UPDATE:
US AIRLINE COST AND PRODUCTIVITY TRENDS

William S. Swelbar
US AIRLINES: A Tale of Two Sectors

• **US Network Legacy Carriers**
  - Between 2000 and 2007, mainline capacity reduced. But some was shifts to smaller aircraft and commuter affiliates.
  - Bankruptcies at US, UA, DL and NW were the first wave of capacity reductions, allowed for labor cost reductions and increased productivity
  - AA and CO re-structured to remain competitive without Chapter 11
  - All network carriers have reduced exposure to domestic flying

• **Low Cost Carriers**
  - LCC share of domestic passengers has increased to over 26%, from 16% in 2000 and only 5% in 1990
  - But unit cost advantages of new entrants tend to disappear as both aircraft and employees mature
    • Fuel cost is proving to be a great equalizer in today’s world
  - ASM growth has facilitated lower unit costs, but not clear there are enough market opportunities for all of the narrow body aircraft on order by LCCs.
The Growth of LCC Market Share
Domestic ASMs by Industry Sector

1995
- LCCs: 8%
- Network Carriers
- Other

2000
- LCCs: 13%
- Network Carriers
- Other

2007
- LCCs: 26%
- Network Carriers
- Other
Cost and Productivity Convergence

• **Lower costs and improved productivity allowed NLCs to return to profitability in 2006 and 2007**
  - Network Legacy Carriers re-structured, reduced/outsourced capacity, and cut costs while improving productivity at the mainline level
  - The network legacy carriers were once again more profitable than the LCC sector (operating profits)

• **The unit cost gap has narrowed dramatically**
  - NLCs have seen large drops in labor and other cost components
  - LCCs still have lower total unit costs than NLCs

• **New 2007 data shows that convergence has slowed**
  - Labor unit costs remain very similar
  - Non-labor (“structural”) unit costs for NLCs are still at least 1 cent per ASM higher than LCCs
  - Just not many areas of cost left to cut
2007 Update: Unit Costs (excl. “Transport Related”)

CASM Ex Transport ($/ASM)

$/ASM


NLC  LCC

$0.022

$0.020 $0.024
• All NLCs cut CASM exTF, with US Airways, United and American achieving almost 25% reductions.

• LCCs showed mixed unit cost performance - reductions at newer carriers (Frontier, JetBlue) and increases at older LCCs (Southwest).
Percent Change in Unit Non-Labor Costs
2001 - 2007

Northwest
Southwest
Delta
jetBlue
Continental
AirTran
United
US Airways
American
Frontier

-40.0%  -30.0%  -20.0%  -10.0%  0.0%  10.0%
2007 Update: Labor Unit Costs

CASM Labor ($/ASM)

$0.012

$0.035

$0.04

$0.045

$0.05

$0.055


$0.003

$0.005

NLC LCC

Massachusetts Institute of Technology
Percent Change In Unit Labor Costs
2001 - 2007

Percent Change

WN  F9  CO  FL  B6  AA  NW  USHP  UA  DL

-50% -40% -30% -20% -10%  0%  10%  20%
The Pending Labor Question: Who Paid for the Brief Recovery?

**Annual Labor Cost Change**

$ Millions

Peak Labor CASM

At YE 2007

**Annual Non-Labor Cost Change**

$ Millions

Peak Non-Labor CASM

At 2007

Peak CASM is defined as highest unit cost since 2001.
Annual expense reduction calculated using 2007ASMs.
Jet Fuel Has Forced Continued Restructuring of the Industry

- Lower costs + improved productivity (+ revenue premium) = only a brief return to profitability for NLCs
  - Network Legacy Carriers have been re-structuring, shifting/outsourcing capacity, and cutting costs while improving productivity
  - But not enough to offset the surge in the cost of jet fuel

