

US major airlines have struggled to be profitable since 9/11. While plagued with rising fuel costs, weakening yields and falling market share; the majors have made large reductions in their non-fuel costs. Have they done enough to halt their long-term decline in the US domestic market?

US airline costs: have the majors done enough?

The weak financial status of the US airlines since 9/11 has been publicised extensively over the past seven years. The seven US major full-service carriers generated their first operating profit after 9/11 only in 2006, while the three large low-cost carriers (LCCs) all consistently made operating profits from 9/11 up to early 2008.

The seven US majors, which comprise Alaska Air, American, Continental, Delta, Northwest, United and USAirways, have been battling with LCCs for market share, and against ever-rising oil and jet fuel costs. This delayed their return to profitability, and high fuel prices returned them to a loss-making position in 2008 after a strong performance in 2007.

The US majors have made efforts to reduce their costs and become more competitive, but the LCCs have also implemented similar measures, and continue to take market share from the majors. How have the majors reduced their costs? Are more savings possible, and are their cost structures low enough for their long-term survival?

Airline history

An understanding of the current financial status of US airlines is gained by

Southwest Airlines has been the benchmark for comparing other airlines' profitability. Southwest has been consistently profitable since 2000, has grown its operation every year, and saved several hundred \$ million each year through fuel hedging.

examining their financial history from the mid-1990s to the first two quarters of 2008. This period can broadly be divided into three: from the mid-1990s to 9/11; from 9/11 to 2005, during which the majors failed to return to profit; and from 2006, when profits were made until fuel prices rose above \$2.20-2.60 per USG.

1995 to 9/11

US carriers recovered from the losses of the early 1990s with an operating profit of \$5.9 billion in 1995. Passenger yields and airline revenues continued to rise on the back of a stock market boom, and operating profits peaked in 1998 at \$9.3 billion, falling slightly to \$8.4 billion in 1999. These were equal to operating

margins of 7.8% and 9.1%; a strong performance by global standards.

During this period Southwest was the only large LCC in operation, and Frontier and AirTran were among the smaller LCCs. The internet was still in its infancy, so airline fare structures had not changed to the simplified and transparent systems now being offered. These older fare structures and relatively high passenger yields meant that airlines were still able to operate with relatively low load factors, ranging from 69-75% for the majors, to about 70% for Southwest.

The older fare structures and limited competition from LCCs meant that yields were relatively high. There was therefore no pressure for airlines to increase their load factors, which fortunately left room



US MAJOR & TOP FOUR LCC FINANCIAL PERFORMANCE 2000 TO MID-2008

Airline	2008 1st half	2007	2006	2005	2004	2003	2002	2001	2000
Revenues-\$m									
Alaska Air	1,549	3,055	2,671	2,395	2,216	2,106	1,823	1,751	1,752
American	10,443	20,283	20,027	18,384	16,709	15,930	15,731	15,378	17,863
Continental	5,976	11,410	10,198	8,696	7,732	7,068	6,883	7,538	8,714
Delta	7,647	14,688	13,343	12,523	11,917	11,434	11,721	12,762	15,146
Northwest	5,864	11,195	10,929	10,421	9,874	8,998	8,988	9,445	10,844
United	8,328	16,796	15,843	13,932	12,930	11,799	12,719	14,842	18,293
USAirways	4,521	9,027	9,021	5,347	5,482	5,423	5,632	7,145	8,209
America West				2,674	2,327	2,215	2,011	2,021	2,291
Sub-total-\$m	44,328	86,454	82,032	74,372	69,187	64,883	65,508	70,882	83,112
Southwest	5,391	9,846	9,072	7,570	6,516	5,923	5,508	5,536	5,632
jetBlue	1,658	2,820	2,349	1,693	1,263	997	635	320	105
AirTran	1,290	2,311	1,893	1,451	1,041	918	733	665	624
Frontier	648	1,197	1,020	823	704	592	465	447	451
Sub-total-\$m	8,987	16,174	14,334	11,537	9,524	8,430	7,341	6,968	6,812
Total costs-\$m									
Alaska Air	1,519	2,925	2,774	2,402	2,255	2,027	1,904	1,816	1,762
American	12,016	19,181	19,211	18,735	17,130	17,318	19,125	16,717	19,125
Continental	6,149	10,789	9,788	8,788	7,854	7,038	7,364	7,688	8,127
Delta	7,660	13,683	13,312	13,720	13,529	12,591	12,757	13,733	13,869
Northwest	5,741	10,071	10,148	11,307	10,269	9,274	9,772	10,242	10,181
United	8,992	15,843	15,392	14,173	14,096	13,353	15,741	18,584	17,552
USAirways	5,251	8,503	8,465	5,560	5,830	5,845	6,551	8,327	8,254
America West				2,795	2,351	2,192	2,215	2,341	2,304
Sub-total-\$m	47,328	80,995	79,090	77,480	73,314	69,638	75,429	79,448	81,174
Southwest	5,098	9,057	8,138	6,751	5,963	5,441	5,091	4,905	4,611
jetBlue	1,631	2,654	2,233	1,631	1,150	828	530	294	126
AirTran	1,370	2,172	1,845	1,437	1,009	832	703	611	543
Frontier	733	1,208	1,033	825	735	567	473	427	369
Sub-total-\$m	8,832	15,091	13,249	10,644	8,857	7,668	6,797	6,237	5,649
Operating profit-\$m									
Alaska Air	29	130	-104	-8	-38	-11	-81	-65	-10
American	-1,573	1,102	816	-351	-421	-1,388	-3,394	-1,339	1,242
Continental	-173	621	410	-92	-123	30	-481	-150	587
Delta	-13	1,005	32	-1,197	-1,613	-1,157	-1,035	-972	1,459
Northwest	122	1,124	782	-886	-395	-277	-783	-797	664
United	-664	952	450	-241	-1,166	-1,554	-3,022	-3,743	741
USAirways	-730	524	557	-213	-348	-421	-919	-1,181	-44
America West				-121	-24	24	-203	-320	-13
Sub-total-\$m	-3,002	5,458	2,943	-3,109	-4,128	-4,754	-9,918	-8,929	4,393
Southwest	293	790	934	820	554	482	418	631	1,021
jetBlue	27	166	117	62	113	169	106	27	31
AirTran	-81	138	49	13	33	86	31	54	81
Frontier	-86	-10	-13	-3	-30	25	-8	20	81
Sub-total-\$m	153	1,084	1,087	892	670	762	547	732	1,214

