MIT Guest Lecture
October 13, 2004

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President and Managing Partner
Eclat Consulting
If Individual Airlines Are Vulnerable, then Why Isn’t the Infrastructure that Supports the Industry Vulnerable and At What Point Does the Government Need to Restructure Its Business Approach to the Industry?
Premise

- **Too many of everything**
  - Network Carriers
  - Regional Carriers
  - Low Cost Carriers
  - Hubs

- **Do not underestimate the competitive response of the Legacy Carriers**
  - Everybody is vulnerable

- **We are entering a new phase of growth**
  - Markets are smaller, and they
  - Already have seen both service and price stimulation
  - As a result, stimulation rates will be lower
American, Continental and United have much less at stake than Delta, Northwest and US Airways relative to the size of their networks

- The lack of any pricing power underscores the problems faced by both Delta and US Airways as their core networks would seem to be most vulnerable to new U.S. growth

The “networks” of Southwest and AirTran are well positioned to withstand what promises to be a vicious battle for substantial revenue, but

- jetBlue seeing margin erosion
- AirTran warning on third quarter results
- Southwest warning on 2005 performance
- ATA teetering on the edge
- Frontier disappointing results
- America West performing nicely but transcon revenue squeeze is on
- Is Spirit taking aircraft too late in the cycle
- If Spirit is late then what about Branson?
An Industry in Transition
In Search of Sustainable Earnings --
Even the Low Cost Carriers Are Warning

U.S. Industry Operating Income

- Concessionary Bargaining
  -- B Scale
  -- Survival

- Concessionary Bargaining
  -- Low Fare Initiatives
  -- UAL ESOP

- Large Settlements

- Recession

- Recession/Gulf War

- Unprecedented Economic Expansion

US Dollars (Billions)

'78 '79 '80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03
Historical Impact on Local Market Traffic Following the Exit of a Hubbing Carrier
As in any good market, results return to the long-term trend line

- Each of the case studies suggest this to be true
  - In each the case of Nashville and Raleigh-Durham, the replacement of the hubbing carrier by Southwest resulted in a steeper long-term trajectory
    - But not all LCCs create demand the same way - Southwest truly creates new demand, whereas jetBlue, AirTran and Frontier create new demand, but also steal from incumbents
  - The question going forward is, should a carrier fail, will all of its hubs be replaced?
    - No not all hubs will be replaced, but sufficient capacity will be added so as to accommodate local demand
    - We see the following hubs as vulnerable: Cleveland (CO); Dallas/Ft. Worth (DL); Cincinnati (DL); Memphis (NW); Pittsburgh (US); and Salt Lake City (DL)
      - Each of these hubs has the 50-seat regional jet as its service backbone
    - We believe that a reduction in the number of connecting hubs will prove healthy for the industry as significant pricing pressure is created at each
    - Hasn’t the consolidation process actually begun within each of the respective U.S. domestic alliances?
Not all U.S. Hubs Survived --
But the Carrier Exiting Was Hardly Noticed
Low Cost Carriers in the U.S. Domestic Market
LCCs have captured 10 full points of U.S. domestic market share since CY 2000

- We expect LCC growth to slow due to:
  - Increasing competitive pressures from incumbent carriers
  - Largest U.S. city pairs now saturated with capacity of all flavors
  - Case in point: Frontier’s decision to abandon 75% of the non-hub routes started at LAX where the carrier announced it wanted to build a focus city

- We expect to see some consolidation within the LCC segment of the Industry
  - Financial trouble most prevalent at American Trans Air
    - Midway a valuable asset in the eyes of other LCCs
  - Given the announced delivery of aircraft within the LCC sector over the next 3-4 years, we do not see a commensurate number of market opportunities
    - Except in the event of a liquidation of an existing carrier
Going forward, markets targeted for growth by the LCCs will look very different than those entered during 2001-2004

- Markets will be smaller
  - Historically, growth has occurred in city pairs that have a large hub airport on at least one end of the itinerary
  - With the market at or near capacity saturation in the largest U.S. city pairs, LCCs will be forced to look at medium and small hub airports to base growth
    - Reason why jetBlue has looked to a shell size smaller than the A320
    - We believe this decision will be among the most watched once jetBlue begins to take delivery in 2005
  - Currently only 226 city pairs with at least 100 passengers per day traveling each way have no LCC service
    - Of those markets, 132 are faced with significant competitive issues

- Stimulation rates will be less
  - While there will be some exceptions, historic stimulation rates will not be replicated
    - Fares are down significantly in markets of all sizes, yet the commensurate increase in traffic has not been demonstrated
      » This is particularly true in short haul markets
The Next Phase of LCC Growth Will Require a Different Mindset About Market Size -- But Will Their Model Really Work?

