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Taxes, Fees Resurrect Debate Over Privatizing Air Traffic Control

High fees and taxes dogging the airline industry are reigniting a debate about whether air traffic control functions should be privatized in order to bring down costs.

Airlines have been complaining for years that fees and taxes take a large bite out of revenue. This is particularly the case in a tough pricing environment that does not allow costs to be passed onto passengers. Instead of giving airlines relief, the Bush administration is moving in the opposite direction. Its budget proposal for fiscal year 2006 substantially increases airline security fees to raise an additional \$1.5 billion a year.

High taxes and fees, combined with devastating losses for major carriers over the past few years, are breathing new life into a long-simmering debate about the benefits of privatizing air traffic control.

A consulting arm of **Unisys** [UIS] is exploring how airlines can dig out from high taxes and fees, and it believes the single most important action to help airlines would be to privatize, or "corporatize," the air traffic control function of the **Federal Aviation Administration** (FAA). The United States has an admirable record of safe and effective air traffic control but is falling behind other countries that are gaining in efficiency, lowering unit costs and fostering modernization, according to Unisys.

The concept of privatizing air traffic control turned into a raging debate a few years ago. In the summer of 2002, a move by the Bush administration setting the stage for privatization triggered a firestorm, spurring several unions to charge that the government was putting profits ahead of safety. The unions were irate that the White House released an executive order stripping air traffic control of its "inherently governmental" designation.

Several major carriers have been intrigued over the years with the prospect that the industry could save hundreds of millions of dollars a year by moving to a privatized system along the lines of the Canadian model, **NavCanada**. But some observers say the main impetus for privatization has been the Bush administration.

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Financial Bite Of Ticket Taxes May Be Less Than Airlines Say

Airline taxes and fees put a huge strain on the industry, but the financial bite is not as bad as airlines sometimes claim, according to professors at the **Massachusetts Institute of Technology** (MIT) and **Daniel Webster College**. They say ticket taxes add about 16 percent to the average domestic fare despite recent statements by some senior airline executives that taxes and fees amount to about 26 percent.

"The airline industry usually computes taxes by picking a single 'typical' ticket," said Joakim Karlsson of Daniel Webster College. "That choice usually results in a much higher estimate of the tax impact, and we usually see the airline industry report the tax as 26 percent." MIT Professor Amedeo Odoni believes the lower tax estimates can add a more "factual note" to the ticket tax debate. "It provides an objective basis for Congress to examine the issue and make informed decisions on future changes to existing taxes and fees on domestic airfares," he said.

The two professors oversee the Ticket Tax Project, which is run jointly by the MIT Global Airline Industry Program and Daniel Webster College.

When illustrating ticket taxes, airline executives often use a ticket priced at around \$200. This is assumed to be a roundtrip ticket with connecting flights, with each airport levying passenger facility charges at the allowed maximum of \$4.50. Since the ticket taxes paid by each passenger depend both on the number of connections and specific airports, these assumptions tend to overestimate the tax paid by the average passenger, according to the professors.

In practice, only about one-third of passengers make a connection, Karlsson said. This is significant because

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most ticket taxes are charged each time the passenger boards an airplane. In addition, he said, airlines make an incorrect assumption that each airport collects a passenger facility charge of \$4.50. In reality, some airports collect less and some collect no charge at all. Moreover, the \$200 pre-tax fare used as an example by the airlines is lower than the true average ticket price paid by travelers, which was \$290 in 2002. The combined effect is an overstatement of the amount of ticket taxes in percentage terms, according to Karlsson.

The professors concluded that while taxes, as a percentage of the total ticket cost, are generally highest on the least expensive tickets, low-cost carriers such as **Southwest Airlines** [LUV] and **Jet Blue Airways** [JBLU] only pay marginally higher taxes than legacy carriers. This is because passengers on low-cost carriers usually make few connections. Also, low-cost carriers prefer regional airports over congested metropolitan airports. Regional airports generally have lower costs and therefore charge lower passenger facility charges compared to their big-city cousins, Karlsson said. There is still a slight difference in taxes, though. The professors found that travelers on low-cost carriers pay an average of 17.1 percent in ticket taxes whereas those on legacy carriers pay 14.6 percent. ■

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Unisys argues that higher fares through increased taxes and fees will hurt airlines and the economy. For the year ended Sept. 30, 2004, there were 398 million originating domestic passengers whose air trips averaged 1.8 flight segments and who paid an average roundtrip base fare of \$291, according to Unisys. At 2005 rates, this \$291 ticket would incur an average of \$51.29 in taxes and fees, or 18 percent of the base fare, it says. It argues that continuing increases in taxes and fees will drive down market demand, with significant negative national economic consequences.

Professors at the **Massachusetts Institute of Technology** (MIT) and **Daniel Webster College** have teamed up to conduct a real-world assessment of airline fees and taxes. Airline ticket prices have dropped over the past several years, but many of the taxes and fees have remained about the same. As a result, the effective tax rate on airline tickets is steadily increasing, and would increase more under the Bush administration's budget proposal.

Joakim Karlsson, a professor at Daniel Webster College, noted that airlines have lost their ability to raise fares, even to keep pace with inflation. The average roundtrip ticket has dropped 40 percent in real terms since 1993. But average ticket taxes and fees have stayed relatively constant at \$45 per ticket. "With the total cost of taxes changing only slightly, the relative share of each ticket that goes to taxes and fees has been steadily increasing," he said.