- Jet fuel though, has had a most significant impact on the LCC sector

- Capacity reductions will result in the most inefficient aircraft being removed from the system
  - Financial positives in fuel, maintenance, overall fleet utilization and operational performance?
Annual Net Profits
1978 – 2008E
But, There Is Not Enough Cost Cutting Left that Can Offset the March of Fuel Prices

Source: ATA, Energy Information Administration, Standard & Poor’s and Morgan Stanley
So, Absent Structural Change in the Industry

- **Continued focus on cost-cutting will remain paramount**
  - But the historic pools of cost are not as readily available
    - Labor costs are not a source of saving; labor will push hard to get back
    - Distribution costs have largely been wrung out of the system
    - Fear is maintenance costs will head up; materials costs already an issue
    - The infrastructure is not the industry’s friend; will continue to mute efficiency efforts
    - And fuel is an uncontrollable cost
  - So, the industry will look to cut capacity
    - Not as easy outside of bankruptcy when contracts cannot be altered
    - The industry spends in excess of $15 billion per year with regional carriers
      - Really only large pool of expense to consider

- **Capacity cuts have risk**
  - Political
  - Financial
Economic Circumstances Sustaining Industry Contraction

Reductions in Scheduled Domestic Air Service vs. Same Quarters in 2007

<table>
<thead>
<tr>
<th></th>
<th>4Q08 vs. 4Q07</th>
<th>1Q09 vs. 1Q07</th>
<th>2Q09 vs. 2Q07</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Flights</strong></td>
<td>(9.3)</td>
<td>(10.2)</td>
<td>(10.4)</td>
</tr>
<tr>
<td><strong>Seats</strong></td>
<td>(8.5)</td>
<td>(9.5)</td>
<td>(10.8)</td>
</tr>
<tr>
<td><strong>ASMs</strong></td>
<td>(10.2)</td>
<td>(11.1)</td>
<td>(12.4)</td>
</tr>
</tbody>
</table>

* An available seat mile (ASM) is one seat flown one mile and is the standard unit of capacity in the passenger airline sector

Source: ATA analysis of Seabury APGDat airline schedules as of Oct. 27, 2008
Domestic Seating Capacity Cuts Span the Industry

% Change in Scheduled Domestic Available Seat Miles: 4Q08 vs. 4Q07

* Includes Allegiant, Virgin America, Sun Country, ExpressJet, Aloha, USA 3000, Great Lakes, Mesa and numerous others (in order of 4Q07 size)

(Sorted left to right by number of scheduled domestic available seat miles in 4Q07)

Sources: ATA, as of 10/8/08.
The Revenue Environment

- To many, the fix is a simple raise of fares. Fares are going up........but
  - The intense level of competition signals that this is not a viable option
  - Transparency makes increasing fares only difficult
    - Therefore the ancillary fees
  - Operating profit for both NLCs and LCCs is elusive when expenses are subtracted from passenger revenue only
    - New revenue sources sought by all

- The absolute level of fare reductions realized by the NLC sector since 2000 is significant
  - With fare reductions of this order of magnitude, the revenue line cannot yet write the check that labor expects in the next round
  - Moreover, fare premiums exist but against a much smaller base fare for the NLC sector

- The LCC sector has been increasing their fares to compensate for increasing costs
  - But still have to price well below their direct competition
  - Given current statements about demand by the LCC sector, will their decision to slow capacity plans have a negative impact on profitability?
Passenger Revenue as a Percent of GDP
Fewer Seats Finally Aligning with Less Revenue?

