Research Review

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Airline Capacity Reductions Now Being Out-Paced By Declines In Passenger Demand

RPM Plunge In November Exceed Fuel-Cost Driven ASM Cuts Planned For 4Q

Evergreen, Colorado, December 8, 2008. Latest data indicate that the US airline industry may be facing much greater declines in air passenger demand in the coming months than previously forecast. After over a year of carefully trimming capacity to adjust to fuel price increases, which maintained high load factors and provided some fare traction, the airline industry may suddenly now be faced with a situation similar in nature to that being experienced by the auto industry: rapid and unexpected double digit free-falls in sales.

Until Now, Surgical Capacity Cuts Have Worked Well. Throughout 2007 and 2008, the US airline industry responded to higher fuel expense by a general strategy of cutting capacity in the face of relatively stable consumer demand, thereby keeping load factors high and providing some pricing power to partially offset the cost of jet-A. The astronomical spike in oil prices – to over $147 a barrel last summer – prompted carriers to massively slash schedule capacity for the fourth quarter of 2009 and into 2009, anticipating continued high fuel costs.

It needs to be noted that the reductions by most carriers focused mainly on trimming schedules, not the wholesale "slashing of unprofitable routes" as some in the media have sloppily reported. These took the form of frequency and gauge reductions in key markets, reduction in longer-haul RJ hub-feed routes, and deletion of some point-to-point RJ flying. Further, contrary to lore, major carriers have not cut flying due to competition from "low fare carriers" – nor have "low fare carriers" been presented with any material market opportunities as a result of American, United, Continental or any other comprehensive network carrier cutting capacity. In point of fact, LCCs have been cutting back capacity also.

November 2008 – Traffic Dropping Like A Piano From The 20th Floor. The capacity cuts over the past 18 months were done in the face of resilient consumer demand – resulting in load factors remaining high, and fare levels beginning to inch up. As of November, however, consumer-driven factors have changed this situation. Demand now appears to be falling even faster than the major capacity cuts airlines made for the fall in anticipation of continued high fuel prices. Conclusion: the recession – with a reduction in consumer spending – has finally reached the airport ticket counter.

November data point to the possibility of a further rapid and pronounced fall in RPMs going into 2009. Even with the fuel-panic schedule reductions for the fourth quarter, planned back in early- to mid-2008, RPMs for the first time this year fell significantly faster than capacity as indicated by preliminary data for the industry as a whole.

	November 2008 Load Factor	November 2007 Load Factor	Point Change In Load Factors	Change in ASM	Change in RPM
US Airline Industry	75.78%	78.38%	-2.60%	-7.53%	-10.60%

Source: Boyd Group International Review of Carrier Filings

A 7.5% year-over-year capacity cut by the airline industry is not inconsequential. But a nearly 11% drop in monthly RPMS indicates demand weakening much faster than anticipated. When load factors have been tracking near 80% for the industry, a sudden drop of this magnitude points toward fundamental market shifts the airline industry must quickly address.

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Major-Carriers' Mainline Traffic – Plunging. When looking at Comprehensive Network Carriers – a.k.a. "legacies – the picture is hardly encouraging. On the surface, Delta experienced a "positive" ASM/RPM ratio, but that situation changes when merged Northwest is added to the mix.

	November 2008 Load Factor	November 2007 Load Factor	Point Change In Load Factors	Change in ASM	Change in RPM
American	76.59%	81.22%	-4.64%	-9.3%	-14.5%
United	76.94%	79.58%	-2.63%	-14.2%	-17.0%
Delta	77.82%	77.35%	0.47%	-2.4%	-1.8%
Continental	77.85%	80.29%	-2.44%	-7.8%	-10.6%
Northwest	81.25%	82.97%	-1.73%	-10.4%	-12.3%
US Airways	77.69%	78.36%	-0.67%	-6.1%	-6.9%
Major Carriers - Mainline Only	**77.75%**	**79.97%**	**-2.21%**	**-8.6%**	**-11.2%**

Source: Boyd Group International Review of Carrier Filings

Note that the above data do not reflect the entire operations of each airline, but only the portions operated by the "mainline" company. This means that the substantial portions of American, United, Delta, etc. that are operated with aircraft leased-in from small jet providers (also mistakenly still referred to as "regional airlines") are not reflected in these numbers. Because these small jet providers have their own separate certificates and corporate structures, their traffic is reported separately, even though in most cases they have no operating brand of their own.[1] This much said, there are no indications that when this traffic and capacity data are included there will be any positive changes in the percentages shown.

"Low Cost Carriers" – Not Immune. In Fact, More Vulnerable. The data for LCCs indicate that it is this retail sector of the airline industry that may be in for the biggest jolts ahead.

