



# *Stormy* Weather

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sars

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## SARS and the war in Iraq combine to deal a one-two punch to an industry still reeling from 9/11 and the collapse of business travel

By Perry Flint

**T**he old joke that “If it weren’t for bad luck, we wouldn’t have no luck at all” became doubly applicable to the airline industry this spring. As the long-anticipated war in Iraq moved from the talking to the fighting stage and fuel prices soared, airline battle plans were thrown into disarray by a mysterious epidemic that crippled traffic in the Asia/Pacific region, heretofore the only part of the world to come close to a full recovery since 9/11.

In an industry still reeling from the seismic shifts to the business environment that have occurred since the end of 2000, the impact of the war and Severe Acute Respiratory Syndrome was like a one-two punch, driving Air Canada to the mat and sending Cathay Pacific to its knees. Around the world, network carriers and their employees endured another round of layoffs, route reductions, order deferrals, aircraft parkings and general belt-tightening.

US airlines, at the center of the storm, experienced double-digit traffic declines following the March 16 Azores Summit that set the US and UK on a firm path toward invading Iraq. Over the next 10 days, they announced plans to eliminate 10,000 more jobs as service was reduced in response to the situation.

Speaking to the International Society of Transport Aircraft Trading early last month, Continental Airlines Chairman and CEO Gordon Bethune estimated that the war will cost his airline an additional “\$200 million in losses” this year. JP Morgan analyst Jamie Baker calculated that travel avoidance added as much as \$1.1 billion in operating losses to what already had shaped up to be a disastrous first quarter for US airlines. He forecast

that the industry will report operating losses totaling \$3.5 billion for the three months ended March 31, roughly comparable to the \$3.8 billion lost in the 9/11-impacted fourth quarter of 2001.

Prior to the onset of fighting, the US Air Transport Assn. predicted that under the “most likely scenario,” a conflict with Iraq would add \$4 billion in red ink to an industry already expected to lose \$6.7 billion in 2003. Admittedly, ATA based its assessment on a three-month war, which was probably way too pessimistic as heavy fighting looked to be over by mid-April. Still, that forecast also was made before SARS emerged as a major threat to travel and tourism. The SARS impact was readily apparent from a review of data that showed Asia/Pacific traffic falling nearly as fast as transatlantic travel as the public became more aware of the disease.

For example, in the first week of war (March 17-23), ATA data showed US airline traffic declining 10.5% year-to-year overall, with the largest impact being felt on the Atlantic where RPMs were down 24.5%. Pacific RPMs dropped 13.1% in the same period. Two weeks later, following a blizzard of media coverage about SARS and the issuance of travel advisories by the World Health Organization, weekly traffic was down 17% year-over-year with the Pacific leading the way with a decrease of 25.8%, slightly worse than the Atlantic fall of 25.2%. Furthermore, advance bookings for the next 60-90 days “suggest no relief in sight,” ATA noted.

“We’re running worse than the [1991] Gulf War in terms of traffic volume and geographic diversity and especially worse in yield,” says ATA Director-Economic and Market Research John Heimlich. He also notes

that airlines are in a far weaker financial position than at the start of past crises owing to the losses associated with 9/11 and the pre- and post-9/11 business travel downturn. Over the past two years, US airlines have taken on \$21.6 billion in new debt, in essence funding day-to-day operations with borrowings.

While previously deaf to airline complaints regarding soaring taxes and security costs since 9/11, the specter of multiple airline bankruptcy filings spurred the US Congress to act. Last month, lawmakers approved more than \$3 billion in emergency aid, ostensibly to compensate carriers for post-9/11 security charges but clearly intended to get the industry over the hump and into the summer season.

Elsewhere, governments have been largely immune to airline pleadings, unwilling to do much more than provide war risk insurance at rates unavailable on the private market. Air Canada President and CEO Robert Milton acknowledged this disparity in announcing his decision to take the airline into bankruptcy under Canada's Companies' Creditors Arrangement Act, broadly the equivalent of US Chapter 11 protection.

