

The Boyd Group Research Review

New 2008 Aviation Metrics

Aviation Insight For Clients of The Boyd Group

Report Summary

The combination of unexpectedly high oil prices, collapsing efficiency of the air traffic control system, and winds of war coming from labor is now resulting in airlines fundamentally rethinking near term operational strategies.

With fuel expense tracking toward \$3 a gallon, the ATC system failing, and labor confrontations coming, strategies airlines had in place just months ago may be completely obsolete.

There is also the added marketplace and competitive uncertainty of United Airlines, which is turning itself into a strategic wild card, and is intent to merge. Regardless of the pros and cons of airline consolidation (and at the end of the day, they are mostly cons), no prudent competitor can ignore the range of potential scenarios that United's "buy me" strategies may bring.

United does have some real assets – such as a Tokyo hub, not to mention valuable intangibles, including one of the most professional customer service operations in the business. Having United "in play" is yet another factor in virtually every comprehensive network carrier re-thinking 2008 strategies.

Revenue Objectives Equally Important To Cost Control. The danger airlines face is a situation where costs continue to increase at the same time as traffic begins to decline materially. On the cost reduction side, there are still a number of options open to airlines, including more focus on dynamic production line control (as outlined at The Boyd Group 12th Annual Aviation Forecast Conference last month). But there is little doubt that labor in 2008 – 2010 will be banging at the bargaining table for a restoration of past concessions. Ultimately, this will probably offset any cost reductions airlines can gain in the near term.

But with current demand still strong, and capacity stable, the airline industry has some flexibility on the revenue side. Therefore, the new airline industry focus will be to raise the "quality" of their revenue streams. At the current time, with load factors in the 80% range, the goal will be to displace traffic with lower-yields and lower strategic value with traffic that is less fare-sensitive and, depending on carrier, best strengthens the airline's competitive position. Every hub-feed market will be analyzed for "quality content" – system traffic to Billings, Bangor, and Beijing will have increasing value compared to fare-generated passengers to Orlando.

International traffic flows will also be reviewed. Contrary to misinformation from some in academia and elsewhere, comprehensive network carriers have been adding international flying to strengthen domestic traffic flows, not eliminate them. But with much higher fuel costs, the bar regarding flow revenue quality will be going up.

Ability To "Valve Off" Capacity To Adjust To Falling Demand. While at this time there are no solid indications that traffic demand will decline, it would be imprudent to assume that it will not do so in the next 12 to 18 months.

Oil price increases at some point will percolate throughout the economy, engulfing other factors that up to now have insulated consumer spending from the effects of higher gasoline and distribution costs. In fact, a decline in single digits could manifest relatively rapidly, and with little warning. Due to the dominance of non-refundable reservations, the booking curves tend to be closer to departure date. This situation can result in a traffic downturn coming on quickly.

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The ability to “valve off” capacity rapidly will be a measure of an airline’s insulation from the effects of a downturn. As our Global Fleet Forecasts indicated three years ago, it is carriers such as American and Northwest that have such abilities, with large fleets of aircraft with low or no ownership costs. LCCs, however, are another matter,

Bottom Line: Expansion and route plans that were “in concrete” for 2008 back in September are being tossed and completely rebuilt. The \$100 oil concept – whether the price falls or not – has set whole new strategic and tactical metrics in motion. Throw out the playbook. New ones are being written.

Points of Interest

Fuel: Up To Unexpected Levels. Oil’s rumbling at the ragged edge of 100 dollars a barrel. That means two things to airlines. The first is that the price of jet-A will follow the general trajectory of a Moon launch. The second is that the combination of higher gasoline prices and higher general distribution costs will likely tend to increase consumer prices and finally have an effect of the dollars left for air travel.

Up until now, the effects on discretionary spending due to higher gasoline prices have been offset by other factors in the economy.

At \$100 per barrel, that may change.

This not only raises the bar in regard to market-by-market profitability, but in some cases may transform some service - both planned and current – into being un-economic. We can assume that several market expansion opportunities that were being considered six months ago being put on back burners for the time being.

As those who attended The Boyd Group’s 12th Annual **Aviation Forecast Conference** last month in Sarasota learned, there is very low potential for oil prices to drop substantially in the months ahead. The best estimates are that the price will fluctuate in the \$75 to \$95 dollar range. A combination of hedge-fund speculation, a plunging dollar, and the specific logistics of transporting jet fuel all point to continued high fuel prices - at levels that were not fully contemplated in airline planning departments six months ago.

