



Market Structure Implosion: An Industry Perspective

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Prepared by:
Jon F. Ash, Managing Director
Global Aviation Associates, Ltd.
1800 K Street, NW - Suite 1104
Washington, DC 20006
www.ga2online.com

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During the months since the events of 9/11, we have read of and witnessed the implosion of the U.S. commercial airline industry. Notwithstanding a financial aid package enacted into law subsequent to 9/11, U.S. major carriers were substantially worse off one year after 9/11 than anyone could have predicted.

The airline industry is massively overtaxed versus other industries, but even with relief in this burdensome area, there are economic trends that have evolved over the past 12 years, since 1990, that dictate the need for fundamental industry restructuring. The trends have become particularly pronounced since 2000, the last reasonably profitable year for the industry. Now, the major carriers have advised Congress that while they are not looking for further aid in the form of subsidy or direct compensation, they do need relief from the myriad of taxes and unfunded mandates that have been imposed upon them. These mandates largely derive from national defense issues and it is the view of the airlines, and a number of members of Congress, that funding should be handled from the general treasury.

Since 1990, the U.S. domestic industry has experienced sound, if less than spectacular, growth. On the other hand, the fundamental economic equation has become entirely distorted, and this is best evidenced by a few trends.

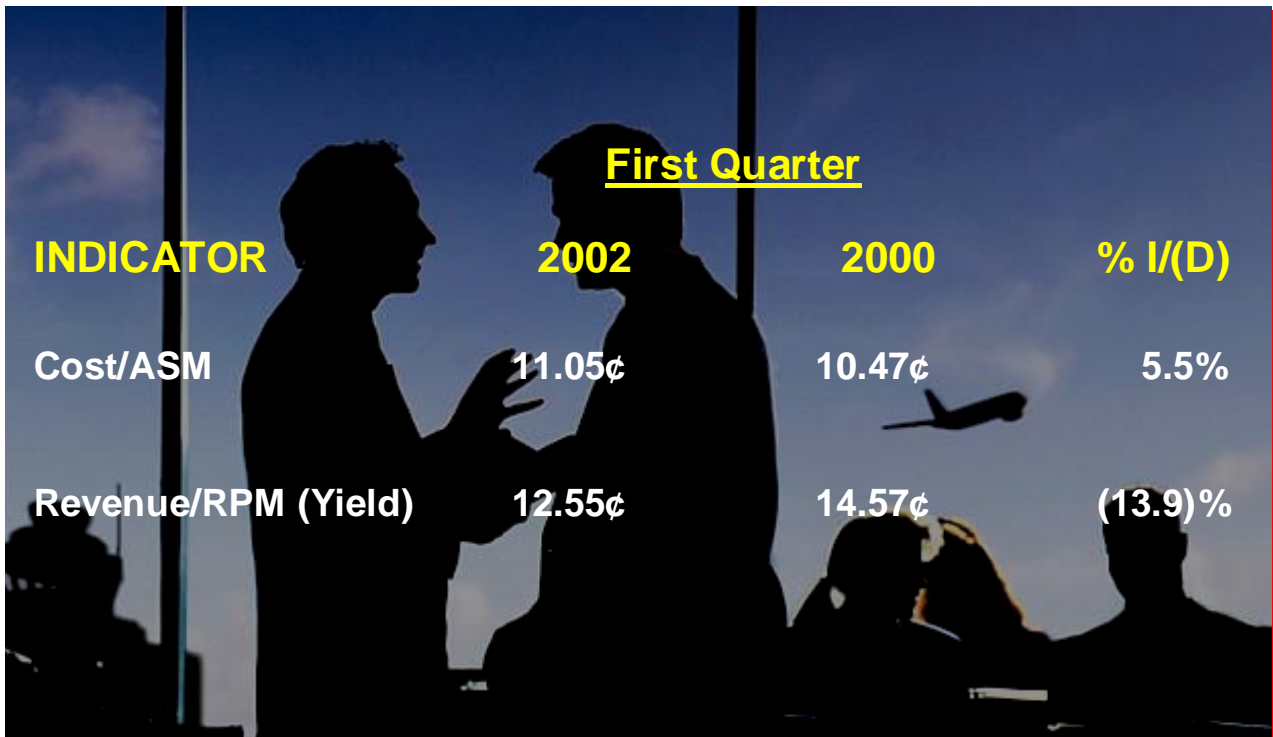
INDICATOR	2001	1990	CAGR*
Cost/ASM	11.41¢	9.27¢	1.9%
Revenue/RPM (Yield)	13.22¢	13.20¢	0.0%
Psgr Traffic (Bil. RPMs)	480.50	346.10	3.0%

*Compound Annual Growth Rate

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When, over the period of 12 years, costs increase at an average annual rate of 1.9% while prices remain unchanged, we have a fundamentally flawed business model. Trends between 2000 and 2002 are even more disturbing.



INDICATOR	2002	2000	% I/(D)
Cost/ASM	11.05¢	10.47¢	5.5%
Revenue/RPM (Yield)	12.55¢	14.57¢	(13.9)%

These data suggest that U.S. carriers have done a reasonable job of holding down increases in unit costs of production. On the one hand, they were the beneficiaries of reduced jet fuel prices, but these gains were more than offset by the negative productivity induced by large reductions in capacity.


