Structural Causes of Airline Cyclicality: Are We Sowing the Seeds for the Next Downturn?

What is Wrong with the Airline Industry, and How Can We Fix It?

Kevin Neels
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The Industry Today

The industry is emerging slowly from a severe and extended downturn marked by a substantial number of bankruptcies

- US Airways
- United
- Northwest
- Delta

The Air Transport Association projects substantial profits for the industry over the year ahead

- US airlines will post a collective $3.5-$4.5 billion net profit in 2008, which would mark the US industry's third consecutive profitable year (excluding bankruptcy restructuring-related losses in 2006), a feat not achieved since 1998-2000.

Whether these good fortunes will last is anybody’s guess
Have we been here before?
Eternal recurrence is a concept which posits that the universe has been recurring, and will continue to recur in the exact same form an incomprehensible and unfathomable number of times.
Sources of Cyclicality

Underlying industry structure

The compensation cycle

The order cycle
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Some Industries are Characterized by High Fixed Costs, Low Variable Costs and Cyclical Demand

![Graph showing revenues and costs over time](image-url)
Such Industries Can Fluctuate between Profit and Loss

Diagram showing fluctuations in profits and losses over time.
Does this describe the airline industry?
US Airline Industry Profits

Source: ATA annual reports

The Brattle Group
But there are some differences...

Generally even a cyclical industry will be profitable over the long term.

Cumulative profitability has eluded the airline industry, however.

- The good times are not good enough
- The bad times are terrible

Several aspects of the airline cycle amplify downturn losses
Sources of Cyclicalality

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The order cycle
Pilot Costs per Air Hour (in 2007 dollars)

Source: Form 41, T-100 data
Delta
Profits and Crew Costs
(in 2007 dollars)

Source: Form 41, T-100 data, and news reports
Northwest
Profits and Crew Costs
(in 2007 dollars)

1993: Flight Attendants, Pilots, Mechanics, ground crew take 15% pay cut
1998: Pilots win pay increase after lockout followed by strike
2004: Pilots take pay cut
May 2006: Pilots approve $358M giveback
May 2007: NW emerges from bankruptcy

Source: Form 41, T-100 data, and news reports
United
Profits and Crew Costs
(in 2007 dollars)

-5,000,000 -4,000,000 -3,000,000 -2,000,000 -1,000,000 0 1,000,000 2,000,000

Profits ('000s)

-5,000,000 -4,000,000 -3,000,000 -2,000,000 -1,000,000 0 1,000,000 2,000,000 3,000,000

Expense per Air Hour

Source: Form 41, T-100 data, and news reports

1994: Employee buy-out

Oct. 2000: Pilots ratify contract with large pay increases

2005: Pilots and Flt Atts sign contracts with pay reductions

1997: Pilots sign agreement with raises Flt Atts sign 10 year deal.

Nov/Dec 2002: UAL files for bankruptcy Pilots and Flt Atts agree to recovery plans involving paycuts

2006: UAL exits bankruptcy

2003: Pilots and Flt Atts sign contracts with pay cuts

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US Airways
Profits and Crew Costs
(in 2007 dollars)

Source: Form 41, T-100 data, and news reports
Southwest
Profits and Crew Costs
(in real 2007 dollars)

Jan 1995: Pilots ratify 10 yr contract with stock options rather than raises

Dec 1997: Flt Attts approve new contract with raises


2004: Flt Attts sign 6 yr deal with raises

2006: Pilots reject offer to extend agreement by 1 year

Source: Form 41, T-100 data, and news reports
The legacy of regulation

- Under regulation workers were well compensated, setting expectations for “what we deserve.”

- Competition created pressures to reduce labor costs.

- Memories are long, however, and expectations slow to adjust.
Eternal recurrence…

- Losses during downturns pressure carriers to demand wage concessions.
- A return to profitability prompts workers to demand a return to pre-concession compensation levels.
- Increased labor costs erode upturn profits and amplify downturn losses.
- New entrant carriers have been less subject to this cycle.
Sources of Cyclicality

Underlying industry structure

The compensation cycle

The order cycle
Profits, Aircraft Orders, and Aircraft Shipments

Sources: Aerospace Industries Association and ATA annual reports
Dynamics of the Order Cycle

- New orders increase during upturns.
- As orders accumulate, delivery schedules lengthen.
- The slow pace of deliveries limits carriers’ ability to exploit the upturn.
- New aircraft deliveries spill over into the downturn, worsening an already unfavorable supply demand balance and amplifying downturn losses.
What to do? Some Potential Ideas for Change

- Bankruptcy, and possibilities for “culling the herd”
- Indexing labor compensation
- Leasing
- Congestion pricing
Should Bankrupt Carriers be Forced to Shut Down?

Some have advocated putting an end to the “living dead.”

However there are potential problems…

- Would a shutdown really eliminate excess capacity?
- Would market concentration increase?
- Do we really want to liquidate firms in response to cyclical downturns?
Indexing Labor Compensation

• Labor compensation has varied over the industry cycle, changing in a series of acrimonious confrontations.
• Could unions and management agree to a formula-based adjustment mechanism?
• The positive example of state rainy-day funds.
• The negative example of the United ESOP.
Leasing Comes in Many Forms

Aircraft, Maintenance, & Crew

Aircraft & Maintenance

Aircraft

Can we move toward a charter model?

Charter

Ownership

Lease Term / Asset Lifetime
If We Move toward the Charter Model…

Costs become more variable.
Profits become less variable.
Expansion incentives during upturns weaken.
Transfer of excess capacity to other markets becomes easier.

However,

Lessors are forced to absorb cyclical risks.
Congestion Pricing Could Dampen Industry Cycles

- Congestion worsens dramatically during upturns.
- Proceeds from slot auctions would rise during upturns.
- Incentives for expansion during upturns would weaken
- Funneling auction proceeds into the Aviation Trust Fund could permit reductions in other user fees.
- The Trust Fund as industry shock absorber.
- The Federal Reserve, the party and the punch bowl.
What Are the Prospects for Real Change?

Lessors have already assumed a larger role, and will likely continue to do so.

Can the labor compensation cycle be broken? Good labor relations as a strategic advantage.

The futures of the Trust Fund and of congestion pricing remain unclear.
Is There a Will to Change?

Do we face Eternal Recurrence, or

A series of unfortunate events…