The Aftermath of 9/11: Implications for Airline Industry Structure & Competition

by

Daniel M. Kasper
LECG, LLC Economics & Finance

Prepared for Presentation
at the

MIT-Boeing Conference on Air Travel Six Months After 9/11

Washington, DC
March 26, 2002

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What has changed since 9/11?

- Demand = down
- Supply = down less than demand
- Costs (security, delays, labor) = up significantly
- Revenues and profits = down precipitously
- Control over “product” quality and customer satisfaction

Will situation "snap back" to the pre 9/11 *status quo ante*?

- Unlikely to happen soon
  - Most new costs will be hard to reduce
    - New security directives
    - Increased time/delays → reduced utilization
    - Labor (e.g., UAL, DL)
    - Fuel prices = likely to increase

Will situation "snap back" to the pre 9/11 *status quo ante*? (cont.)

- Unlikely to happen soon (cont.)
  - Demand may also be slow to rebound
    - Increased travel times → reduced demand, particularly for business and short haul travel
    - Increased "hassle" → increased customer ill will & reduced demand, particularly for business travel
    - Business travel & purchasing patterns may also be changing
      - Increased price sensitivity/resistance by business travelers disproportionately affects network carriers…
      - And benefits LCCs
    - As a result, revenues & profits will be slow to recover, particularly for network carriers

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Will situation "snap back" to the pre 9/11 *status quo ante*? (cont.)

- LCCs have been less affected by– and have recovered more quickly from -- the events of 9/11 than have the large network carriers
  - But LCCs need dense markets
  - Most dense short haul markets = already served
  - Greatest LCC opportunities = longer haul routes
  - But weakness in demand should increase the value/importance of <u>surviving</u> hub networks

What are the implications for airline competition and industry structure?

- Network carriers will continue to lose market share to LCCs
  - Prior to 9/11, there was already substantial evidence of excess network carrier capacity (chronic sub-par returns for even the most profitable)
  - Increasing costs and declining business revenues since 9/11
    - Have exacerbated an existing problem and
    - Portend further shrinkage in the market share of large network carriers vs. LCCs

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What are the implications for airline competition and industry structure? (cont.)

- Network carriers will continue to lose market share to LCCs (cont.)
  - This reduction in network carrier market share should – and probably will -- occur more by subtraction (i.e., shrinkage and/or bankruptcies) than by merger or acquisition.
    - Most majors cannot presently afford the financial or organizational costs of a large acquisition/merger
    - Any capacity reductions following a merger would benefit all competitors but the costs of acquisition/merger would be borne predominantly by the acquirer (assuming no anti-competitive effects)

What are the implications for airline competition and industry structure? (cont.)

- Continued growth in RJ flying is likely
  - Lower labor costs permit profitable operations at lower levels of demand
  - Pax are willing to pay higher fares for non-stop service
  - But lower labor costs = key to continued growth of RJs
  - More independence for regional airlines ???

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Can Network carriers remain competitive enough with LCCs to sustain service to small points that can only be served profitably via hubs?

- Highly unlikely that hub networks will disappear

- But further shrinkage in the number of networks seems inevitable

- How much shrinkage will depend on:
  - Cost differentials between network carriers and LCCs – where productivity differences will be crucial
    - Majors could increase productivity with less restrictive work rules
    - Standardized aircraft configuration could also be productivity plus
  - Adequacy of infrastructure = big unknown
    - ATC capacity
    - Airports/runways
    - But can government deliver???

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What are the characteristics of the carriers that are likely to survive the coming “squeeze”?

- For network carriers, keys include:
  - Strong balance sheet
  - Low unit costs relative to competition
  - Structure of their route networks
    - Competitive scope domestically and internationally
    - Least exposure to LCCs, particularly domestic
    - Less may be better
    - Ultimately, 4 large US networks plus a handful of LCCs seem likely to be viable

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What are the characteristics of the carriers that are likely to survive the coming “squeeze”? (cont.)

- For LCCs, keys will include:
  - Strong balance sheet → deterrence
  - Low unit costs → offset lower unit revenues
  - Competitive scope → why coverage and connections count
  - Credible brand identity → WN and who else?