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Red Eyes **For U.S. Airlines, a Shakeout Runs Into Heavy Turbulence**

**It's Not Like Other Industries,
 Where Weaklings Just Die;
 Lenders, Government Help**

Flying More and Paying Less

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The U.S. airline industry has a business problem that's simple to state and difficult to solve: Twenty-seven years after deregulation, major airlines' costs exceed revenues, and they can neither cut costs nor raise fares enough to turn a profit.

In classic competitive markets, such as retailing and auto-parts manufacturing, such circumstances kill off the least efficient players, freeing survivors to raise prices enough to make money. In the airline industry, this process is proving to be excruciatingly prolonged.

How come?




Reason one: Airlines that go into bankruptcy don't go away. They shed costly contracts and continue to fly, making it impossible for competitors to raise prices. One key to survival: Wall Street, banks, credit-card companies and aircraft makers keep lending them money, figuring they're worth more alive than dead.

And though the government has resisted the temptation to re-regulate the industry, it periodically interferes with the Darwinian struggle. It handed the industry \$5 billion after Sept. 11, offered loan guarantees to a few others, and has blocked an occasional merger and shielded U.S. airlines from foreign competition.

When demand for a factory's products falls, it can lay off the third shift. Airlines can't. Unable to cut labor or fuel costs quickly, they instead try to cut losses by reducing prices to fill empty seats on planes that would fly anyway. That makes for volatile earnings.

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After years of trying, managements of the big carriers that operate hub-and-spoke networks still haven't found a successful way to compete with low-cost airlines. They were slow to see how much profitable Southwest Airlines, which carries more passengers domestically than any other U.S. airline, was changing the rules just as Wal-Mart Stores Inc. did in retailing. When US Airways filed for bankruptcy protection last year, the second time in as many years, it said it had failed to "accurately anticipate the magnitude of the structural shift" in favor of low-cost airlines.

Airline unions haven't made it easy. Like their counterparts in steel and autos, they have resisted cutting wages and benefits or easing work rules enough to put their employers in the black. Northwest Airlines, which filed for bankruptcy protection last week, spends 4.53 cents on labor per seat for each mile flown. Low-cost carriers such as Southwest, JetBlue Airways and AirTran Airways spend an average of 2.42 cents.

The result: Even before the recent run-up in jet fuel prices, the U.S. airline industry lost \$32.3 billion between 2001 and 2004, wiping out the more than \$18.2 billion it earned between 1938 and 2000.

Last week, both Northwest and **Delta Air Lines** sought Chapter 11 bankruptcy protection on the same day. Four of six legacy carriers are now attempting to reorganize under court supervision. Since 1978, there have been more than 100 airline bankruptcies, including UAL Corp.'s United Airlines in 2002, the biggest ever.

All this hurts airline workers and retirees, and businesses that sell to them, invest in them and lend to them. About 135,000 workers have lost their jobs since 2000, the Air Transport Association says. Some airlines have abandoned pension promises made to their workers, sticking billions of dollars in obligations with the government's pension-insurance agency.

But for the traveling public, it's hard to see a problem. Americans are flying more -- 5.7% more in the first half of 2005 than in the year-earlier period -- and paying less. Overall, domestic and international fares charged by U.S. airlines have risen just 4% over the past decade, the Bureau of Transportation Statistics says. The price of everything else has risen 27%.

Indeed, the most common customer complaints are symptoms of the high volume of business: delays caused by congested airports and flight lanes, and planes so crowded that middle seats are often occupied. Airplanes are flying closer to full than ever. In contrast, plants in the overcrowded auto and steel industries don't have enough orders.

"There's nothing wrong here," says Severin Borenstein of the University of California at Berkeley, an economist who studies the dynamics of airline deregulation. "From a consumer perspective, prices are low. Levels of service rebounded quite nicely after 9/11. There's no sign of inadequate investment. We should stop worrying and learn to love bankruptcy, which is simply the transfer of assets from equity holders to debt holders."

Not surprisingly, airline executives don't see it that way. Robert Crandall, former chief executive of **AMR Corp.**'s American Airlines, says the industry will be unstable until the government stops allowing failed airlines to reorganize in bankruptcy court and forces them to sell assets, just as long-gone Eastern Airlines and Pan American World Airways did. Otherwise, he says, "the capacity never comes out, and it takes all the guys who haven't gone bankrupt and drives them into bankruptcy."

"The U.S. government's only policy is to make sure there are low prices for consumers," he says. "In my mind, that isn't a satisfactory aviation policy." He warns that if hub-and-spoke network carriers disappear, airline service could be restricted to people who live in big cities or along heavily traveled routes. People living in Tucson, Ariz., might find it hard to find a one-connection flight to Buffalo, N.Y.