<table>
<thead>
<tr>
<th>LCC Markets Entered</th>
<th>Total City Pairs</th>
<th>Large Hub Airports to/from</th>
<th>Medium Hub Airports to/from</th>
<th>Small Hub Airports to/from</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>Large Hub</td>
<td>Medium Hub</td>
<td>Small Hub</td>
</tr>
<tr>
<td>1994</td>
<td>3</td>
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<tr>
<td>1995</td>
<td>54</td>
<td>8</td>
<td>30</td>
<td>3</td>
</tr>
<tr>
<td>1996</td>
<td>44</td>
<td>12</td>
<td>23</td>
<td>4</td>
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<tr>
<td>1997</td>
<td>56</td>
<td>15</td>
<td>26</td>
<td>9</td>
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<td>1998</td>
<td>51</td>
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<tr>
<td>1999</td>
<td>57</td>
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<td>2000</td>
<td>55</td>
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<td>31</td>
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<td>2001</td>
<td>53</td>
<td>24</td>
<td>21</td>
<td>6</td>
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<tr>
<td>2002</td>
<td>24</td>
<td>10</td>
<td>10</td>
<td>4</td>
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<tr>
<td>2003</td>
<td>36</td>
<td>15</td>
<td>10</td>
<td>7</td>
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<tr>
<td>2004YTD</td>
<td>70</td>
<td>20</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>503</strong></td>
<td><strong>166</strong></td>
<td><strong>216</strong></td>
<td><strong>70</strong></td>
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% of Total

<table>
<thead>
<tr>
<th>Large Hub</th>
<th>Medium Hub</th>
<th>Small Hub</th>
<th>Non-Hub</th>
<th>Medium Hub</th>
<th>Small Hub</th>
<th>Non-Hub</th>
<th>Small Hub</th>
<th>Non-Hub</th>
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<tr>
<td>33.0%</td>
<td>42.9%</td>
<td>13.9%</td>
<td>2.6%</td>
<td>5.2%</td>
<td>1.6%</td>
<td>0.2%</td>
<td>0.2%</td>
<td>0.4%</td>
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Cumulative % of Total

<table>
<thead>
<tr>
<th>Large Hub</th>
<th>Medium Hub</th>
<th>Small Hub</th>
<th>Non-Hub</th>
<th>Large Hub</th>
<th>Medium Hub</th>
<th>Small Hub</th>
<th>Non-Hub</th>
<th>Small Hub</th>
<th>Non-Hub</th>
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</thead>
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<tr>
<td>75.9%</td>
<td>89.9%</td>
<td>92.4%</td>
<td>97.6%</td>
<td>99.2%</td>
<td>99.4%</td>
<td>99.6%</td>
<td>100%</td>
<td></td>
<td></td>
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</table>
Now Fully Exploited, Can Even the Largest U.S. Markets Support All of the Capacity In Place Today?

LCC Share of Domestic Air Service, July 2004

- **Total Los Angeles**: 40%
- **Total San Francisco**: 33%
- **Total Denver**: 16%
- **Total Chicago**: 18%
- **Total Dallas/Ft. Worth**: 21%
- **Total Houston**: 28%
- **Total Washington**: 24%
- **Total Atlanta**: 14%
- **Total Miami**: 19%
- **Total Philadelphia**: 9%
- **Total New York**: 12%
- **Total Boston**: 13%

Legend:
- Large Hub
- Medium Hub
- Small Hub
It Is Time for Another Round of Consolidation -- And the Government Should Look the Other Way

U.S. Low Fare Carriers

Weekly Seats (000)

First Phase of Consolidation

+12.4% per annum

Second Phase of Consolidation?