for many airlines to increase their revenues after 9/11 when competition from LCCs increased and yields declined.

Despite the relatively easy market conditions, operating margins declined in 2000, although the eight major carriers (USAirways merged with America West in 2005) and the two largest LCCs still made a collective operating profit of \$5.5 billion, a margin of 6.1%.

In 2000 jetBlue began operations from JFK, and was only a small player in this period with revenues of \$105 million. The airline continued to grow rapidly, and surpassed AirTran and Frontier in revenues in 2002. This was the first significant presence of an LCC in the North-Eastern US.

Industry-wide passenger yields actually declined in 2000, firstly because airlines added capacity faster than traffic was growing, and then because of the weakening stock market. Despite this, the eight major carriers, and Southwest and AirTran, still generated a high operating margin.

The growth of the internet resulted in airlines adopting simpler and more transparent fare structures, which led to a weakening of yields and revenues. Airline costs also rose sharply during 1999 and 2000, with majors agreeing large salary increases with unions, particularly pilots'.

It was during this period that unit costs of cents per available seat-mile (CASM) exceeded an average of 11.0

cents in 2000, and rose to 11.9 cents in 2001.

Airlines were starting to show a weakened performance in the first half of 2001, prior to 9/11. Many major carriers continued to add capacity at the same rates they had in 1999 and 2000, and to award further salary increases, resulting in additional costs, even as increasing pressure and capacity growth from LCCs was beginning to erode their share of domestic traffic.

The majors' yields started to decline, while the airlines held load factors similar to 1999 and 2000 levels. Oil and fuel prices had also started to increase from long-term lows. Overall, unit revenues weakened while unit costs rose, and operating margins declined as a result.

9/11 to 2005

The immediate effect of 9/11 was for traffic volumes to fall by up to one-third for some carriers. Airlines had to cut capacity to maintain load factors in an effort to shore up yields. Traffic fell for all major carriers, although for Southwest it actually remained stable. The majors managed to reduce capacity almost in-line with traffic, and load factors were down by 5% in the worst cases.

The airlines worst affected were those operating on the Eastern Seaboard. Alaska Airlines, for example, saw its revenue passenger miles (RPMs) drop by only 5%, while United and Northwest saw theirs fall by more than 20% in the second half of 2001 compared to the same period in 2000.

Although load factors were kept close to pre-9/11 levels, passenger yields were hit hard and heavily affected airlines' revenues. Yields dropped by about 15% for most majors, but by up to 38% for USAirways in the second half of 2001.

LCCs post-9/11

In the meantime, Southwest took advantage of the situation and dropped fares, and consequently yields, in order to stimulate traffic. It also raised capacity by about 6% in the second half of 2001. The internet was becoming more prominent during this period. Giving passengers the ability to book tickets by themselves allowed airlines to make large savings in the sales process, but since this required simpler and more transparent fare structures, it also meant that fares would be lower.