$25 billion less
## Domestic Fare Profile

**All Domestic Markets**

<table>
<thead>
<tr>
<th>Year</th>
<th>Continental Pax Share</th>
<th>Other Network Carrier Share</th>
<th>LCC Share</th>
<th>Other Carrier Share</th>
<th>Continental Revenue Share</th>
<th>Continental Average Fare</th>
<th>OA Fare</th>
<th>Continental Fare Premium</th>
<th>Average Passenger Trip Length</th>
<th>Coupons</th>
<th>Total Market Revenue ($Mils)</th>
<th>Total Market Pax (Mils)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>9.8%</td>
<td>64.6%</td>
<td>17.7%</td>
<td>0.9%</td>
<td>9.7%</td>
<td>$159.81</td>
<td>$162.83</td>
<td>(1.9%)</td>
<td>1,156</td>
<td>1.35</td>
<td>$9,187</td>
<td>56.5</td>
</tr>
<tr>
<td>1996</td>
<td>8.9%</td>
<td>61.8%</td>
<td>19.7%</td>
<td>2.2%</td>
<td>9.1%</td>
<td>$154.98</td>
<td>$150.28</td>
<td>3.1%</td>
<td>1,180</td>
<td>1.26</td>
<td>$9,552</td>
<td>63.4</td>
</tr>
<tr>
<td>1997</td>
<td>8.9%</td>
<td>62.0%</td>
<td>19.4%</td>
<td>2.0%</td>
<td>9.1%</td>
<td>$168.87</td>
<td>$164.38</td>
<td>2.7%</td>
<td>1,221</td>
<td>1.24</td>
<td>$10,703</td>
<td>65.0</td>
</tr>
<tr>
<td>1998</td>
<td>9.6%</td>
<td>64.3%</td>
<td>19.7%</td>
<td>1.5%</td>
<td>10.0%</td>
<td>$180.17</td>
<td>$171.57</td>
<td>5.0%</td>
<td>1,231</td>
<td>1.32</td>
<td>$12,068</td>
<td>70.0</td>
</tr>
<tr>
<td>1999</td>
<td>9.6%</td>
<td>66.1%</td>
<td>18.4%</td>
<td>1.2%</td>
<td>10.4%</td>
<td>$192.00</td>
<td>$175.05</td>
<td>9.7%</td>
<td>1,238</td>
<td>1.32</td>
<td>$13,237</td>
<td>74.9</td>
</tr>
<tr>
<td>2000</td>
<td>8.8%</td>
<td>64.6%</td>
<td>20.8%</td>
<td>1.4%</td>
<td>10.1%</td>
<td>$212.16</td>
<td>$182.53</td>
<td>16.2%</td>
<td>1,265</td>
<td>1.33</td>
<td>$15,075</td>
<td>81.4</td>
</tr>
<tr>
<td>2001</td>
<td>8.9%</td>
<td>61.0%</td>
<td>22.2%</td>
<td>3.5%</td>
<td>10.3%</td>
<td>$185.32</td>
<td>$158.35</td>
<td>17.0%</td>
<td>1,322</td>
<td>1.36</td>
<td>$12,190</td>
<td>75.8</td>
</tr>
<tr>
<td>2002</td>
<td>9.0%</td>
<td>61.7%</td>
<td>24.3%</td>
<td>1.7%</td>
<td>10.3%</td>
<td>$184.02</td>
<td>$158.56</td>
<td>16.1%</td>
<td>1,328</td>
<td>1.34</td>
<td>$11,557</td>
<td>71.8</td>
</tr>
<tr>
<td>2003</td>
<td>9.5%</td>
<td>58.9%</td>
<td>26.7%</td>
<td>2.0%</td>
<td>10.7%</td>
<td>$188.20</td>
<td>$163.72</td>
<td>15.0%</td>
<td>1,379</td>
<td>1.36</td>
<td>$12,330</td>
<td>74.3</td>
</tr>
<tr>
<td>2004</td>
<td>8.6%</td>
<td>58.0%</td>
<td>27.1%</td>
<td>3.4%</td>
<td>10.1%</td>
<td>$184.37</td>
<td>$153.82</td>
<td>19.9%</td>
<td>1,352</td>
<td>1.33</td>
<td>$13,222</td>
<td>84.5</td>
</tr>
<tr>
<td>2005</td>
<td>8.6%</td>
<td>54.4%</td>
<td>30.7%</td>
<td>3.2%</td>
<td>10.2%</td>
<td>$191.89</td>
<td>$159.55</td>
<td>20.3%</td>
<td>1,355</td>
<td>1.32</td>
<td>$14,733</td>
<td>90.8</td>
</tr>
<tr>
<td>2006</td>
<td>10.3%</td>
<td>55.6%</td>
<td>27.5%</td>
<td>3.5%</td>
<td>11.6%</td>
<td>$204.23</td>
<td>$178.39</td>
<td>14.5%</td>
<td>1,343</td>
<td>1.30</td>
<td>$15,157</td>
<td>83.7</td>
</tr>
</tbody>
</table>