Regardless of A Potential Drop, The Airline Industry Is Spooked. Airline planning metrics will now also be fundamentally changing. Even if oil goes back into the \$70s, the airline industry has seen that it can go to \$100 or higher, and that means they’re going to plan accordingly.

As of this date, air travel demand is expected to remain firm for the near future. But it could very quickly collapse by single-digit percentages if the economic, fuel, and consumer planets align the wrong way. Best case, airlines will be working to change the structure of the traffic they’re carrying. Comprehensive network carriers are already adjusting their systems to refine and improve revenue quality. Volume is nice, but unless it represents the right revenue streams, the right system contribution, and the right competitive strengths, it’s no longer the top priority. This is particularly true in light of the fact that capacity at comprehensive network carriers is being kept flat or reduced.

Yield and competitive contribution are the metrics going forward. Deal with it: passengers generated by Billings and Beijing are becoming more important than hordes of fare-driven traffic to Florida. And that means, also, that diversity in fleets and route systems are key factors in the ability to weather a downturn. Advantage: CNCs.

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Capacity Flexibility: Making It Disappear Quickly & Cheaply. Also, as our industry analyses first indicated back three years ago at our 10th Annual Aviation Forecast Conference, it will be the comprehensive network carriers that are in the best position to deal with the situation. Back then, while the usual-suspect aviation analysts were still swooning over the wonders of the LCC sector, our Global Fleet Demand Forecast indicated that the lack of net-new capacity coming on line at CNCs, compared to the bomber-streams of new 737s, A-319s, and E-Jets on order at LCCs, was huge insurance against an eventual traffic downturn.

While there is no strong indication of a traffic downturn at this moment, it would be imprudent not to begin planning for one. As we noted in 2004, carriers such as American and Northwest were examples of carriers with the ability to pull down capacity quickly, with large, low-ownership cost fleets of MD-80s and DC-9s, respectively.

In the first week of November 2007, United noted it has significant 737 lift it could cheaply park. (They were clear that such would be a response to a traffic downturn, although much of the media breathlessly misread it as being due directly to high fuel costs.)

In the event of any measurable downturn in traffic, the goal line will be in getting excess flying out of the system quickly. AA can park MD-80s in a relative flash, taking out operational costs with them. Southwest, jetBlue, and other LCCs don't have that financial luxury. True, new planes have lower fuel and maintenance costs, but if they're flying empty or at a loss due to a traffic downturn, they can toss some serious red ink at the bottom line. But they can't be parked cheaply - the payments are due every month. And if they represent excess lift in a declining market, they still burn fuel. Airplanes quietly sitting in the desert - even if they're old - are hands-down a lot more fuel-efficient than new airliners flying around the sky when there's not enough traffic to fill them.

LCCs Are Not Without Options. Take Note Of Frontier. This does not mean that LCCs cannot adjust, only that they do not have the ability to cost-effectively pull down significant percentages of capacity. Nevertheless, we are seeing some visionary moves in this sector.

Notably, Frontier has quietly announced re-deployment of resources in the past month. Some of their off-hub flying experiments, such as MEM-LAS, are being discontinued. More tellingly, it appears that Frontier is dismantling most of its point-to-point flying to Mexican vacation cities. The lift is being re-deployed mostly to circle the wagons to build on the carrier's strengths flowing passengers to and through Denver.

Frontier clearly understands that the traditional LCC model is neither bulletproof nor one with unlimited growth.

These actions indicate an airline that clearly sees the future and is planning for it. Vacationers from Sacramento to Mexican resorts are just one-off revenue with zero brand loyalty. In an environment of a falling dollar, high fuel costs and the potential for decreased consumer spending, this type of flying is getting riskier and strategically less valuable. On the other hand, adding a sixth frequency between Denver and San Diego builds for the future.

Underscoring the emerging industry focus on improving revenue quality, it is noted that Southwest is heavily engaged in building its image as an airline for business travelers. While the image of Southwest being a "backpacker" airline was entirely a media myth, the airline is now moving aggressively to capture more business revenue - moving to assigned boarding (not assigned seating, at least yet), seeking corporate contracts, and other perks aimed at improving the quality and brand-loyalty of the revenue in the cabin of its 737s.

