DOMESTIC U.S. AIRLINES

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The U.S. airline industry is emerging from a tumultuous half decade of price cutting only to find itself confronted with a new set of issues: changing customer demographics, softening demand for business travel, and a pressing need to modernize their fleets. Adding to the uncertainty are potential policy initiatives in the wake of the 1993 report issued by the National Commission to Ensure a Strong, Competitive Airline Industry (the "Commission").

This panel of executives, government officials, consultants, and academics believed that, despite these changes, the industry will continue to follow the evolutionary pattern established during the 1980s. It will experience modest increases in concentration as one or more struggling carriers retrench or liquidate. Stimulated by declining average fares, it will enjoy steady growth of pleasure travel but disappointing demand for business travel. The panel was also bullish about the expansion opportunities of low-cost and niche carriers. These developments will compel major carriers to develop cautious expansion strategies and to emphasize new risk-sharing financial arrangements, such as employee ownership and equity sharing with suppliers.

Financing Issues

Due to the airline industry's sagging financial condition, traditional financing tools, such as new equity and debt financing, will be unattractive alternatives. With debt-equity ratios already exceeding 4:1, major carriers must look to venture capitalists and industry "stakeholders," such as employees, foreign airlines, local governments, and manufacturers, for capital.

The panel expected both major and secondary airlines to develop equity-sharing schemes with company personnel akin to those already in place at American West and TWA. Employee ownership, already a

prominent source of capital, gives organized labor the impetus to participate genuinely in efforts to cut costs. It aligns labor interests with company interest, thus enhancing efforts to increase productivity. Foreign airlines are stakeholders because they depend on domestic carriers for access to U.S. markets. The panel expected foreign investment laws to be changed soon, giving foreign airlines the opportunity to participate more fully in managerial decisions. Most expected an increase in the foreign ownership allowance from 20 percent to 49 percent. However, with numerous marketing agreements already in place, the opportunities and rationale for additional investment may be limited.

State and local governments, including airport authorities, will assume more aggressive investment positions. The interest-free loan granted by the State of Minnesota and the favorable terms offered by airport officials in St. Louis to local hub carriers provide vivid, if controversial, illustrations of things to come. To promote local air infrastructure, growth-conscious public institutions are turning toward reductions in aeronautical fees, local tax abatement, and subsidized airport facilities. Some airport authorities are even expressing a willingness to directly subsidize money-losing flight operations. While there will be contrary examples (e.g., the recent fee increases imposed in Los Angeles), indirect public financing is on the rise.

Venture capitalists and major suppliers are stepping forward with new, if unpublicized, risk-management tools, particularly for start-up carriers. For example, a major "blue-chip" company, EDS, is offering technical and financial assistance to Reno Air in exchange for equity. Innovative leasing and sale-leaseback arrangements for new aircraft will also play a more direct in industry expansion. Manufacturers and financial institutions, because they are more fundamentally stable, have greater access than the airlines to low-cost capital.

The panel, however, could reach no consensus about the nature or scope of such strategic partnerships. Manufacturing companies emphasize that the once-common practice of selling or leasing equipment at below-cost prices is unsustainable, rendering it an unreliable source of capital.

Commission Recommendations

While the troubled industry must confront new regulatory and tax policies, it would be unwise to radically adjust forecasting models on the basis of the Commission's proposed agenda. The panel did not expect Congress to adopt those recommendations that could stimulate traffic or bolster industry profitability.

The panel expected the fuel tax reduction provision — one of the cornerstones of the commission's report — to face formidable legislative hurdles and, indeed, this provision was not passed. Similarly, the Commission's plea for an "advisory panel" to oversee airline activity is being received skeptically by Congress. The panel expects Congress to change the Federal Bankruptcy Code, limiting the time in which a carrier can operate under Chapter 11 protection to 12 months. However, this is likely to have only symbolic implications; the bankrupt carriers, such as Braniff Airlines and Eastern Airlines, which provoked industrywide fare cuts to raise cash are already out of business.