Source: US DOT DB1B via BTS for the third quarters of each year.
## Domestic Fare Profile

### All Domestic Markets

#### SOUTHWEST

<table>
<thead>
<tr>
<th>Year</th>
<th>Southwest Pax Share</th>
<th>Network Carrier Share</th>
<th>Other LCC Share</th>
<th>Other Carrier Share</th>
<th>Southwest Revenue Share</th>
<th>Southwest Average Fare</th>
<th>OA Fare</th>
<th>Southwest Fare Premium</th>
<th>Average Passenger Trip Length</th>
<th>Coupons</th>
<th>Total Market Revenue ($Mils)</th>
<th>Total Market Pax (Mils)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>38.8%</td>
<td>44.1%</td>
<td>7.0%</td>
<td>5.4%</td>
<td>25.0%</td>
<td>$71.18</td>
<td>$135.80</td>
<td>(47.6%)</td>
<td>525</td>
<td>1.13</td>
<td>$3,329</td>
<td>30.1</td>
</tr>
<tr>
<td>1996</td>
<td>34.8%</td>
<td>47.7%</td>
<td>6.9%</td>
<td>5.0%</td>
<td>22.6%</td>
<td>$72.64</td>
<td>$132.98</td>
<td>(45.4%)</td>
<td>560</td>
<td>1.13</td>
<td>$4,128</td>
<td>36.9</td>
</tr>
<tr>
<td>1997</td>
<td>31.9%</td>
<td>51.1%</td>
<td>7.1%</td>
<td>4.1%</td>
<td>20.0%</td>
<td>$80.64</td>
<td>$151.11</td>
<td>(46.6%)</td>
<td>568</td>
<td>1.12</td>
<td>$5,259</td>
<td>40.9</td>
</tr>
<tr>
<td>1998</td>
<td>32.6%</td>
<td>51.4%</td>
<td>6.7%</td>
<td>4.5%</td>
<td>21.3%</td>
<td>$86.75</td>
<td>$154.91</td>
<td>(44.0%)</td>
<td>616</td>
<td>1.15</td>
<td>$5,767</td>
<td>43.5</td>
</tr>
<tr>
<td>1999</td>
<td>31.6%</td>
<td>52.8%</td>
<td>7.0%</td>
<td>4.4%</td>
<td>21.3%</td>
<td>$91.60</td>
<td>$156.38</td>
<td>(41.4%)</td>
<td>623</td>
<td>1.15</td>
<td>$6,431</td>
<td>47.3</td>
</tr>
<tr>
<td>2000</td>
<td>33.2%</td>
<td>52.3%</td>
<td>7.0%</td>
<td>4.0%</td>
<td>22.1%</td>
<td>$97.61</td>
<td>$171.24</td>
<td>(43.0%)</td>
<td>652</td>
<td>1.15</td>
<td>$7,373</td>
<td>50.2</td>
</tr>
<tr>
<td>2001</td>
<td>34.7%</td>
<td>49.6%</td>
<td>7.9%</td>
<td>4.3%</td>
<td>25.2%</td>
<td>$92.36</td>
<td>$145.91</td>
<td>(36.7%)</td>
<td>688</td>
<td>1.16</td>
<td>$6,030</td>
<td>47.4</td>
</tr>
<tr>
<td>2002</td>
<td>35.6%</td>
<td>47.7%</td>
<td>9.2%</td>
<td>4.8%</td>
<td>26.4%</td>
<td>$94.93</td>
<td>$146.80</td>
<td>(35.3%)</td>
<td>717</td>
<td>1.16</td>
<td>$5,921</td>
<td>46.1</td>
</tr>
<tr>
<td>2003</td>
<td>37.9%</td>
<td>44.9%</td>
<td>9.9%</td>
<td>5.1%</td>
<td>27.5%</td>
<td>$98.33</td>
<td>$158.49</td>
<td>(38.0%)</td>
<td>729</td>
<td>1.15</td>
<td>$6,172</td>
<td>45.5</td>
</tr>
<tr>
<td>2004</td>
<td>35.1%</td>
<td>47.6%</td>
<td>11.0%</td>
<td>4.4%</td>
<td>26.9%</td>
<td>$101.27</td>
<td>$149.11</td>
<td>(32.1%)</td>
<td>763</td>
<td>1.16</td>
<td>$6,868</td>
<td>51.9</td>
</tr>
<tr>
<td>2005</td>
<td>30.2%</td>
<td>49.9%</td>
<td>13.7%</td>
<td>4.0%</td>
<td>22.1%</td>
<td>$107.26</td>
<td>$163.68</td>
<td>(34.5%)</td>
<td>788</td>
<td>1.16</td>
<td>$10,214</td>
<td>69.6</td>
</tr>
<tr>
<td>2006</td>
<td>30.9%</td>
<td>49.6%</td>
<td>12.9%</td>
<td>4.5%</td>
<td>23.1%</td>
<td>$120.52</td>
<td>$179.57</td>
<td>(32.9%)</td>
<td>818</td>
<td>1.16</td>
<td>$11,465</td>
<td>71.1</td>
</tr>
</tbody>
</table>