Other LCCs also expanded rapidly during this period. In jetBlue's first year of operations in 2000 it carried 1.1 million passengers, generated about 1 billion RPMs and had revenues of \$105 million. It expanded rapidly, taking advantage of the high-yield environment of the North-Eastern US. Its rapid

development over the next two years meant that in 2002 it carried 5.7 million passengers, generated 6.8 billion RPMs, and earned revenues of \$635 million. From 2001 to 2002 its RPMs increased by a factor of 2.08 and its revenues by a factor of 1.98, despite the more localised effects of 9/11 on the major carriers in the region.

AirTran also continued to grow, with revenues and RPMs in 2002 increasing by 10% and 24% over 2001.

Pressures

Major carriers therefore faced several downward pressures after 9/11: lower traffic volumes which would take months or even years to recover; increased capacity and a growing market share by a larger number of more powerful LCCs; and the pressure to offer simpler and more transparent fares which was leading to lower fares and yields.

After 9/11 the major airlines also still had high inherent non-fuel costs, including: sales commissions; aircraft rent, depreciation and maintenance; and staff employment costs, due mainly to the generous salary increases given in 1999, 2000 and in early 2001.

Non-fuel unit costs in cents per ASM rose in 2001, as would be expected due to the sharp drop in traffic and ASM capacity after 9/11. Most major airlines failed, however, to lower these costs in 2002 and 2003. Non-fuel costs per ASM were actually higher in 2002 than they were in 2000. Airlines started to make reductions, but only significant advances were made by most majors from 2004.

USAirways had the highest unit non-fuel cost of all majors of 10.73 cents in 2000. This was 9.95 cents in 2003, and had been reduced to 7.86 cents by 2007 (see second table, this page). American Airlines had the second highest unit non-fuel cost in 2000 at 10.52 cents, and was the only major to have a lower cost in 2001.

In contrast, Northwest only regained a unit non-fuel cost similar to its 2000 level in 2006, while Alaska Air and Delta did not achieve this until 2005. America West, Continental, United and USAirways improved faster and had got their non-fuel costs down to 2000 levels by 2002 and 2003.

Rising fuel costs

Majors also faced the steady rise of oil and fuel costs after 9/11. The link between the price of crude oil and the price of jet fuel is approximately the dollar per barrel price of oil plus \$15-20 per barrel for refining and processing divided by 42 US Gallons (USG) per barrel to give the cost per USG for fuel.

Crude oil prices remained low and

US DOMESTIC YIELDS 2000 TO MID-2008: CENTS PER RPM									
Airline	2008 1st half	2007	2006	2005	2004	2003	2002	2001	2000
Alaska Air	13.75	13.87	13.54	12.74	12.25	12.60	12.63	13.11	13.40
American	13.26	12.64	12.52	11.72	11.28	11.99	11.84	14.06	14.55
Continental	13.02	12.60	12.45	11.90	11.71	11.87	12.01	13.09	14.38
Delta	13.20	12.60	12.23	11.06	11.28	12.06	11.89	13.04	14.05
Northwest	13.87	13.82	13.85	13.00	13.10	13.17	12.90	13.45	14.36
United	13.08	12.54	12.19	11.21	10.67	10.92	11.40	12.92	14.59
USAirways	13.50	13.18	13.16	13.28	13.38	14.34	14.15	15.52	17.37
America West				10.28	9.30	9.81	9.58	10.08	11.38
Average	13.38	13.04	12.85	11.90	11.62	12.10	12.05	13.16	14.26
Southwest	13.37	12.68	12.63	11.78	11.45	11.71	11.54	11.89	12.78
jetBlue	11.47	10.24	9.54	8.04	7.77	8.38	9.01	9.47	10.18
AirTran	13.02	12.73	13.11	12.34	11.83	12.40	12.78	14.38	14.71
Frontier	11.81	11.30	11.45	10.75	10.70	12.00	13.22	15.81	16.21
Average	12.42	11.74	11.68	10.73	10.44	11.12	11.64	12.89	13.47
Difference	0.96	1.30	1.17	1.17	1.18	0.97	0.41	0.27	0.79