Small Lift Providers: Pilot Shortage Looming. Not To Mention Other Things. Adding to this situation is an emerging shortfall in new pilot hires at small lift providers (what Wall Street still calls "regional airlines"). Expansion

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is going to be tough when there's not enough pilots, but some of these operators are now at the point of being hard-pressed just to meet current commitments. For a pilot applicant, ask which is more attractive: a position with a major airline, which entails a career path up to 777s flying to Tokyo, or one with a small lift provider where career potential is left seat on a CRJ-700 flying to Fargo?

Countering this, in an ominous way, would be any significant reductions in mainline flying. The first – and inaccurate – conclusion in some analyst corners would be that small lift providers would pick more hours to make up the difference in reduced mainline flying. Unfortunately, that is not accurate.

Any reduction in mainline flying would be due to declining demand. While small jets might look like good replacement options, there are at least two key dynamics that would erase any smiles in the front offices of small lift providers. The first is that the costs of regional jets will also be affected by high fuel prices, and that means the ability to economically feed traffic may not be there. The second is labor. If United parked 100 aircraft due to a downturn, it will be concurrent with a reduction-in-force of 500 or more pilots. There is no way that the union would calmly sit back and let United out-source flying to other operators while furloughing its own members.

Finally, depending on airline, some pilot contracts have codicils regarding the mix of SLP and mainline fleets. A major reduction in mainline-operated aircraft could trigger the contractual requirement to reduce SLP flying. Given the temperature of most airline unions today, it would not be wise for mainline carriers to expect any slack in this regard across the bargaining table.

Consolidation: Not A Panacea. There is enormous chatter about the “need” and the “inevitability” of airline consolidation. For any airline CEO, the benefits of having one or more major competitors disappear are obvious. It needs to be kept in mind that this is the intent of any major airline consolidation: to reduce production, and be able to charge more for what's left. In an environment where airlines can make money at \$75 oil, and demand is strong to the point of 80% load factors, it's a weak argument to claim that eliminating competition will be good for the public. Putting two systems together – or attempting to do so – won't lower the effects of \$100 a barrel oil. The belief is, however, that it will cut the number of seats, allowing higher yields – read: higher fares.

Consolidation has one objective: cut out some production capacity so that what's left will command higher fares.

Unfortunately, there's no guarantee it will work that way.

Nevertheless, it is an honorable and necessary tactic to attempt to zap competition. That much said, it is unfortunate that there is the belief that merging major airline systems will result in higher synergies, higher yields, and a reduced capacity environment. In the major, high-density markets, there is little or no proof that any reduction in capacity will remain permanent. But with the closure of overlapping hubsite operations, it is a certainty that small and mid-size communities will see less competition and a tendency for higher fares.

The point is that mergers are in play, for the main reason that United has put itself up for sale, and no airline can ignore the competitive scenarios that could result. But the belief that consolidation will do much more than just constrict capacity – albeit temporarily – is not accurate.

Emerging Strategies & Competitive Tactics To Watch For

In summary, The Boyd Group would suggest that the following will be increasingly evident in the airline industry in 2008 – 2010.

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Slam-dunk Expansion Only. Unless there is clear, compelling traffic and revenue data to indicate that the new flying will be successful (i.e., more revenue than what it replaces, and/or specific traffic flows - read: international - that it seeks), any new planned markets will come off the table. This may well include some already-announced expansion programs.

Revenue Quality, Not Volume. While numbers of passengers are an important metric in determining whether to add or keep service, even more important will be the "quality" of that revenue. Low-yield connecting traffic to Florida has a much lower priority than a destination spread of passengers to mid-size and large business destinations beyond a carrier's hubsite.

Current Market Scrutiny. Existing markets will be put under a microscope, and it is entirely possible that some air-service pink slips will be in the mail to some communities. Since the revenue bar is going up, air carriers' revenue hurdles will be going up as well. Some markets may not be able to meet the new revenue requirements.

Block Time Efficiency. The industry does not have "airline delays" so much as it has "FAA delays." The air traffic control system is antiquated, and despite what the FAA is saying, there is no real fix on the horizon. This means that the excess block times that airlines must now build into their schedules will be increasingly scrutinized in light of skyrocketing fuel costs. Routes that have relatively low block speeds are expensive in fuel, crew time, and aircraft time. Airlines will be giving more scrutiny to this metric, comparing these to revenue generation.

While there are strategies that airports and communities can implement to deter, off-set, and even take advantage of these changes, we believe that all air service development programs need to be reviewed in light of this fundamental airline industry changes.