Source: US DOT DB1B via BTS for the third quarters of each year.
## Domestic Fare Profile

### All Domestic Markets

**AMERICAN**

<table>
<thead>
<tr>
<th>Year</th>
<th>American Pax Share</th>
<th>Other Network Carrier Share</th>
<th>Other CarrierShare</th>
<th>American Revenue Share</th>
<th>American Average Fare</th>
<th>AMerican Fare Premium</th>
<th>Average Passenger Trip Length</th>
<th>Coupons</th>
<th>Total Market Revenue ($Mils)</th>
<th>Total Market Pax (Mils)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>15.8%</td>
<td>56.5%</td>
<td>18.5%</td>
<td>2.3%</td>
<td>$192.35</td>
<td>$153.56</td>
<td>25.3%</td>
<td>1,363</td>
<td>$10,446</td>
<td>65.4</td>
</tr>
<tr>
<td>1996</td>
<td>15.3%</td>
<td>54.8%</td>
<td>19.3%</td>
<td>2.8%</td>
<td>$188.93</td>
<td>$143.72</td>
<td>31.5%</td>
<td>1,388</td>
<td>$10,473</td>
<td>69.5</td>
</tr>
<tr>
<td>1997</td>
<td>15.9%</td>
<td>54.6%</td>
<td>19.0%</td>
<td>2.2%</td>
<td>$194.40</td>
<td>$159.72</td>
<td>21.7%</td>
<td>1,384</td>
<td>$11,511</td>
<td>69.7</td>
</tr>
<tr>
<td>1998</td>
<td>15.0%</td>
<td>56.4%</td>
<td>20.4%</td>
<td>3.1%</td>
<td>$205.67</td>
<td>$162.95</td>
<td>26.2%</td>
<td>1,381</td>
<td>$12,531</td>
<td>74.0</td>
</tr>
<tr>
<td>1999</td>
<td>13.6%</td>
<td>57.1%</td>
<td>20.1%</td>
<td>3.8%</td>
<td>$204.16</td>
<td>$162.68</td>
<td>25.5%</td>
<td>1,367</td>
<td>$13,878</td>
<td>82.4</td>
</tr>
<tr>
<td>2000</td>
<td>13.7%</td>
<td>54.6%</td>
<td>23.9%</td>
<td>3.7%</td>
<td>$221.74</td>
<td>$169.64</td>
<td>30.7%</td>
<td>1,340</td>
<td>$15,934</td>
<td>90.1</td>
</tr>
<tr>
<td>2001</td>
<td>13.3%</td>
<td>51.9%</td>
<td>25.7%</td>
<td>4.9%</td>
<td>$185.63</td>
<td>$150.03</td>
<td>23.7%</td>
<td>1,368</td>
<td>$12,537</td>
<td>81.0</td>
</tr>
<tr>
<td>2002</td>
<td>17.9%</td>
<td>48.7%</td>
<td>28.1%</td>
<td>2.2%</td>
<td>$175.99</td>
<td>$151.05</td>
<td>16.5%</td>
<td>1,367</td>
<td>$12,336</td>
<td>79.3</td>
</tr>
<tr>
<td>2003</td>
<td>16.6%</td>
<td>47.9%</td>
<td>28.8%</td>
<td>3.7%</td>
<td>$180.67</td>
<td>$157.38</td>
<td>14.8%</td>
<td>1,409</td>
<td>$12,585</td>
<td>78.0</td>
</tr>
<tr>
<td>2004</td>
<td>15.9%</td>
<td>45.6%</td>
<td>30.1%</td>
<td>5.5%</td>