US AIRLINE UNIT NON-FUEL COSTS 2000 TO MID-2008: CENTS PER ASM									
Airline	2008 1st half	2007	2006	2005	2004	2003	2002	2001	2000
Alaska Air	8.13	8.87	8.83	8.17	8.79	8.43	8.67	8.82	8.55
American	9.78	7.87	7.83	7.83	7.86	9.04	9.81	9.46	10.52
Continental	7.65	7.70	7.57	7.61	7.86	7.98	8.47	8.15	8.17
Delta	7.49	7.25	7.41	7.54	8.59	9.17	8.59	8.52	8.23
Northwest	8.44	8.01	8.09	9.11	8.96	8.87	9.05	8.77	8.15
United	8.14	7.77	7.54	7.36	7.83	8.40	9.38	9.87	8.69
USAirways	9.01	7.86	7.79	7.59	9.02	9.95	10.44	11.04	10.73
America West				6.64	5.97	6.54	7.12	7.41	7.07
Average	8.38	7.90	7.87	7.73	8.11	8.55	8.94	9.01	8.76
Southwest	6.70	6.55	6.48	6.20	6.32	6.30	6.16	6.20	6.32
jetBlue	5.68	5.36	5.18	4.80	4.95	4.71	5.49	5.91	7.84
AirTran	6.32	6.28	6.47	6.68	6.42	6.47	6.63	7.30	6.89
Frontier	6.89	6.38	6.80	6.41	6.70	7.06	7.05	8.31	7.52
Average	6.40	6.14	6.23	6.02	6.04	6.20	6.33	6.93	7.14
Difference	1.98	1.76	1.63	1.71	2.07	2.35	2.61	2.08	1.62

stable at \$20-30 per barrel up to about 2003. Before 2003, refining costs per barrel were lower, at \$5-10 per barrel, putting the cost of jet fuel 60-85 cents. Individual airline costs varied with each carrier's fuel hedging and purchasing policy, however.

In 2004 crude oil prices rose to \$38-40 per barrel, and jet fuel prices for the eight majors were 110-122 cents per USG. Southwest was the only large airline in the US to avoid this sudden increase, via a hedging policy, and enjoyed an average price of 92 cents in 2004, which saved it about \$290 million on its annual consumption of 1.2 billion USG.

Crude oil and fuel prices continued to increase steadily in 2005, with the majors seeing their average fuel price rise from 117 cents to 170 cents per USG from 2004 to 2005. Collectively the eight majors consumed about 12 billion USG annually, so the rise in fuel costs increased their yearly expenditure on fuel by about \$6.5 billion. The seven major airlines consumed 12.0-12.7 billion USG a year from 2002 to 2005. A 10-cent rise in the price of jet fuel, caused by a \$4.20

rise in the price of crude oil, led to a rise in costs of about \$1.2 billion.

The eight majors' fuel costs increased by \$11.6 billion over a three-year period, rising from \$8.9 billion in 2002, to: \$10.0 billion in 2003; \$14.3 billion in 2004; and \$20.5 billion in 2005.

Overall results

By contrast, the eight majors' non-fuel costs were \$66.6 billion in 2002, and subsequent savings made allowed a steady reduction to \$56.9 billion in 2005, a decrease of \$9.7 billion. The majors therefore faced a net cost increase of about \$1.9 billion from 2002 to 2005.

This was in parallel with a falling domestic market share. As a result of expanded international networks and operations, however, the majors' total revenues grew over this period from \$65.5 billion in 2002 to \$74.4 billion in 2005, an increase of \$8.9 billion and 14%. While this revenue growth exceeded the net increase in costs of \$1.9 billion, it was still insufficient to return the majors to profitability by 2005. The

eight majors' collective operating losses improved by \$6.8 billion from 2002 to 2005, increasing from a loss of \$9.9 billion to a loss of \$3.1 billion.

In contrast, the LCCs' revenues grew from \$7.3 billion in 2002 to \$11.55 billion in 2005, an increase of \$4.21 billion and 57%. Their competitive fares and the growing utilisation of the internet by passengers when purchasing tickets triggered high growth rates. The LCCs' traffic volumes increased by 62%, with jetBlue growing the fastest over the period: a quadrupling of traffic saw its RPMs increase by 395%. AirTran and Frontier grew by more than 100%, while the dominant Southwest grew by 33%.

The three largest LCCs have persistently achieved higher operating margins. Frontier, however, failed to be profitable for five years from 2000 to 2007. The four LCCs have had operating margins of 7% from 2002, despite continually rising fuel costs.

The LCCs have managed to lower their non-fuel unit costs, and keep them lower than the majors'.

US domestic market

The majors' share of domestic RPMs fell from 88.7% in 2000 to 79.7% in 2005. The actual US domestic market

actually grew by 10% from 2000 to 2005, and the majors' absolute domestic traffic volumes only declined by 1.2%. The LCCs absorbed virtually all traffic growth in the domestic market. The two airlines which saw the largest drops in domestic traffic were United and the combined USAirways and America West. These two carriers have been in extensive restructuring under Chapter 11 bankruptcy protection.

While the majors' domestic RPMs fell by just 1.2%, their revenues from domestic operations fell by 19.2%, because of declining yields due to increased competition from LCCs. The majors shrank domestic capacity at a faster rate than the decline in traffic volumes in order to push up load factors in an effort to force up passenger yields.

The majors suffered in 2002-2005 from the combination of declining domestic market shares and revenues, a failure to lower non-fuel costs, and steadily rising fuel prices, which resulted in most of the majors consistently making operating losses from their US domestic operations.