+28.4% per annum
Industry Revenue Declines Are Not Limited to Markets With Current LCC Presence -- More than Adequate Competition Exists in the Smallest U.S. Markets -- Government Take Note

A Look at Revenue 2003 v. 2000

<table>
<thead>
<tr>
<th>Large Hub Airports to/from</th>
<th>Medium Hub Airports to/from</th>
<th>Small Hub Airports to/from</th>
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</thead>
<tbody>
<tr>
<td>Large Hub</td>
<td>Medium Hub</td>
<td>Small Hub</td>
</tr>
<tr>
<td>Traffic</td>
<td>-11.1%</td>
<td>-5.5%</td>
</tr>
<tr>
<td>Avg. Fare</td>
<td>-15.6%</td>
<td>-10.1%</td>
</tr>
<tr>
<td>Revenue</td>
<td>-25.0%</td>
<td>-15.0%</td>
</tr>
</tbody>
</table>
Revenue Degradation in Markets Across the Mileage Spectrum Appears to be Systemic

2003 v. 2000
While the U.S. Domestic Market Remains Sick - Financial Results Are Being Cross Subsidized by Healthy International Markets

6 Months Ended June 2004 v. 6 Months Ended June 2003

Traffic Yield Revenue
Pacific

<table>
<thead>
<tr>
<th>Traffic</th>
<th>Yield</th>
<th>Revenue</th>
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</thead>
<tbody>
<tr>
<td>27.1</td>
<td>12.1</td>
<td>42.5</td>
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</table>

U.S. Domestic

<table>
<thead>
<tr>
<th>Traffic</th>
<th>Yield</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.1</td>
<td>6.8</td>
<td>13.9</td>
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</table>

Total International

<table>
<thead>
<tr>
<th>Traffic</th>
<th>Yield</th>
<th>Revenue</th>
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</thead>
<tbody>
<tr>
<td>20.1</td>
<td>6.8</td>
<td>28.2</td>
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</table>

Atlantic

<table>
<thead>
<tr>
<th>Traffic</th>
<th>Yield</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>18.1</td>
<td>7.1</td>
<td>26.5</td>
</tr>
</tbody>
</table>

Latin America

<table>
<thead>
<tr>
<th>Traffic</th>
<th>Yield</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>15.4</td>
<td>3.2</td>
<td>19.1</td>
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</table>
The Myth of Market Stimulation
The Myth of Stimulation --
Total Market Traffic Stimulation Is Less Than 12%,
So What Is All of the Hoopla Over?

1994 - 2002

<table>
<thead>
<tr>
<th>New City Pairs Introduced</th>
<th>Actual Passenger* Stimulation</th>
<th>Redirected Incumbent Traffic</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ind. Carriers</td>
<td>Total Market</td>
</tr>
<tr>
<td>Southwest</td>
<td></td>
<td>+11.1M</td>
</tr>
<tr>
<td>AirTran</td>
<td></td>
<td>+4.8M</td>
</tr>
<tr>
<td>jetBlue</td>
<td></td>
<td>+1.8M</td>
</tr>
<tr>
<td>Spirit</td>
<td></td>
<td>+3.5M</td>
</tr>
<tr>
<td>ATA</td>
<td></td>
<td>+1.3M</td>
</tr>
<tr>
<td>Frontier</td>
<td></td>
<td>+1.5M</td>
</tr>
</tbody>
</table>

**Total**  
+29.8M or +24.0M (5.8M)  

*Measured 12 months prior to service inauguration by LCC, versus 12 months after.
But the Airplanes Are Full and the Bank Accounts Are Empty

Since 1990, Southwest Has Entered 30 New Markets

- 12 months after WN’s service inauguration, yield
  - Decreased an average of 13.5% from these markets to all domestic destinations (indirect competition), and
  - 18.6% to all Southwest Airlines markets (direct competition)
- In no case did revenue growth in any of these 30 markets exceed traffic growth – traffic stimulation only
- Traffic has been stimulated by lower prices
- The LCCs have an aggressive growth schedule ahead – a fact that will increase the proliferation of low fares across each legacy carrier’s network