The Commission's report could inadvertently divert attention from the industry's competitive problems. For example, the biases and high fees associated with computer reservation systems are likely to remain low-profile policy issues. Travel agent commission overrides (TACO) and frequent flyer programs are also likely to escape regulatory attention. Weaker carriers will need to pioneer new technologies and distribution systems to overcome these competitive obstacles.

It is likely that the Federal Government will be prodded to restructure parts of the Federal Aviation Administration. With few exceptions, however, this initiative will not significantly alter the character or performance of domestic airlines.

Structural Changes

The three megacarriers (American, Delta, and United) will remain the dominant forces in long-distance travel. While the era of industry consolidation appears to be drawing to a close, the share of revenue passenger miles (RPM) handled by these three carriers will remain near 60 percent through 2000. The panel was divided as to whether these carriers' market shares will continue their upward ascent.

On short- and medium-haul routes, startup carriers will enjoy brisk market-share growth. These startup carriers have learned from their failed predecessors, avoiding rapid expansion and head-to-head competition with major carriers. Their share is expected to rise threefold over the next decade to roughly 6 percent of RPMs.

Copying Southwest Airlines' model, these carriers emphasize low costs, high productivity, and high-frequency point-to-point operations. While majors are expected to match upstart fares, it is unlikely that

they will be able to eliminate upstart competition entirely as the majors' entrenched hub operations will make commensurate productivity improvements and cost reductions an extremely difficult task.

In contrast to past strategies emphasizing price discounts with capacity controls, major carriers may well respond by developing interline agreements with upstarts. They will use these low-cost carriers to handle traffic on short-haul routes previously operated by the majors, which will help feed the majors' more profitable long-haul routes. However, as demand increases, allowing for the operation of larger aircraft, major carriers are likely to resume service with their own aircraft on many of these routes.

It is uncertain what impact the expansion of megacarriers and upstarts will have on "second tier" carriers, such as America West, Continental, TWA, Northwest, and USAir. These carriers tend to be in poor financial condition, and the disappearance or merger/acquisition of one or more of them over the next three years is likely. Nevertheless, several of these carriers have emerged from Chapter 11 status, restructured with significantly lower costs or -- in the case of TWA -- turned to employee ownership. Such carriers may continue to pose a competitive threat to the dominance of the majors.

The exemplary success of Southwest Airlines will accelerate structural shifts in the industry. Considering that Southwest Airlines has earned healthy profits during the past three years -- a period in which the industry recorded $6 billion in red ink -- it will serve as a valuable industry model for others to follow. Southwest's overhead is among the industry's lowest, and it achieves exceptional equipment utilization. The carrier strives for simplicity in its operational and marketing activities, emphasizing routes under 500 miles, point-to-point operations, and maximum aircraft utilization with minimal ground time (obviated by the lack of passenger connection requirements). Southwest has shown an increasing willingness, with its entry into the California market and the recent foray to the East Cost, to go beyond niche routes and directly challenge markets previously dominated by the majors.

Although Southwest-type carriers are unlikely to succeed in congested, high-cost airports or make a significant impact on longer-haul routes where differences in operating costs are less pronounced, these carriers are expected to participate in most major short-haul markets within a decade. The resulting price cuts could expand ridership on these routes by almost 300 percent, doubling market share for these carriers to about 10 percent of RPMs. Major carriers will selectively retaliate and harm some of the weaker startups. However, on the whole, these tactics will only delay their growth slightly.

The panel urged forecasters to recognize that the Southwest model, while the dominant competitive force in many domestic markets, is not applicable everywhere. It is best suited for high-volume short-haul markets, which account for only 10 to 15 percent of total industry RPM. Moreover, that major carriers may well continue serving most of these markets, even at a deficit, to support their hub systems and feed more profitable longer-haul flight.

Amid these structural shifts, long-distance routes are expected to become the real profit centers for major hub operators. With many cost-cutting measures already in place, major carriers will turn their attention to labor salaries and productivity. They are already establishing high-productivity subsidiaries on short-haul routes. However, progress on this front is expected to be slow and may be delayed by labor resistance. It is unlikely that these spinoff carriers will replace the majors' traditional hub-and-spoke operations. Instead, they will merely supplement them.