Milton's primary focus, however, is on cutting labor costs, which he said "are simply untenable in the new airline environment. There cannot be a successful restructuring without a radical wholesale revision to work rules and changes under the collective agreements governing the company's 31,000 unionized employees." He had requested C\$650 million in permanent annual labor concessions last winter and said, "I was very clear on Feb. 6 to our union leaders that the world has changed . . . and that either we dealt with that reality or there would be consequences."

Air Canada's bankruptcy filing, some 14 years after it was fully privatized and two years after it absorbed failing Canadian Airlines to become the country's only network carrier, means that Canada has managed to recreate the US airline experience in one-third less time: Deregulation . . . merger and consolidation . . . bankruptcy.

Ironically, the severity of the current crisis could be beneficial to survivors in the long term if it helps them to achieve

meaningful cost savings from recalcitrant unions that have dragged their feet on concessions since 9/11 in hopes of an eventual recovery. American Airlines was only minutes away from a Chapter 11 filing on March 31 when its three unions tentatively agreed to \$1.6 billion in wage and benefit reductions and work rule changes. If, as expected, the agreements are ratified, annual savings, in conjunction with a further \$180 million from nonunion customer service staff, management and clerical workers, will total \$1.8 billion. American also warned that should the unions reject the contracts, it immediately would seek bankruptcy protection and ask for an additional \$500 million in labor savings.

Wall Street analysts anticipate that the deal at American—if finalized—will have a domino effect, spurring unions at other legacy airlines to agree to similar levels of savings to keep their carriers competitive. Adding pressure is the fact that US Airways emerged from Chapter 11 on schedule on March 31, touting \$1 billion in annual labor savings and another \$1 billion in fresh liquidity. Even United Airlines' unions appeared to be coming onboard. The airline reached tentative agreements with all of them, which when combined with pay

cuts imposed on non union salaried and management staff, will save \$2.56 billion per year.

"If AMR can achieve a negotiated restructuring, so too can Delta, Northwest, Continental and so forth," stated Baker in an April report.

But it also is clear that United and other carriers are under crushing pressure in the short term. United achieved its first EBITDAR hurdles under its debtor-in-possession financing, but the May 30 and June 30 targets of reducing negative cash flow to \$738 million and

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\$585 million respectively are considerably more difficult, particularly in light of the current revenue crisis. Failure to achieve these levels could result in the airline's DIP lenders refusing to provide additional cash and even calling for repayment of the initial amount.

United's salvation may lie in the government aid package that should provide it with several hundred million dollars. Paradoxically, in the unlikely event of a United shutdown, the industry's immediate crisis would be solved,

### Iraq War and SARS Punish Airlines\*

#### US MAJOR AIRLINES

Airline	Job Eliminations	Capacity Cuts
American	2,500 <sup>1</sup>	6% international cut in April, 13% reduction for May, 2% domestic reduction in May
America West	250	
Continental	1,200 <sup>2</sup>	Selected international service reductions, summer capacity down 2%
Delta	-	12% interim capacity reduction
Northwest	4,900	12% ASM reduction until further notice; grounding 20 aircraft
United	3,400 attendants and mechanics placed on unpaid leave	12% interim capacity reduction for May; grounded 21 aircraft
US Airways <sup>3</sup>	-	5% interim reduction in ASMs; selected international service reductions

#### SELECTED NON-US AIRLINES

Air Canada	3,600	15% ASM reduction in April and May
Air France	-	7% capacity reduction in April; deferred 7 A320 family aircraft, retiring Concorde
Austrian	150	11% in April/May, 4 aircraft parked
British Airways	-	4% capacity reduction in April and May; retiring Concorde
Cathay Pacific	-	37% interim schedule reduction
Finnair	1,200	
Japan Airlines	-	12% schedule reduction in April, 17% in May
KLM	Up to 3,000	
Lufthansa	-	Selected international flight cancellations; 7 additional aircraft parked
Qantas	1,700 involuntary and voluntary furloughs	20% schedule reduction between April and July
SAS	4,000	
Singapore	206 cabin trainees	19.7% interim ASK reduction

\* Selected airline cutbacks since mid-March. 1. As part of \$660 million concessionary agreement with pilots. 2. Also reduced senior management positions 25%. 3. Implemented 5% pay deferral. **Source:** Airline reports