Delta, Northwest, United and USAirways did, however, generate operating profits from their domestic operations in 2006 and 2007, despite fuel prices exceeding an average of \$2 per

USG.

Continental, meanwhile, has failed to make an operating profit from its domestic operations since 2000, and American only once made an operating margin of less than 1% from revenues of \$12.5 billion in 2006.

The majors' domestic yields climbed again in 2006 and 2007 as they continued to force load factors higher, and contributed to the majors regaining profitability in the US domestic market. The collective operating profits of the seven majors were \$2.9 billion in 2006 and \$5.0 billion in 2007.

Meanwhile, the LCCs' costs grew as their operations increased in size. Non-fuel costs for Southwest, jetBlue, AirTran and Frontier increased by 42% from \$5.65 billion in 2002 to \$8.04 billion in 2005. However, the 57% growth in revenues shows that the LCCs were able to take advantage of economies of scale. Average unit non-fuel costs for the four carriers were 6.33 cents per ASM in 2002, and had fallen to 6.02 cents in 2005. jetBlue and Frontier made the biggest reductions of 0.70 cents and 0.65 cents.

Fuel costs rose with the rise in oil prices. Southwest managed to make large savings with fuel hedging consistently from 2003, and had a fuel price



advantage of up to 55 cents per USG over other carriers. AirTran and Frontier even had fuel prices higher than the average.

The three largest LCCs were able to ride out the increasing cost of fuel and reported operating profits from 2002 to 2005, albeit at lower margins. Frontier, however, struggled to maintain consistent profitability, despite its ability to reduce its non-fuel costs.

2005 to 2008

The majors' main strategy for recovery from the long-term decline in domestic market share and continually rising fuel prices was to redeploy capacity and resources to international operations. This required little or no fleet changes by the majors. International markets have higher yields and lower unit costs on account of longer mission lengths.

The two international markets that have seen the largest expansion in RPMs by American, Continental, Delta, Northwest, United and USAirways are the transatlantic and Latin America, with both having close to a 30% increase in RPMs by the carriers serving them. In contrast, the trans-Pacific saw an increase of only 11% in RPMs from 2001 to 2007.

The second option available to the

majors was to continue to reduce non-fuel costs. The third option was to continue to push domestic load factors higher, and make domestic operations profitable again. The increased revenues and higher operational efficiency would be used to return the airlines to profitability.

This approach generally succeeded, since all majors except Alaska reported an operating profit in 2006, and all seven majors made higher operating margins in 2007, even though the price of fuel continued rising from 2005 levels during 2006 and 2007.

Fuel prices

The average fuel price paid by the majors in 2006 was 201 cents per USG; an increase of 31 cents from 2005. This raised the majors' annual fuel bill by almost \$3 billion over 2005, on a consumption of about 11.6 billion USG.

Further rises in the price of crude in 2007 saw fuel prices averaging 213 cents per USG, increasing annual fuel costs by another \$1.4 billion.

Fuel costs continued to rise for the first six months of 2008. Crude oil started the year at \$90-100 per barrel, equal to a jet fuel cost of about \$2.85 per USG. Crude oil prices rose sharply,

peaking at \$147 per barrel in early July. This would result in a jet fuel price of about \$4 per USG. If sustained at this level the US majors' annual fuel bill would be \$46-47 billion; \$21-22 billion more than their 2007 fuel bill of \$24.7 billion. This increase compares to the operating profit of \$5.0 billion generated by these seven carriers in 2007.

Airlines had little choice but to add fuel surcharges to fares. If high oil and fuel prices had been sustained, airlines would have been forced to make large capacity reductions to maintain yields at levels high enough to cover costs.

First-quarter fuel prices averaged 281 cents, and rose to 323 cents in the second quarter and 363 cents in the third quarter.

However crude oil prices fell steadily from their mid-year peak, and by the end of the year had dropped to about \$40 per barrel, equal to a jet fuel price of about \$1.50 per USG. This is 20 cents less than the average price for 2005.

If sustained at this level, the majors' annual fuel bill would be about \$18 billion, thereby saving them \$6.7 billion over their 2007 fuel cost.