<td>$172.36</td>
<td>$148.86</td>
<td>15.8%</td>
<td>1,400</td>
<td>$13,829</td>
<td>90.6</td>
</tr>
<tr>
<td>2005</td>
<td>16.1%</td>
<td>43.6%</td>
<td>31.3%</td>
<td>5.8%</td>
<td>$181.69</td>
<td>$157.14</td>
<td>15.6%</td>
<td>1,366</td>
<td>$15,437</td>
<td>95.8</td>
</tr>
<tr>
<td>2006</td>
<td>15.9%</td>
<td>44.2%</td>
<td>31.1%</td>
<td>5.8%</td>
<td>$191.87</td>
<td>$172.73</td>
<td>11.1%</td>
<td>1,344</td>
<td>$16,740</td>
<td>95.2</td>
</tr>
</tbody>
</table>

Source: US DOT DB1B via BTS for the third quarters of each year.
The Restructuring Refuses to Stop
Honestly, It Cannot

- The historic relationship of GDP as a predictor of US airline industry health breaks down
  - The revenue breakdown caused the industry to resort to cost-cutting as we had never experienced – as there was little to no choice

- The Growth of the Low Cost Carriers

- The legacy network carriers shift/outsource capacity to their regional partners

- The restructuring that occurred between 2002 and early 2007, removed approximately $20 billion in expense
  - But the restructuring began when fuel was an equivalent of $30 per barrel “in the wing”; and today we are paying $40 billion more
  - The new economic order is all about $100+ per barrel “in the wing” jet fuel

- Tomorrow, global forces will shape our domestic services
Some Concluding Thoughts

• **Domestically, there will be a changing of the guard**
  - Particularly in leisure-oriented markets like Las Vegas, Orlando, Tampa and quite possibly San Francisco
  - And we should not just assume that it will be today’s LCCs that will inherit the domestic market
    • What about today’s regional carriers?
    • What about a combination of US Airways and jetBlue being the US domestic provider for the STAR alliance?

• **Cost and Productivity Convergence No Longer a Nicety**
  - It is a necessity unless ancillary revenues can make for fare premiums similar to those in the late 90’s

• **There will be more airline deaths**
  - More than sufficient replacement capacity and competition will remain
    • This market has proven that time and time again
Cumulative Net Profits 1978 - 2008E

Because This Just Does Not Work for Anyone