## US Traffic Has Plunged Since Mid-March\*

Week beginning	Domestic	Atlantic	Latin	Pacific	System
Jan. 5	8.5%	6.8%	2.1%	5.6%	7.5%
Jan. 12	5.1	14.3	2.7	9.5	6.8
Jan. 19	2.4	6.8	3.5	9.0	3.8
Jan. 26	1.2	3.7	3.9	9.2	2.6
Feb. 2	3.2	2.5	-0.7	1.7	2.6
Feb. 9	-3.0	-4.5	-8.3	-1.7	-3.5
Feb. 16	-2.6	-4.1	-6.5	8.4	-2.0
Feb. 23	-3.5	-3.9	-6.2	-2.9	-3.7
March 2	-1.0	-6.3	4.8	-1.8	-1.4
March 9	-3.3	-11.0	4.7	-6.4	-4.1
March 16	-2.3	-12.9	4.8	-6.6	-3.5
March 23	-7.5	-24.5	-7.9	-13.1	-10.5
March 30	-9.1	-18.9	-12.0	-18.6	-11.5
Apr. 6	-13.1	-25.2	-17.8	-25.8	-17.4

\*US RPM growth/decline, 2003 vs. 2002. Source: Air Transport Assn.



It appears that both American and United were able to achieve significant labor savings.

but at a huge cost. As UBS Warburg's Samuel Buttrick observed in a report last winter, the disappearance of United and its 19% share of industry capacity would restore the industry to "almost immediate profitability, but before fixing long-term costs." Consultant Michael Boyd agrees: "The worst thing that could happen is United going out of business in the real near term . . . It would be short-term gain and long-term pain."

Either way, the cost reduction targets established by it and American do not solve all of their problems. Baker estimates that AA's new labor structure would result in a unit cost, excluding fuel, of 8.3 cents per ASM, which should move it from last place—excluding United and US Airways—to the middle of the pack between Delta and Northwest. This would be enough to dodge the bankruptcy bullet but not enough to return the airline to profitability. "After all, Delta and Northwest weren't making money the last time we looked," Baker observes.

Nevertheless, Baker told *ATW*, "had industry labor expense been 30% lower in 2002, the industry would have broken even instead of losing \$7 billion. With most carriers targeting a 20%-30% reduction in aggregate labor expense, we'd expect modest profitability in 2005 and 2006 even absent significant revenue recovery."

Some say that airlines still must address an overcapacity issue despite the hundreds of aircraft that have been parked since 9/11. "There is absolutely excess supply in the marketplace. Demand remains soft and the industry problems are not going to get solved until there is a better balance between these two factors," US Airways President and CEO David Siegel said last

month in Washington. According to BACK Aviation Solutions, approximately 1,351 aircraft were parked out of a world fleet of 17,457 at the end of March. In the US, some 12.9% of the fleet was in storage or temporarily inactive, including 835 of the former and 136 of the latter.

"I'm one of those types that are hung up on the capacity side of things," says Annapolis-based analyst John Walsh. "I think depending on how you count, somewhere between 1,000 and 1,500 planes need to be taken care of [worldwide]." He also notes that there has been "a rather alarming dropoff in utilization," which is down "10%-15%." Bethune said in April that there are "15%-18% too many seats in the sky."

Others disagree. "There is no overcapacity," declares Phil Roberts, chairman and CEO of Unisys R2A Transportation Management Consulting. "The overcapacity is capacity at a price that the passenger is not willing to pay. We have industry load factors of 70%-75% depending on who you are looking at. That doesn't imply overcapacity to me. That means that if everyone could make money at those fares we'd be dandy. And some carriers are."

Roberts also suggests that issues such as overcapacity, vanishing business travel, a broken business model and economic stagnation are "merely a continuation of the restructuring caused by the market forces unleashed through airline deregulation." The "key element" in this restructuring, he said "is that an increasing number of airlines have found ways to substantially lower fares and passengers—leisure and business—are flocking to climb aboard their flights."

While expressing skepticism that the current level of cost-cutting by network airlines is sufficient to provide sustainable profits, Roberts is generally encouraged, particularly by American's achievements. He cites AA's switch to so-called "rolling hubs" that have freed up gates and aircraft at its biggest hubs (*ATW*, 11/02, p. 22). "At Dallas they eliminated 34 gates," he says. Under its new pilot agreement, "American is going to fly their schedules with 20% fewer pilots. That's huge."