Karlsson has focused on measuring the tax rate and has not examined the potential effect of privatizing air traffic control. But he did offer a few opinions. For starters, he believes taxes and fees aren't as high as the airline industry makes them out to be. The **Air Transport Association** (ATA) usually reports taxes as 26 percent of the fare, but his research demonstrates that on average, the actual rate is closer to 16 percent (see sidebar on p. 1).

Privatization of air traffic control would not remove taxes, Karlsson stresses. Some portion of today's taxes would simply become user fees. He said a key message of Unisys is that privatizing air traffic control would introduce efficiency improvements, thereby making user fees paid by airlines lower than the current tax and fee system. "This is a compelling argument, but it is also unproven and a difficult political sell," he told *Airline Business Report*. "Private industry does not always do a better job than government, although the international evidence for air traffic control seems positive."

More than one-third of the FAA's budget does not come from taxes

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and fees. Instead, it comes from general federal tax revenues. "I suspect that any serious privatization proposal would result in considerable pressure to reduce or eliminate this," Karlsson said of the general tax revenues. "That would make it much harder for a privatized air traffic control system to deliver cost savings to the end user. I am all for reducing inefficiencies and making taxes as low as possible. However, it's a complex problem which is unlikely to have a simple solution."

When expressed as a percentage, the tax rate on airlines is rising. But this is due to the drastic decline in base fares, not because taxes are rising per se. "This considerably weakens the argument that the current industry woes are caused by the high level of taxes," he said. There is no doubt the airlines would benefit from a reduction in taxes, but he questions the importance of taxes in explaining the large losses racked up by the airline industry as a whole.

Karlsson and his research partner, MIT Professor Amedeo Odoni, agree that the proposal by the Bush administration to increase security taxes would take its toll on airlines. The increased security fees would place a further strain on airlines when several of them are struggling to stay afloat, according to Odoni. After the administration's proposed hike in security fees, passengers would, on average, pay 19 percent in taxes and fees on top of the ticket price, he said. In 2004, passengers paid 16.1 percent in taxes on top of the price of a domestic ticket. This is up from 15.5 percent in 2002 and 10.9 percent in 1993, Odoni said.

Nevertheless, he says it is difficult to argue that taxpayers at large should subsidize the security costs of airline customers. Unisys and ATA strongly disagree. For example, Unisys says aviation security needs to be funded by all of taxpayers, much like taxes fund the Coast Guard, Border Patrol and the FBI.

Ron Kuhlmann, an analyst at Unisys, does not expect privatization to happen in the near future. "The labor questions, the transfer of equipment and authority, and the inertia of the system make all this unlikely in the short run," he told *Airline Business Report*. But if the lack of funding for air traffic control ever leads to operational difficulties or horrific accident, the discussion may take on a whole new life, he said. At this time, it appears the government is more interested in saving money than pushing for privatization or other reforms, he said.

Airline CEOs are becoming increasingly vocal about the impact of high fees and taxes. Joe Leonard, chairman and CEO of **AirTran Airways** [AAI], said in late March that federal taxes and fees on airlines are now higher than those on liquor and cigarettes. A few weeks earlier, the head of **Mesa Air Group** [MESA], Jonathan Ornstein, made the same case. He emphasized that airlines already face a higher tax and fee burden than any other industry, including alcohol and tobacco, where the taxes are imposed to discourage consumption. ✈

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Aircraft Leasing Firms Accused Of Distorting Market By Bailing Out Carriers

Aircraft leasing companies are pumping up failed business models by renegotiating contracts with financially stressed carriers, according to airline executives and analysts. Meanwhile, the controversy about whether regional jets are clogging airports is cropping up again.

When carriers run into financial problems, especially filing for bankruptcy, lessors often cut deals to help keep the airlines in business. Joe Leonard, chairman and CEO of **AirTran Airways** [AAI], contends that the growing use of bankruptcy as a business strategy is skewing the marketplace. Speaking at the **Aero Club** in Washington, D.C., in late March, he said bankruptcy used to be a measure of last resort but airlines have begun using it almost as a routine part of business planning.

Bankruptcy is increasingly seen as a smart and savvy means to duck credit obligations, according to Leonard. "Bankruptcy is allowing old-school carriers to avoid dealing with marketplace realities," he said. "In the end, Chapter 11 hardly guarantees a carrier will emerge with a workable plan for success. On the contrary, many carriers are using the bankruptcy laws to leave their debt obligations behind and hold onto the same failed business plans."

Leonard made the case that while there are significant challenges to enter the airline business, they pale in comparison to the barriers keeping airlines from exiting the business. A key barrier is the motivation of leasing companies to renegotiate contracts with airline clients.

Will Ris, senior vice president of **American Airlines** [AMR], made this point last May. Speaking at a conference sponsored by the **U.S. Chamber of Commerce**, he said liquidation is not a real option for airlines. "It is almost impossible to go out of business if you are an airline," he said. The last thing a leasing company wants is to take back possession of its aircraft. Instead, lessors bend over backwards to give the carrier financial concessions. James May, the president and CEO of the **Air Transport Association**, also agreed with this assessment (*ABR*, May 24, 2004, p. 8).

Robert Ashcroft, an analyst at **UBS Investment Research**, says aircraft lessors may have substantially altered U.S. commercial aviation, especially **General Electric Capital Aviation Services** (GECAS). He says airline capacity