Unfortunately, the consumer and marketplace are telling the network carriers that this level of cost control is inadequate. Structurally, the airline pricing paradigm is out of sync with consumer expectations. The average fare (yield), having dropped by 13.9% between the first quarter of 2000 and the comparable quarter of 2002, continues to be the challenge. Preliminary data covering August and September 2002 suggest that traffic is recovering more slowly than originally anticipated, but the real issue is that prices have dropped dramatically. In both August and September of 2002, the average fare paid by the consumer is approximately 17% below that paid in August and September of 2000.

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This decline in yield has the effect of driving the industry breakeven load factor to unattainable levels.

For example:



		<u>First Quarter</u>	
		2002	2000
Passenger Breakeven Load Factor (BELF)	$= \frac{\text{Cost/ASM}}{\text{Revenue/RPM}}$		
BELF =	$\frac{11.05}{12.55} = 88.0\%$		$\frac{10.47}{14.57} = 71.9\%$

While the example is somewhat simplified, and the actual breakevens are somewhat lower due to other revenue generators such as mail and freight, the general relationship is more than telling. While costs are climbing, albeit modestly, yields are declining precipitously. Thus, unit costs are increasing the breakeven load factor slightly, but declining yields are increasing the breakeven load factor dramatically.

In its press release covering August traffic, Continental Airlines noted that it expected its breakeven percentage to be in the 80s for September—and Continental is a relatively low cost network carrier.

Because demand is uneven, an actual load factor in the mid-80s is unachievable over time. In fact, over the period of a year, we have seldom seen average load factors exceed 75%.

The data then begs the question: How do we deal with this problem?

For those that believe, “this too shall pass,” let’s examine some market structure, fare and yield information.

On a macro level, the low fare carriers, including Southwest, accounted for roughly 8% of market capacity in the early 1990s, but now account for about 18% of market capacity. These low cost/fare carriers (Southwest, America West, Frontier, jetBlue, American Trans Air and Spirit) are growing at annual rates of between 10% and 15%, while the major network carriers have been growing their domestic systems by only 3% per year.

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On a micro level, we analyzed major non-resort city-pair markets and found that during the first quarter of 2002, one of the low fare carriers was dominant in 24 of the 85 largest markets. Additionally, there are 54 low fare carrier appearances in the first or second market share position in 46 of the 85 largest city pair markets. These low fare carriers, with an average cost per ASM of below 8 cents, are creating the market price for the major network carriers which have average costs per ASM of about 11 cents, roughly 35% higher.

The low fare carriers now drive pricing and this phenomenon is being compounded in this post-9/11 environment by other factors that are negatively impacting pricing:

1. Business travel is being adversely affected by the soft economy;
2. Business travelers are looking for ways to avoid the "hassle" of travel, e.g., teleconferencing;
3. Business travelers have concluded that "unrestricted" fares a) have become unreasonably high, i.e., the price/value equation is broken, and b) at 8-10 times non-refundable fares, are out of balance with the "restricted" fare alternatives;
4. Business travelers are using sophisticated managed travel programs, corporate net fares, and direct internet access to find the lowest available and practical fares; and
5. The low fare carriers increasingly provide alternatives to the network carriers with little or no offset in quality or convenience.

Only items 1 and 2 above are likely to change as the economy recovers and security becomes more sophisticated and user friendly. Thus, there is a permanent structural change that will dictate the future of the network carriers. That is, there are two immutable economic principles that must be adopted by those that wish to survive the ultimate industry shakeout.

First, wages and benefits need to be reduced by roughly 20%, with another 5+% coming from "real" productivity gains through enlightened work rules.

Labor costs for the network carriers have grown to account for 40-45% of total costs. Network carriers' unit labor costs are generally 25% higher than is sustainable given the fares that consumers are willing to pay.

Second, as noted by American Airlines Chairman Don Carty in his comments before the House Transportation and Infrastructure, Aviation Subcommittee, on September 24, 2002, the major network carriers will have to substantially advance technology as a vehicle for improving the productivity of people and physical assets such as aircraft, plant, and other

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equipment and processes. Technology can drive significant productivity improvements in areas including booking of travel, passenger check-in, security (biometrics), aircraft maintenance and overhaul, and airport staffing including gate and ramp personnel and equipment. Much of this improved productivity will ultimately lead to reduced space requirements and overhead, and consequently reduced capital demands and facility lease and rental expenses. In other words, internal airline systems will be able to talk to each other, to the passenger, and to scheduling and maintenance crews.

The carrier that is deadly serious about these two areas of focus can reduce unit costs by 10%-15%. While this may not bring the network carriers to the cost level of the point-to-point low fare carriers, fleet allocation, network synergies, and economies of scope can serve to level the playing field. For example, more regional jets operating into the hubs from smaller communities will facilitate avoiding head-on competition in many internal U.S. markets. Southwest with larger B-737 aircraft and jetBlue with A320 aircraft will not provide multiple frequency service in markets such as Sioux Falls, SD, to Austin, TX. However, on an online one-stop basis, Northwest, United and American certainly can. Equally, it is unlikely that the point-to-point carriers will offer either the Sioux Falls or Austin passenger online one-stop service to major world centers such as London, Frankfurt, Paris, Tokyo or Sao Paulo.

In summary, aircraft fleet simplification and allocation, labor cost productivity, and technology investment and innovation can level the playing field between the currently disadvantaged network carriers and the low fare and growing point-to-point carriers. There is room for both types of carriers in the U.S. airline industry, but the network carriers must act quickly and decisively to maintain their current share of the market.

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