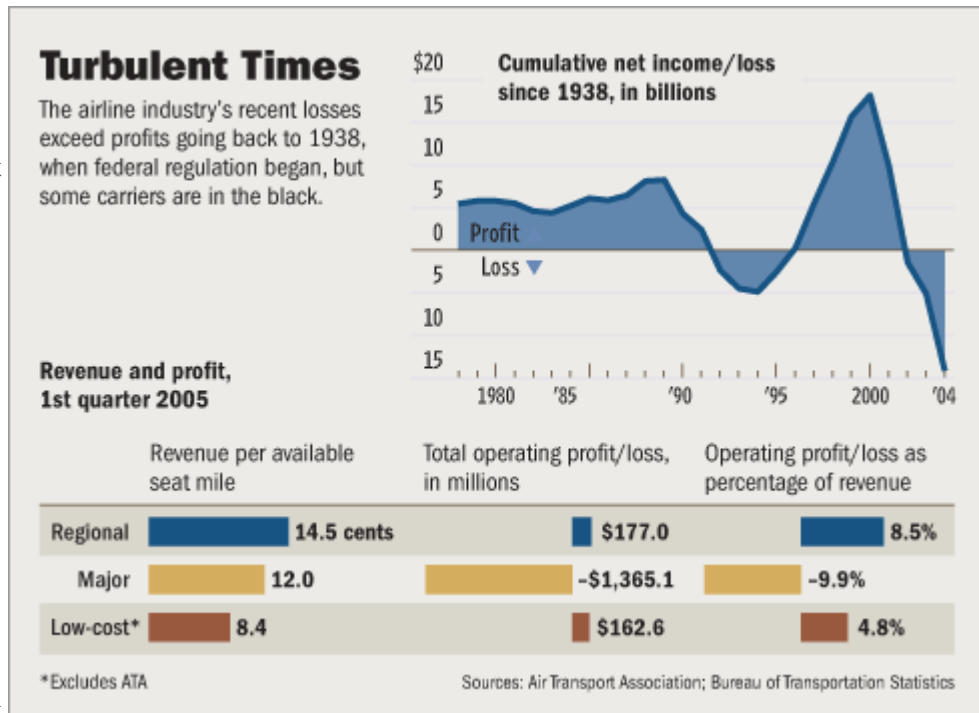
In many respects, the airline industry's problems resemble those of other industries that have been slow to change. U.S. auto makers, despite productivity and quality improvements, are struggling again. Like airlines, U.S. steel makers face high labor costs and low-cost domestic competition, but they also face government-backed foreign

competitors. Fifty steel companies filed for bankruptcy between 1998 and 2003, including such venerable names as Bethlehem Steel Corp. Now minimills with low-cost electric furnaces -- the steel industry's version of the discount airline -- produce a growing share of American steel, an estimated 48% this year, up from 40% a decade ago, according to consultants World Steel Dynamics of Englewood Cliffs, N.J.

Deregulation forced wrenching changes in other industries as well. Prices fell steeply in the trucking industry after it was deregulated, but so did costs after many nonunion workers entered the business. Electricity deregulation, despite setbacks like the California power crisis and the collapse of Enron Corp., is moving ahead slowly, pushing a few players into bankruptcy. And in telecommunications, where technology is changing far more rapidly than in airlines, the old Baby Bells' chief complaint is that the government won't give them the regulatory freedom that airlines have to compete with rivals.

Yet the airline business is unusually treacherous. It stumped legendary investor Warren Buffett, who invested in US Airways in 1989, publicly regretted it for several years afterwards, and then got out when times were temporarily good in the late 1990s. "A great management in that business will not necessarily get a great result," he told Berkshire Hathaway Inc. shareholders at their 2003 annual meeting. "In the airlines, you have a huge amount of capacity...something close to a commodity product with high fixed costs and no marginal costs," he said. "That extra seat doesn't cost you anything, so the temptation to sell that at a terrible price is overwhelming."

The airlines' bumpy ride began with deregulation in 1978. Before then, there were hardly any bankruptcies. The industry made money most years, and labor claimed its share. Even when



business turned down, prices didn't.

For a time, it looked as if the so-called legacy airlines were adapting to a world in which they couldn't rely on the government to set fares above costs. Airlines could now fly anywhere in the U.S. at any price they set, without government approval. When mergers were blocked by antitrust authorities, airlines turned to a revenue-sharing arrangement called "code sharing" under which partner airlines can place passengers on each other's flights. Frequent flyer programs gave travelers an incentive to choose higher-priced airlines. Sophisticated pricing systems helped airlines charge business travelers more, and fill the remaining seats with price-conscious leisure travelers.