Domestic operations

The majors' domestic operations



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**US AIRLINE EMPLOYEE PRODUCTIVITY 2000 TO MID-2008:
\$000S REVENUE PER EMPLOYEE**

Airline	2008 1st half	2007	2006	2005	2004	2003	2002	2001	2000
Alaska Air	294	297	271	250	213	195	180	163	176
American	266	255	254	226	199	180	161	156	179
Continental	297	290	270	241	205	182	170	170	193
Delta	297	292	281	228	196	162	167	164	190
Northwest	379	365	348	288	251	225	199	188	204
United	300	306	283	241	209	184	167	152	181
USAirways	253	253	261	233	201	197	171	160	181
America West				200	183	182	154	151	171
Average	298	294	281	238	207	188	171	163	185
Southwest	314	291	281	239	207	179	166	179	196
jetBlue	274	255	222	200	200	221	216	151	102
AirTran	300	275	251	222	178	170	156	155	152
Frontier	230	215	208	180	159	175	162	156	212
Average	279	259	241	210	186	186	175	160	165
Difference	19	35	40	28	21	2	-4	3	20

US FUEL PRICES 2000 TO MID-2008: CENTS PER USG

Airline	2008 1st half	2007	2006	2005	2004	2003	2002	2001	2000
Alaska Air	301	220	203	168	122	81	70	78	93
American	287	205	194	168	115	82	71	78	72
Continental	308	212	193	171	117	89	71	78	86
Delta	306	227	209	171	113	80	65	68	65
Northwest	284	205	203	169	118	81	70	80	83
United	296	211	202	170	118	99	73	83	75
USAirways	334	223	208	174	107	93	69	80	89
America West				172	122	88	72	92	92
Average	302	215	202	170	117	87	70	80	82
Southwest	216	170	154	114	92	80	76	78	81
jetBlue	291	210	199	161	106	87	73	76	96
AirTran	320	208	198	160	116	98	90	94	101
Frontier	333	233	221	181	127	84	86	78	111
Average	290	205	193	154	110	87	81	82	97

rebounded in 2006 and 2007. Domestic traffic volumes continued to fall for most majors, in particular Delta, which deployed a lot of capacity and aircraft onto international services. The airlines generally managed to tighten capacity faster than traffic declined, and so load factors were pushed above the 80% level.

This improved domestic yields. In 2006 the majors' average domestic yields were 0.95 cents higher than in 2005; an increase of 8%. Further gains were made in 2007 when average yield climbed to 13.04 cents per RPM.

Alaska Air, which had relatively little competition, Northwest and USAirways had the highest domestic yields from 2000. United has consistently had the poorest yields of US majors.

During 2006 and 2007, this increase in yields produced the first increase in domestic revenues since 2000, despite the fall in RPMs. Most majors made an operating profit in 2006, except Alaska Air and Continental. Continental also made a loss in 2007, and became the only major to have consistently made losses in

its domestic operations from 2001. American also made a small operating loss of \$77 million. The other five carriers achieved a collective operating margin of 7%.

Domestic operations became unprofitable again in 2008. Load factors were maintained while RPMs continued to decline and LCCs gained further market share. The majors' yields continued to climb, and reached an average of 13.54 cents in the second quarter of 2008. Revenues were not enough, however, to overcome the steep rise in fuel prices. Operating losses for the first half of 2008 were \$2.6 billion.

International operations

Apart from Alaska Air, which has only a small international operation in the Latin American market, the six majors have substantial operations in the three main international areas. International RPMs for the six airlines grew from 31% of their total traffic in 2000 and 2001 to about 38% by the

second half of 2008.

International RPMs for the airlines have collectively only increased by about 2% since 2000; the increase in share of total traffic is because of the reduction in domestic RPMs due to competition from LCCs. The transatlantic and Latin America are the two markets with a significant growth. American, Continental and Delta have increased their transatlantic operations by about 50% since 2000. Delta has had the largest expansion in the Latin American market, while United and USAirways have actually reduced their operations.

Not all majors have benefited from international services. Delta has consistently made operating losses on its international operations since 2000, especially on the transatlantic. Northwest made losses on its international services from 2000 to 2005, and only made a modest margin in 2006. Its transatlantic services are its stronger market, while it has struggled to make a positive margin on the trans-Pacific, despite being the second largest US operator to United.

Of the four majors to have gained from international operations, United has had the poorest performance, making losses for three years since 2000. Profits from international services were too weak to offset losses from domestic services in 2004 and 2005, while performance was strong in 2006 and 2007.

American has had strong international performance for most years since 2000, while Continental is the leader. Continental has been profitable every year since 2000, and had the highest profits of the six majors in six years out of eight. This is fortunate for Continental, since these margins have offset losses from domestic operations, but only allowed the airline to be profitable in 2006 and 2007.

Non-fuel costs

With revenues under pressure, the majors have clearly had to make reductions in their non-fuel costs, of which labour and staff costs are the largest element. Non-fuel costs have been reduced since 2001, with the average unit non-fuel cost for the majors falling from 9.01 cents in 2001 to 7.90 cents in 2007 (see second table, page 31).

Non-fuel costs rose again for five of the seven majors in 2008. The worst affected were American Airlines, which saw its non-fuel unit cost increase by 1.91 cents; and USAirways, which had a rise of 1.15 cents (see second table, page 31).