Only those carriers experiencing severe fiscal stress are likely to succeed in efforts to create spinoff carriers. (That Continental Airlines, a troubled carrier, was the first major carrier to unveil a plan for a low-cost subsidiary is hardly a surprise). American, Delta, and United are not likely to enjoy similar success in cutting costs before the end of the century.

Capacity and Pricing Changes

Carriers are already committed to reducing their capacity in upcoming years. While carriers added 150 or more aircraft to their fleets during both 1991 and 1992, they will reduce their fleets by 45 and 24 planes, respectively, during 1993 and 1994. After retiring older Stage II aircraft, their fleets will increase by only 10 planes in 1995.

These reductions will encourage carriers to scale back services at secondary hubs and on unprofitable routes. Particularly vulnerable are smaller hubs such as Washington Dulles, Raleigh-Durham, Nashville, and Memphis. Low-price competitors will fill much of the void left by these cutbacks.

Low-cost competition and cash-flow problems cannot be blamed for the industry's recent pricing woes. Major carriers will continue to use pricing as a tool to generate incremental revenue. Little evidence suggests that carriers have learned from the price wars of the past. Currently, yields are lower than they were in 1981 (12.86 cents vs. 12.97 cents). Adjusted for inflation, real yields

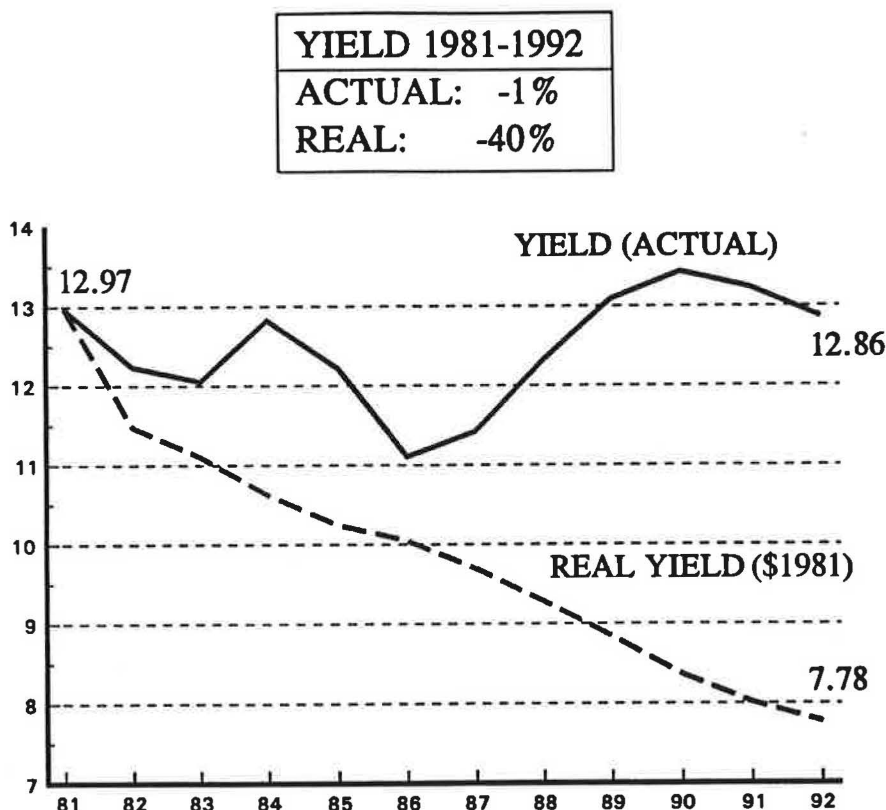

FIGURE 41 Domestic industry yields.

have declined for twelve consecutive years (Figure 41), a trend that panelists expected to continue in the years ahead.

The proliferation of corporate discounts and other specially negotiated prices will make long-lasting changes to yield management difficult. Adding to these problems are the recent court rulings that make upward pricing action more cumbersome and the expanding burden of frequent flyer programs. (Free trips are expected to rise from 8 to 10 percent of RPM by 1997.)