Others are less impressed. One observer, a former airline executive who now is a consultant, says that both United and American are focused solely on reducing labor costs without questioning the premise upon which their hub-based business model is based.

"The only big things that have

## Europe's Traffic Impact Is More Scattered\*

Week beginning	Europe	North Atlantic	Middle East	Far East/Australasia	Total Int'l.
Jan. 6	4.9%	15.5%	14.3%	4.1%	7.7%
Jan. 13	3.2	14.0	12.5	3.6	6.7
Jan. 20	1.9	11.1	15.1	3.5	6.6
Jan. 27	1.9	9.8	7.8	-1.1	2.8
Feb. 3	-4.1	4.0	9.2	-3.3	0.2
Feb. 10	-2.4	5.1	-6.6	7.4	2.2
Feb. 17	-0.5	5.2	-2.1	-1.7	1.9
Feb. 24	0.6	4.1	-15.8	-1.2	1.7
March 3	-1.3	1.6	-23.2	-0.8	0.3
March 10	-4.5	-2.5	-22.7	-4.5	-2.4
March 17	-14.8	-10.4	-42.5	-12.3	-12.4
March 24	-5.7	-3.1	-52.5	-11.3	-7.4
March 31	-15.0	-7.7	-45.5	-10.1	-10.4

\*RPK growth/decline, 2003 vs. 2002. Source: Assn. of European Airlines



**“In the long term, the legacy carriers are in a perpetual state of going out of business”**

**Air Canada filed for protection from creditors citing the need to shrink labor costs by C\$650 million.**

changed since two years ago are average wages and pilot productivity,” he says. “Since no one has ever claimed that these two factors [though important] were the dominant cause of the big hub crisis, then no one can claim we have solved the crisis. I see no evidence that any of the carriers even understand the need to think about things differently. It is not just that they have failed to cut capacity sufficiently but the way the pieces fit together—capacity, pricing, routes, RJs, how you compete with Southwest—has changed. American’s analysis, for example, is totally static: ‘Our old model expected so much revenue, we looked last month and we are \$4 billion short, so we solve all our problems if we cut costs by \$2 billion, that makes the pilot cuts \$700 million, please sign here.’ Has anyone explained how those \$4 billion of unnecessary costs appeared in the first place? Does anyone see a link between this approach and the changes that have occurred in the industry over the last five years?”

One of the most pertinent changes, of course, is the rise of the low-cost carriers that now account for more than 20% of US capacity, up from 6% in 1996. Hand-in-hand is the decline in revenue, with real yield falling 5% over the same period, says Bear Stearns.

According to ATA, average industry unit revenue was 8.51 cents per ASM last year, down from 10.29 cents in 2000 and 8.79 cents in 1996. Thus the industry has lost six years’ revenue growth

but has not shed six years of unit costs or six years of capacity additions.

“You’re talking about an industry that’s suddenly 20% smaller,” Boyd agrees. “Could McDonalds exist under that scenario? I don’t know, but you’ve got to get that infrastructure down.”

Although the epicenter of these changes is in the US market, the European market also is being transformed by the rise of Ryanair and easyJet (*ATW*, 8/02, p.27). OAG data cited by Unisys R2A show that “low-cost flying in Europe increased by 63% in 2002 in an industry that saw only 1% growth overall.” SAS has been particularly hard hit, but Lufthansa is also under pressure and easyJet is set to land at Paris Orly this year. Unisys R2A VP Ron Kuhlmann argues that “the traditional network carriers need to realize that even if the ‘good times’ were to return, it would not produce ‘traditional’ yields and would likely end in yet another down cycle.”

And Baker observes: “In the long term, the legacy carriers are in a perpetual state of going out of business. While the industry may occasionally flirt with profitability, the airline business is far from being self-sustaining. Additional capital is routinely required and subsequently destroyed. Having said that, significant labor cost restructuring should better position the legacy carriers for the next up-cycle where they will face an increasingly robust discount sector.”

It is a sobering thought: Airlines that manage to escape the fire today still will end up back in the frying pan. ❖