Both airlines had a large expense on non-recurring items during 2008. American had about \$1.24 billion of non-recurring costs, related to capacity reductions, in the second quarter of 2008. Non-fuel unit costs would have been in

USAirways has made the largest reduction in non-fuel costs since 9/11; with a 27% reduction from 2000 to 2007. The airline has clearly benefited from its merger with America West, and has generated an operating margin of more than 5% in 2006 and 2007, despite rising fuel prices.

line with 2007 levels when these costs are excluded.

The airlines' capacity has also been reduced, so the carriers have either had to reduce non-fuel and labour costs at a larger rate than ASMs, or try to maintain or reduce costs while ASMs have grown. The majors have had varying degrees of success in reducing labour and non-fuel costs. Alaska Air has made no progress, with unit non-fuel costs 0.05 cents higher in 2007 than in 2001. The other six majors had reduced their unit costs by 0.45-3.18 cents between 2001 and 2007 (see second table, page 31).

Labour is the main cost targeted. Labour as a percentage of non-fuel costs has decreased from about 47% in 2001 to about 37% in 2007 and 2008. This has been achieved through higher employee productivity, fewer staff numbers, and negotiations that have kept annual salaries close to 2001 levels.

Productivity in terms of revenue generated per employee has therefore risen from an average of \$163,000 in 2001 to \$295,000 in 2007, an improvement of 81% (see first table, page 34).

American and Continental have actually increased ASMs since 2001, and both have increased non-fuel costs by about \$1 billion each. The overall result has been for Continental's unit non-fuel cost to have reduced by 0.45 cents per ASM over the period. American has reduced its unit cost by 1.59 cents.

In 2008 American had to pay for items such as early pilot retirements, aircraft groundings and facility write-offs. Excluding these items, the airline's non-fuel costs were \$16.75 billion for the first nine months of 2008, which is equal to a unit cost of 8.35 cents. This compares to 2007's non-fuel unit cost of 7.87 cents. The airline would then have incurred a loss of \$550 million, compared to the actual loss of \$1.8 billion.

Delta, Northwest, United and USAirways have all reduced the size of their overall operations since 2001. Delta, which had 10% fewer ASMs in 2007, had reduced its costs by \$2.8 billion and 23%, thereby reducing its unit cost from 8.52 cents to 7.25 cents.

Northwest reduced its ASMs by 22% and saved \$1.7 billion in costs, a 20% reduction. Its unit cost is down from 8.77 cents to 8.01 cents in 2007.



United Airlines had 14% fewer ASMs in 2007, and achieved cost reductions of 32%, equal to \$5.2 billion. This is the second largest achievement, and it realised a 2.10 cent reduction in unit cost by 2007. United reduced its workforce from 97,500 to 55,000 employees.

USAirways made the largest gain of all the majors. Taking into account America West's workforce of 2001 prior to its merger with USAirways in 2005, the two carriers' total number of employees was reduced from 59,000 in 2001 to 36,000 in 2007. USAirways had reduced the two carriers' non-fuel costs from \$9.3 billion in 2001 to \$6.0 billion in 2007, a saving of 36%. This was in parallel to a reduction in ASMs of 19%, and resulted in unit costs declining by 3.18 cents by 2007.

USAirways had about \$1.5 billion of non-recurring costs in the second and third quarters of 2008. These were similar to American's non-recurring costs. Excluding these, USAirways' non-fuel costs for the first nine months would have been \$4.04 billion, and unit non-fuel costs would have been 7.07 cents per ASM. This compares with an actual unit cost of 9.70 cents and the 2007 unit cost of 7.86 cents. The airline would then have broken even, compared to the actual loss of \$1.4 billion.

The future

So how are the majors prepared for the future? The issue is basically one of cost competitiveness. While the majors have shown themselves to be profitable at low or medium fuel prices, the strong surviving LCCs are able to continue offering lower fares and taking domestic traffic from the majors, as well as to accommodate all the growth in the

domestic market. This will invite other LCCs to start up, particularly in parts of the US where LCCs are less prominent. Does this mean the majors can only stop this market erosion if they have the same unit CASM as the LCCs?

The majors' unit revenues per ASM steadily increased by about 2.50 cents from 2001 to 2007 as a result of tight capacity controls and higher load factors leading to improved yields. The majors have also widened the gap between their unit revenues and the LCCs' unit revenues, which only increased by about 0.40 cents over the same period, and also declined in the interim.

The majors' unit costs also steadily increased over the same period by about 2.0 cents, while the LCCs' costs rose by about 0.80 cents. The gap in unit CASM between the two groups has therefore nearly doubled, from 1.54 cents to 2.74 cents. The increase in costs is due to rising fuel prices, so even if the latter fall, the majors will still have higher costs than the LCCs. This raises the effect of low fuel prices on the majors' profitability.