Note: Yield change does not include Philadelphia. Traffic data is not yet available since Southwest entered Philadelphia only recently in May 2004.
Today, Pricing Is Influenced by the LCCs in 88% of the U.S. Domestic Market

Southwest Serves: 60 U.S. Airports

**Within 100 Miles**
- Indirect Competition: 114 U.S. Airports
  - % of Airports Impacted: 42.1%
  - % of O&D Traffic Affected: 78.0%

**Within 150 Miles**
- Indirect Competition: 198 U.S. Airports
  - % of Airports Impacted: 62.5%
  - % of O&D Traffic Affected: 86.3%

**Within 200 Miles**
- Indirect Competition: 235 U.S. Airports
  - % of Airports Impacted: 71.4%
  - % of O&D Traffic Affected: 88.0%
But It’s Not Just Southwest Anymore
Fifty Largest Metro Areas Without Southwest Service --
Even for Southwest, Growth Will be Challenging

- Population 1 Million +
- Population 500,000 – 1 Million
- Population Less Than 500,000
Potential Growth Opportunities for the LCCs Other Than Southwest Will Further Pierce the Revenue Veil of Delta and US Airways
The Regional Jet in the U.S. Domestic Market: Past, Present and Future Trends
- **Growth of Regional Jet (70 seats and less) will slow significantly**
  - The 50-seat “bubble” will break
    - Currently no U.S. deliveries scheduled beyond 2005
    - Economics will prove unattractive over medium term and unsustainable over long term – High fuel prices, labor demands and stressed infrastructure
    - The transformation of Atlantic Coast into Independence Air will be critical and watched by the regional industry as a way to lower costs over the long term
  - 70-seat aircraft will prove to have a place, but specialized
    - Currently only US Airways looking to use the aircraft in a significant way
    - Again, in a low fare environment we question the economics given the saturation of low cost carriers and too many hubs
  - The common configuration will settle in the 90-120 seat range
    - The issue of mainline pilot scope will again rear its head
      - We believe that the mainline pilots will negotiate rates and rules that permit the mainline to do the flying, thus hurting the regional industry as we know it
As We Near the End of Phase 1 of Regional Carrier Growth, the Next Growth Phase is Clear as Mud

High Regional Carrier Unit Costs

1Q 2004 CASM

**Definition:**
CASM: Cost Per Available Seat Mile.
Note: Calculation above represents total operating expenses divided by available seat miles flown.
Current Regional Carrier Capacity Is Not Cheap Capacity - Will It Prove To Be The Answer to Total Network Costs?

Despite the Substantial Reductions in Regional Carrier Unit Costs, They Remain 31% Higher than Mainline Unit Costs
Is It Time to Begin Rethinking the High Frequency/Small Aircraft Approach In This Pricing Environment?
Sources of Capacity Change in the U.S. Domestic Market -- We See the Platforms Getting Bigger

-10%  -8%  -6%  -4%  -2%  0%  2%  4%  6%  8%  10%

% Change in Departures  %Change in Average Seats  %Change in Average Stage Length

Route Structure Development
A Tale of Two Sectors

- The Network Carriers
  - Seats deployed are 6% less today than they were in July of 2000
  - The two most troubled carriers in the group have shed significant capacity
  - Continental has navigated a difficult marketplace with measured capacity growth
  - With few exceptions, the growth has occurred within the network through each of the network carriers’ regional affiliates
    - As mentioned earlier, we expect this trend to slow significantly and to see refocus on measured growth using aircraft larger than 70 seats

- The Low Cost Carriers
  - Growth has been well documented
  - The LCCs have experimented with regional jet aircraft and have determined that they are not economic within their respective systems
  - Concern is that there are not sufficient “right sized” market opportunities for all of the narrowbody aircraft scheduled to be delivered to Southwest, jetBlue, AirTran and Spirit
Delta and US Airways’ Networks Have the Most to Lose From Planned LCC Growth

Percent of Revenue Exposed to Direct LCC Competition

- American: 85%
- Continental: 81%
- Delta: 69%
- Northwest: 69%
- United: 88%
- US Airways: 60%

Legend:
- Green: Percent of Revenue Derived in Markets Served by Other LCCs, 2003
- Gray: Percent of Revenue Derived in Markets Served by Other LCCs, 2000
LCCs Have High Levels of Direct Competition With One Another -- They Will Be Looking for New Areas to Exploit. But Will They Find Profitable Markets?

