0% on account of higher passenger load factors. This saw United widening the gap between revenue and costs from 2004 to 2005 with its annual operating loss of $854 million in 2004 falling to $219 million in 2005.

United is expected to continue to maintain its capacity and size of operation throughout 2006 and into the whole of 2007. Although fuel costs have continued to rise throughout 2006, the airline has been fortunate enough to experience traffic growth and passenger yield improvements that have allowed its overall revenue to stay ahead of its rising costs. Traffic and passenger yields were respectively 5% and 10% higher in the second quarter of 2006 than in the same period for 2005, and the airline consequently generated an operating profit of $260 million compared to $48 million for the same three months in 2005. United is forecast to have profitable third and fourth quarters. The forecast for 2006 is an operating profit of $634 million, compared to a loss of $219 million for 2005.

Capacity will be held constant in 2007, but no growth in traffic is anticipated given the competitive conditions of the market. Revenues are forecast to rise, however, as yields further strengthen. A drop in fuel prices will bring some relief, and United is forecast to make an operating profit of $972 million for the year, which is equal to 4.8% of revenue. This will be one of United's highest performance levels, but like all other airlines, it is hampered by high fuel prices. Fuel cost for 2007 is forecast to be $4.6 billion, $1.65 billion more than in 2004, despite the airline's operational size remaining almost the same for the past two years.

USAirways

USAirways has had the negative publicity of being in Chapter 11 bankruptcy protection twice since September 2001. As it also merged with America West in September 2005, comparisons of its current financial performance with earlier results are meaningless, since capacity and traffic volumes have changed dramatically during the 2004 to 2006 period.

USAirways increased the size of its operation from 30 billion ASMs in 2004 to 42 billion ASMs in 2005. The airline incurred an operating loss of $183 million in 2005, which is equal to 3.6% of revenue. By this stage its unit revenue had reached 9.52 cents per RPM, having risen from 7.77 cents per RPM for the whole of 2004. Unit cost had also seen a large increase, however.

The airline has recently reported an impressive financial performance, with an operating profit of $342 million for the second quarter of 2006. This is equal to 10.7% of revenue, which is the one of highest margins of all US carriers and illustrates the benefit of merging with America West. The two merged carriers had a unit revenue of 12.3 cents per ASM, which is one of the highest of all US majors, and a unit cost of 11.06 cents per ASM.

USAirways also reported an operating profit in the first quarter of 2006 and is forecast to do the same in the last two quarters of the year. The airline is further forecast to generate an operating profit of $738 million for the year, which equates to an operating margin of 6.3%, the highest of all US majors.

The airline operates with high load factors of 80-82%, as well as recording passenger yields in the region of 13.0-13.5 cents per ASM.

Despite maintaining the size of its operation, American Airlines has experienced a 75% increase in its fuel costs since 2004. The airline nevertheless generated an operating margin of 8% on the April-June quarter.

USAirways' average fuel price for 2006 is forecast to be $2.18 per USG. The predicted easing of fuel prices and steady passenger yields in 2007 is expected to widen the gap between revenues and costs to deliver an operating profit of $940 million, equivalent to a margin of 7.6%.

Air Tran

Not surprisingly, low-cost carriers (LCCs) have increased their operating margins to a higher level than the major airlines. Air Tran is the second highest performing LCC in the US, having generated an operating margin of 10.3% of revenue in the second quarter of 2006. It has also experienced a traffic growth rate of 27.3% over the same period in 2005, and is expanding its fleet and operation to cope with demand. Air Tran generated 23.3% more ASMs in the second quarter of 2006 than it did in 2005.

Air Tran's unit revenue per ASM was 11.14 cents compared to a unit cost of 9.99 cents, and allowed an operating margin of 10.3% or $55 million. The airline is forecast to generate an annual operating profit of $109 million for the year, equal to a margin of 5.5%. Unit cost excluding fuel has remained unchanged since 2004, however. The total cost is expected to decline in 2007 due to slackening fuel prices. Margins will widen to 8.5% of revenue and an operating profit of $206 million is expected.

JetBlue

JetBlue has had varying results over the past year which have attracted an excessive amount of criticism, since the airline has been profitable and achieved respectable operating margins for most quarters since 2004. The airline actually reported losses in two consecutive quarters: the last of 2005 and first of 2006. Operating margins were -7.1% and -5.1% in these two periods.

This is explained by a surge in unit cost over this period which increased faster than unit revenues, and is mainly explained by the sharp rise in fuel prices. Unit cost excluding fuel rose sharply over this period also, however. Unsurprisingly, aircraft maintenance was one culprit, since the maintenance honeymoon of JetBlue's fleet was expected to come to an end as the first heavy checks on its oldest A320s became due and the number of engine shop visits escalates. Traffic increased by 22.0% and 24.8% in the last quarter of 2005 and first of 2006 respectively, over the same period a year before, while maintenance increased by 40.2% and 55.1%. Rental, landing fee and equipment depreciation costs rose by 46.8% and 39.2% in these same two quarters.

JetBlue managed an impressive turnaround in the second quarter of 2006, however, and reported an operating profit of $47 million: a margin of 7.7% of revenue. The main factor in this recovery was a large rise in average passenger yield from 8.36 cents per RPM the previous quarter to 9.77 cents. Other factors such as passenger load factor and unit cost remained similar to the previous three months. This improved passenger yield is forecast to persist throughout the rest of 2006, with an operating profit of $112 million predicted: a margin of 4.7%. Further improvements are forecast in 2007 as the fuel price eases.

Southwest Airlines

Southwest reported the highest operating margin of all US carriers in the June quarter of 2006, having enjoyed the advantage of the lowest fuel price. The airline had hedged its fuel purchasing, which resulted in a fuel price of $1.42 per USG, compared to the $2.0-2.2 per USG that most airlines have had to bear.

Southwest reported an operating profit of $402 million for the second quarter of 2006: a margin of 16.4% of revenue. Load factor was higher by 5.4 percentage points for the same period the year before, but yield had improved by more than 1.1 cents per ASM over the same period and was the main item that allowed Southwest to generate such an impressive operating margin.

This increase in yield and unit revenue was in fact so strong that it allowed the airline to overcome the effect of a sharp increase in fuel price of 36% from $1.04 per USG from the previous quarter. Unit cost excluding fuel had increased by about 5% over the year.

Southwest is forecast to generate an operating margin profit of just over $1.0 billion for the whole of the 2006. This will be the second highest profit of all US carriers for the year, and will also be Southwest's highest recorded annual profit. This will be equal to a margin of 10.8% of revenue. Annual operating profit is expected to reach about $1.2 billion for 2007. AC