Crude oil prices fell to about \$40 per barrel at the end of 2008, equal to a fuel price of \$1.50 per USG. This is similar to prices paid in the first half of 2005. Simply substituting a fuel price of \$1.50 per USG into 2007 results naturally provides high profit margins. Revenues and non-fuel costs are unaffected, while the annual cost for the majors falls by about \$7 billion, thereby improving their collective operating margin to \$12.8 billion. This would be an operating margin of 15%. The majors' unit costs would also be reduced by 1.0-1.2 cents. The drop of \$7 billion in annual fuel costs accounts for 9% of total costs.

The LCCs, of course, also benefit from lower fuel prices. Annual fuel costs



for the four main LCCs would fall by about \$0.9 billion and their operating profit would rise to \$2.0 billion, giving them an operating margin of 12%. Their unit costs would fall by 0.80-1.10 cents.

Lower fuel prices would therefore provide more room for LCCs to lower fares, but the majors have managed to raise their revenues through higher load factors and yields and to reduce their non-fuel costs to such an extent that they could also be more competitive. Their share of the domestic market has been reducing by about two percentage points per year. Lower fares possible through lower fuel prices would halt this erosion.

Current low fuel prices and the ability to offer lower fares is fortunate for airlines which are operating in the depths of severe recession in the US. The majors' traffic volumes and revenues declined in the first three quarters of 2008, particularly in the middle of the year when oil prices reduced passenger demand. Traffic and revenues will be affected further in 2009 if fares are maintained at 2008 levels. Fares therefore need to be lowered to stimulate demand.

This raises the issue of how long will oil and fuel prices remain low, or how volatile will they be. Using the same simple substitution, the majors would break even on a fuel price of \$2.50-2.60 per USG. Fuel prices are likely to remain

low at least during the first half of 2009 due to global economic weakness. An economic recovery will see a fast increase in oil prices, however, and the long-term prices are likely to be \$100 or more per barrel. This takes the price of jet fuel to at least \$3 per USG, and will return the airlines to a loss-making position. Fuel prices may become less volatile in the future with the development of jet fuel and biofuel blends, but it will be several years before these are available in large volumes for practical use.

The majors face other cost rises if low fuel prices are sustained and strong profit margins are experienced. Labour costs in particular are likely to rise as a result of pressure from unions. One particular concern are pilot salary scales. These are due for renegotiation for many of the majors over the next few years. A 10% rise on all salaries would raise the seven majors' annual labour bill by about \$2.2 billion. Current fuel prices give them the room to accommodate this, although revenues are also likely to be lower. The majors will be able to use losses made in 2008, and the current recession to limit or hold off salary rises in the near term.

The majors can use mergers and acquisitions to make economies of scale, particularly with labour costs. USAirways has clearly benefited from its merger with America West, achieving the largest drop

American has made the second largest reduction in non-fuel costs of all US majors. It has increased its employee productivity, while its domestic operation has grown with the acquisition of TWA and managed to raise domestic yields in 2006, 2007 and 2008.

in non-fuel cost of all majors. Both airlines consistently made losses from 2000, and only generated a positive operating margin in 2006 after merging (see table, page 30). USAirways has, however, made one of the smallest gains in employee productivity of all majors, despite cutting staff numbers by about 40% since 2001.

Northwest has made the largest gain in employee productivity, raising RPMs per employee by 85% from 2001 to 2008. This made it an attractive merger candidate for Delta, with the two airlines merging at the end of October 2008. Northwest has become a wholly owned subsidiary of Delta, and the airline will be known as Delta.

The combined carriers will form the largest airline in the US, putting them ahead of American. Taking complete 2007 results, the two airlines carried 127 million passengers and generated 176 billion RPMs. The two airlines had about 81,000 employees, whose numbers are expected to be reduced to about 75,000. At current salary levels this would save about \$450 million per year. Combined 2007 revenues are \$26 billion, non-fuel costs about \$16 billion, fuel costs for the year were \$7.6 billion and operating profit was \$2.1 billion. A simple substitution of current fuel prices raises the operating profit to \$4.0 billion.

The merged airline expects to gain from an overall \$2 billion in enhanced revenues and cost savings, further raising its 2007 operating profit to \$6 billion.

The new airline has the largest domestic and international networks of all US carriers. Using 2007 data, domestic RPMs would be 106 billion, compared with 85-90 billion for American and 70 billion for United. International RPMs would be 70 billion, compared to 48 billion for American and 47 billion for United.

The merger of Delta and USAirways has produced obvious benefits. Will it act as a catalyst for Alaska Air, American, Continental and United, to consider the advantages of a merger? **AC**

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