Percent of Revenue Earned in Direct Competition With at Least One Other LCC

- jetBlue: 91%
- Frontier: 94%
- AirTran: 50%
- America West: 92%
- Spirit: 78%
- ATA: 75%
- Southwest: 72%

Percent of Revenue Derived in Markets Served by Other LCCs, 2003

Percent of Revenue Derived in Markets Served by Other LCCs, 2000
As LCCs Expand, Regional Carriers Are Exposed to Strict Pricing Pressure as Never Before -- Let’s Also Not Forget the Price of Fuel

Percent of Revenue Earned in Direct Competition With at Least One Other LCC

- American: 76%
- Continental: 82%
- Delta: 82%
- Northwest: 54%
- United: 88%
- US Airways: 62%

- Percent of Revenue Derived in Markets Served by Other LCCs, 2003
- Percent of Revenue Derived in Markets Served by Other LCCs, 2000
Have the Network Carriers Become Too Reliant on the Regional Jet?

Mainline to Mainline Connectivity

Source: Official Airline Guide; Eclat Air Service Model
Are All of the Mid-Continent Hubs, Reliant on Regional Jet Capacity, Necessary?

Excludes IAD, JFK, EWR, LAX, SFO, MIA (International Gateways)
If Connecting Revenue Is to Be the Target of Planned LCC Growth, the Power of the Hub Will Be Tested

Excludes IAD, JFK, EWR, LAX, SFO, MIA (International Gateways)
Network Carrier Vulnerability to Growth by the “Big 3 LCCs”

Index = 100

<table>
<thead>
<tr>
<th>Carrier</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Delta</td>
<td>100.0</td>
</tr>
<tr>
<td>Northwest</td>
<td>75.4</td>
</tr>
<tr>
<td>American</td>
<td>54.0</td>
</tr>
<tr>
<td>US Airways</td>
<td>48.1</td>
</tr>
<tr>
<td>United</td>
<td>46.2</td>
</tr>
<tr>
<td>Other Industry</td>
<td>41.4</td>
</tr>
<tr>
<td>Alaska</td>
<td>29.0</td>
</tr>
<tr>
<td>Continental</td>
<td>27.0</td>
</tr>
</tbody>
</table>

Other Industry Comprised of: America West, Spirit, AirTran, Southwest, Midwest, ATA, Frontier, Sun Country and jetBlue. (Listed in Order of Vulnerability)
How Industry Changes Have Impacted Airports
Price Differentials Have Driven Changes in Airport Prospects

Primary Means of Competition

<table>
<thead>
<tr>
<th>Schedule Driven</th>
<th>Deregulation</th>
<th>Price Driven</th>
</tr>
</thead>
</table>

- Development of hub and spoke system by legacy carriers (1975-1984)
- Strong capacity growth (B-scale labor rates)
- LCCs begin to make inroads, but strong economy buoy demand for business fares
- Gap between business and leisure fares widens from traditional 2-3 times to 3-5 times
Implications for Airports

- **The battle over the catchment* area has intensified**
  - “City” airports have become “regional” airports

- **Previously**
  - Limited airport competition for passengers
    - Based on schedule issues (frequency and nonstop destinations)
    - No airport fare competition for passengers

- **Now**
  - Intense airport competition for passengers
  - “Diversion” and “recapture” battles

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* The catchment area is the geographic area that would naturally use the airport
Is There an Equilibrium for Small/Medium Airports?

The Business Traveler Will be Critical to Finding the Balance
Some Conclusions About Capacity

- Infrastructure expansions will be inadequate to keep up with the growth in demand.