	November 2008 Load Factor	November 2007 Load Factor	Point Change In Load Factors	Change in ASM	Change in RPM
Frontier	78.50%	78.26%	0.25%	-16.0%	-15.7%
Southwest	**63.22%**	**69.28%**	**-6.06%**	**0.2%**	**-8.5%**
AirTran	75.78%	75.22%	0.55%	-7.1%	-6.5%
jetBlue	75.74%	76.99%	-1.25%	-6.3%	-7.8%
LCC Carriers	**69.18%**	**72.78%**	**-3.60%**	**-3.7%**	**-8.4%**

Source: Boyd Group International Review of Carrier Filings

The numbers in this sector are dominated by Southwest. In November, on essentially flat – i.e., no cuts – ASM production, the airline suffered an 8.5% reduction in RPMs, and a rather disturbing 6 point decline in load factor. It must be noted that Southwest is in the midst of re-structuring much of its route system – for example shifting capacity to Denver – and this drop in load factor could simply be a temporary situation. But it could also represent a fundamental decline in core traffic demand that may threaten carriers that possess less-diverse fleets and revenue streams, such as Southwest.

[1] Note that while entities such as Air Wisconsin or Chataugua or Pinnacle are considered as "airlines" by the DOT, their entire fleets are leased-out to major carriers, which apply such resources as they see fit. These "regional airlines" do not independently sell seats or services to the public.

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Competitive Review

If, as indicated by November data, core air traffic demand is in a steep decline, carriers are facing a situation where the ability to cut capacity and retain control of core revenue streams will be essential to profitability. The challenge is to not get competitively squeezed out of core market flows (note: market flows over connecting hubs, not necessarily major O&D markets).

Fare War: It Will Be Revenue Access, Not Just Costs That Will Make The Difference. But cutting capacity takes time – schedules must be filed 60 to 90 days in advance, and there are compelling internal issues, such as crew scheduling and aircraft maintenance cycles that need to be addressed. That raises the specter of the potential of carriers resorting back to fare incentives to keep seats filled until they can get capacity in line with falling demand.

The veneer conclusion is that this would give LCCs the advantage, but it does not.

In fact, these carriers may be the most vulnerable. Even where a carrier actually does have lower ASM costs – such as AirTran certainly does – the real strength in the case of declining fares and declining demand will be the diversity of the revenue streams. Key segments of traffic flows from emerging mid-size markets such as Montgomery and Gulfport – where there is increasing and relatively stable industrial investment – will be valuable. LCCs do not have the fleet diversity to access these flows. The same is true of international feed. For example, most of the business travelers coming from Shanghai to Detroit on Northwest (Delta) continue on to other NW destinations, thereby feeding the domestic system. That represents a revenue-stream advantage LCCs do not have.

Ability To Cut Capacity Cost-Effectively. In the event of a free-fall in RPMs, carriers that can cut capacity the most rapidly and the most cost-effectively – and retain a cost-viable remaining fleet – will be in the best position to weather the recession storm. The most obvious here is American Airlines which has a fleet of MD-80s, portions of which can be pulled out of service, and due to their age, likely have relatively low ownership costs. AMR also has substantial sub 50-seat units in its American Eagle fleet that can be parked. AA also has 737-800s on order which will replace other MD-80s, making the carrier more cost-efficient. Specific also to American is the situation at Boeing, which may be facing a partial meltdown in its Asian orderbook. This could place AA – which has a large residual MD-80 fleet – in a very favorable bargaining position with the manufacturer.

Delta is in a positive position as well. Currently, it is over-invested in leased-in "regional jets" and has plenty of potential for cutting capacity, including a number of "competitive nuisance" markets where it operates RJs into Atlanta competing with AirTran. The combination with Northwest will also provide some near term capacity cuts in the RJ-sector, as well as with the remaining fleet of NW DC-9s.

United: Shrinking Into A Brand Instead of An Airline? Of concern, however is United Airlines. Its corporate strategy apparently has been to substantially shrink the mainline UAL fleet, replacing and outsourcing the flying to some degree with 50-seat and 70-seat jets operated by small jet providers. For comparison purposes, UA had about 450 mainline jets at the end of the 2Q 2008, and these include the 737 fleet that they intend to retire over the next year. American had 650 mainline jets, plus a comprehensive fleet-replacement program. United has no new airliners on order at this time. While the sector costs of the GoJet CRJ-700 that replaces a UA 737 are lower, the ASM costs are much higher. That is not a favorable situation to be in when yield growth may be stopped in its tracks by a recession.

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