Cutbacks in capacity could provide temporary relief, slowing down these yield declines. (One panelist went so far as to predict that capacity reductions will significantly improve yields by early 1994 and that excess capacity would not be a significant pricing problem until 2000.) Also buttressing yields is the industry's recovery from the "simplified" Value Plan fare structure, implemented briefly last year, which slashed business revenue dramatically.

The panel could reach no consensus about the future structure of air fares. Several panelists asserted that simplified structures were destined to reemerge as carriers battled the proliferation of "unpublished" fares. Others maintained that these structures would not viable because of their dilutionary effects on business revenues.

Air Travel: A Mature Industry?

As the millennium approaches, the U.S. air travel market exhibits the telltale signs of a mature industry. Firms are increasingly selling to experienced buyers; competition is shifting toward cost control; new products are becoming more difficult to develop; and overcapacity remains a perennial concern.

This phenomenon is illustrated statistically in Figure 42. Between 1950 and 1980 domestic air travel was a recession- proof sector of the economy, experiencing a rise from 0.2 percent of GDP in 1950 to 0.85 percent in 1980.. Beginning in 1991 the industry begin its inevitable descent.

As the industry matures, its growth will be roughly proportional to overall U.S. economic growth. Airlines will need to turn to price reductions to generate large numbers of new passengers. These price cuts could depress total industry revenues.

The business market is maturing most rapidly. Business traffic is expected to decline by roughly 0.5 percentage points per year (it currently accounts for about 40 percent of RPM). Advances in telecommunications will chip away at demand. The technology necessary for widespread "desktop video-

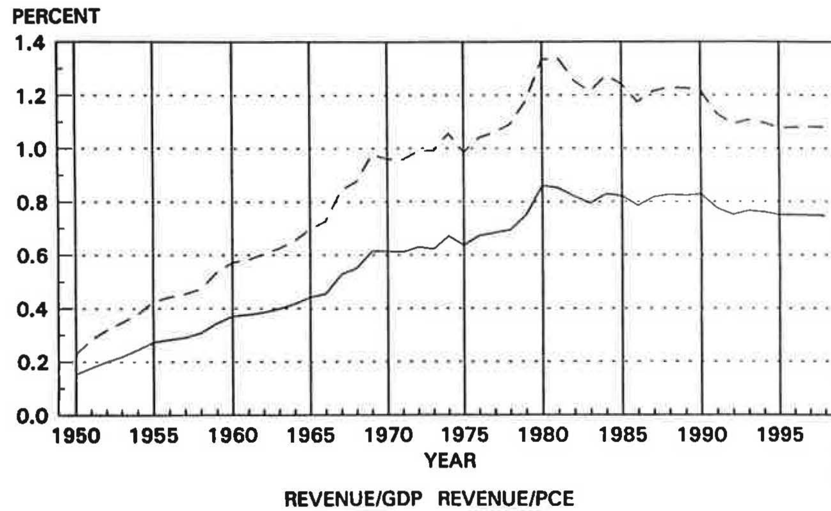

FIGURE 42 Domestic passenger revenue, as a share of the economy.

conferencing" (i.e., a visual system linked with personal computers) is only three to five years away. One panelist estimated that this technology could provide an effective substitute for as much as 33 percent of business traffic by the next century, although other panelists questioned this assertion.

In general, new technology will affect air travel in unpredictable ways. Conceivably, the growth in long-distance communication ushered in by advanced telecommunications could *stimulate* air travel. However, the technology is likely to render business travelers more price sensitive, eroding the base of full-fare traffic. The panel did not foresee high-speed rail services having a similar effect on air travel in the next decade, with the possible exception of Northeast Corridor services. In the pleasure market, changing demographics will produce two offsetting effects. The aging of the "baby-boom" generation (a segment responsible for the recent explosion of pleasure travel) will lessen discretionary demand. Conversely, the expanding number of retirement-age travelers (a sector with the time and resources to travel extensively) will boost demand on leisure routes. Taken together, these countervailing forces suggest only modest growth in pleasure travel.

The wild card in long-range forecasts is the state of the macroeconomy. Rising State and Federal tax burdens could chip away at disposable income, particularly for upper income groups. However, this effect could be swamped by a general economic recovery, which appears finally to be taking hold.