- Future “solutions” will involve:
  - New uses of technology
  - Market-based (and political) methods of allocating capacity

- To what extent will capacity constraints drive changes in aircraft size and scheduling?
Concluding Thoughts
Dispelling the Myths:

Myth 1: The Low Cost Carriers create new traffic
   — Some do/some don’t

Myth 2: The Network Carriers will all die
   — Some will/others will thrive

Myth 3: All of the current LCCs will thrive
   — Southwest, AirTran and jetBlue should

Myth 4: The Regional Carriers are the Network Carriers’ lifeline
   — May prove to be the most troubled part of the Network Carriers’ competitive makeup
   — Certainly do not bring overall network costs down
Dispelling the Myths:

**Myth 5: Labor costs are the Achilles Heel of the Network Carriers**
- Has anybody paid attention to the labor cost trends among the LCC and regional sectors lately?
- Can we bring non-labor costs to a level that can produce profits when realized in addition to labor cost reductions?

**Myth 6: Small airplanes are the future**
- Maybe ACA Is Right
- And in Mesa’s Case, “If I can’t buy them, emulate them” -- by considering big airplanes

**Myth 7: The LCCs will be able to satisfy all of the growth plans in the U.S. market**
- Our models show it to be very difficult
- jetBlue signaling opportunities elsewhere
Dispelling the Myths:

**Myth 8: Traditional means of measuring levels of competition fit today’s network business model**

— Absolutely not. Continued attempts to measure competition on a city pair by city pair basis lost its meaning following the sunset of the Civil Aeronautics Board and the advent of the hub and spoke system. It is about network and alliance competition

— And rethink the whole cross border investment concept as well. This is a global industry not a U.S. domestic industry

**Myth 9: Small U.S. markets continue to get price gouged**

— That is not what the data says

— And with no LCC presence, it is the legacy carriers and the hub and spoke system that has allowed this previously disenfranchised group to participate in price reductions

— Yes, it is true there is indirect LCC competition, but when assessing the competitive intensity of the U.S. marketplace, one should look at just how many options per day consumers have to fly from small market to any market

**Myth 10: This revenue problem will pass**

— At 3+ years and counting, let’s just admit it is structural and therefore has permanence to it
Eclat Consulting

An Overview

Eclat specializes in the economics of commercial aviation. Over the past 20 years, Eclat principals have been involved in some capacity in every major airline restructuring in the United States. As a result of that experience, Eclat has also served in important advisory roles with other North American, European and Asian carriers.

Our clients rely on our expertise in identifying market trends and structural shifts within the commercial aviation industry. Eclat’s knowledge and understanding of the interaction of the human and capital aspects of the airline business is unrivaled by any firm.

We help position clients in a competitive marketplace by providing: economic, labor, financial and operational analyses; infrastructure assessments; asset valuations; and forecasts. These services help guide our aviation clients in developing new markets or establishing policy.
Eclat Consulting’s Major Assignments

**Airlines**
- Air Canada
- Air China
- Alaska Airlines
- American Airlines
- bmi british midland
- China Southern
- Emery Air Cargo
- Express.Net
- Federal Express
- Hawaiian Airlines
- Lufthansa
- Northwest Airlines
- Primaris Airlines
- Sabena
- United Airlines
- US Airways

**Airports**
- Aeroports de Montreal
- Allegheny County Airport Authority
- City of Phoenix Aviation Department
- Commonwealth of Pennsylvania
- Commonwealth of Virginia
- Erie International Airport
- Harrisburg International Airport
- Hickory, N.C. Regional Airport
- Shenandoah Valley Regional Airport
- Williams Gateway Airport
Eclat Consulting’s Major Assignments

**Financial and Legal Communities**
- Aon Fiduciary Counselors
- Davis Wright Tremaine LLP
- Ernst & Young
- Ford & Harrison
- Helios Investment Partners
- Milestone Merchant Partners
- Morgan Stanley
- Pension Benefit Guaranty Corporation
- Texas Pacific Group

**Labor Related**
- Air Line Pilots Association
- Association of Flight Attendants
- Canadian Union of Public Employees
- Independent Pilots Association
- International Association of Machinists and Aerospace Workers
- Transport Workers Union

**Manufacturers & Other**
- Airbus North America
- Economic Strategy Institute
- Institute of Defense Analyses