The last half of the 1990s was very good, as it was for much of American business. When low-fare airlines made a move, major carriers would match the cheap fares and wait for the smaller airlines to withdraw or fold. Of 21 airlines formed between 1993 and 1995, only three survived to 2003, Mr. Borenstein says.

But that maneuver no longer works. As low-cost carriers attracted business travelers, they gained critical mass in the domestic market and broad pricing clout. In 1990, they controlled about 8% of domestic capacity. Today, it's 30%, and it's headed up, given the hundreds of airplanes they have on order and their relative profitability. Meanwhile, the Internet has made it easy for Americans to comparison-shop for air travel.

The legacy airlines are under tremendous pressure to match low-cost carriers on costs, a goal that has thus far eluded them. There is also pressure to drop restrictions such as Saturday-night stays and the round-trip purchase requirements that helped them charge some travelers more than others, as Delta did earlier this year. In bankruptcy-court filings, Northwest blamed Delta for exacerbating its woes. "The other legacy carriers had no choice but to match this Delta initiative (certainly on routes with head-to-head competition)," Northwest Chief Executive Doug Steenland said in a court filing.

In the past 4½ years, the legacy airlines have lost nearly \$35 billion before tax, and added \$30 billion in long-term debt. But Southwest, Frontier Airlines and other low-cost airlines have managed a collective pretax profit of \$2.3 billion.

There have been spectacular errors of judgment. Despite talk of Southwest entering the Philadelphia market, US Airways continued to charge high fares on flights to and from that airport, its most lucrative hub. It assumed its rival would use a less-convenient airport in Allentown, an hour north of Philadelphia. Instead, Southwest swooped into Philadelphia in May 2004, forcing US Airways to add flights and cut fares. Four months later, US Airways was back in bankruptcy court for the second time in as many years.

The soaring cost of jet fuel has exacerbated the industry's problems. Four years ago, jet fuel at New York Harbor cost about 82 cents a gallon. Although it has retreated from its Katrina-triggered spike, it's still above \$1.90.

Without a major change in the government-set rules of the game, the turmoil will continue. Airlines currently operating under bankruptcy-court protection will try to emerge with costs low enough to mimic successful low-cost carriers, and will perhaps even merge with them. On Friday, a judge approved US Airways' plan to exit bankruptcy and merge with low-cost carrier **America West Airlines**. The market share of such low-cost airlines is likely to grow, and there may be

mergers among them as well. Already, Southwest has rescued ATA Airlines, a low-cost carrier operating under bankruptcy-court protection since October 2004, with an extensive code-sharing deal.

Whether these moves will stabilize the industry depends on the answers to a few pivotal questions.

Will mergers and bankruptcies reduce competition and industry capacity enough to give the survivors pricing power? Will antitrust authorities, who blocked UAL Corp.'s pre-Sept. 11 plan to acquire US Airways, permit mergers even if they result in higher fares? Will lenders ever cut off credit to crippled airlines? Will new, low-cost airlines continue to emerge, offering fares low enough to produce pain even for newly lean airlines emerging from bankruptcy?

The legacy airlines hope the tide will turn soon, but there's ample reason for skepticism. Peter Walsh, head of Mercer Management Consulting Inc.'s aviation practice, expects "a cascading sequence" of bankruptcy filings that will prompt court-supervised mergers and reduce the number of legacy airlines to three or four, from today's six. But he foresees "no dramatic reduction in capacity."

Delta and Northwest will surely shrink while in bankruptcy. Delta already has eliminated its Dallas hub, and announced big cuts in its Cincinnati hub where, until recently, it had managed to maintain high fares. But Glenn Engel, an analyst at Goldman Sachs, says the resulting reduction in industry capacity will be "less than half is what is needed to bring prices up enough to offset \$60 oil."

Perhaps the toughest question is whether experimentation among airlines will uncover a business model that works in a deregulated business where demand can be volatile. A quarter-century after deregulation, a surprising number of unknowns remain: Can hub-and-spoke networks be efficient? Will low-cost carriers lose their agility as they grow? Is it smart for big airlines to integrate vertically by buying small regional airlines? Can airline managements ever convince distrustful labor unions to grant them the flexibility they seek?

"I wouldn't predict that five years from now we'll be in a calm market," says Mr. Borenstein, the Berkeley economist.

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