Finding Flight:
The Airline Industry

Long before the tragic events of September 11th where terrorist used jetliners as bombs, the airline industry was experiencing serious financial problems. During the past year, those woes have deepened and many industry leaders are scrambling to find ways to stop the bleeding. Increase fares or cut costs? Add perks or eliminate them all together? Yet despite the huge losses, a few airlines are showing a profit. This case study will look at the various business decisions being considered or implemented by the Big 6 and the smaller regional airlines. It will also examine where the industry is going and what it will look like in 12 months.

Cover Story

Airlines' balance of power shifts

Decade of change finds giants smaller, discounters rising

By Marilyn Adams
USA TODAY

FORT LAUDERDALE -- Dotted with palm trees, Fort Lauderdale-Hollywood International Airport a decade ago was a sleepy, second-class airport controlled by giants Delta Air Lines and US Airways.

Today, it’s a snapshot of the airline industry’s new order.

Low-fare giant Southwest Airlines now carries more Fort Lauderdale passengers than any airline except Delta. US Airways, once the airport’s No. 2, has dropped to third place. Southwest and fellow low-

USA TODAY Snapshots®

Big Six airlines decline

The Big Six airlines -- American, United, Delta, Northwest, Continental, and US Airways -- are retrenching as a growing share of the domestic market shifts to their regional airline partners and low-fare rivals. Share of domestic seats:

<table>
<thead>
<tr>
<th>Month</th>
<th>Big Six</th>
<th>Regionals of Big Six</th>
<th>Low-fare airlines</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 1992</td>
<td>Big Six: 72%</td>
<td>Regionals of Big Six: 11%</td>
<td>Low-fare airlines: 10%</td>
</tr>
<tr>
<td>May 2002</td>
<td>Big Six: 56%</td>
<td>Regionals of Big Six: 15%</td>
<td>Low-fare airlines: 23%</td>
</tr>
</tbody>
</table>

Source: Back Aviation Solutions

By Keith Simmons, USA TODAY

U.S. airline industry jobs tumble

The U.S. airline industry cut 79,000 jobs in 2001, more than one of every 10.

<table>
<thead>
<tr>
<th>Year</th>
<th>Jobs in 2000</th>
<th>Jobs in 2001</th>
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<tr>
<td>2000</td>
<td>732,049</td>
<td>653,488</td>
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</tbody>
</table>

Source: Bureau of Transportation Statistics

By Shannon Boff and Adrienne Lewis, USA TODAY

Case Study Expert

William S. Swelbar
Managing Director, Eclat Consulting

By Marilyn Adams
USA TODAY

Don’t expect rivals to pounce on United

By Dan Reed

Why airlines have trouble turning profit

By Dan Reed

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fare airlines like AirTran, American Trans Air, JetBlue and Spirit carry one-third of Fort Lauderdale passengers, up from just 7% in 1996. More domestic passengers fly in and out of Fort Lauderdale than nearby Miami International, Florida’s busiest airport and an American Airlines hub.

“No way could I ever have forecast this,” says Fort Lauderdale airport official Ed Nelson.

At airports nationwide, the airline industry is undergoing a historic shake-up. The giants are reeling and smaller carriers are growing -- some are even prospering. In the process, travelers are benefiting from the most robust competition in at least a decade: More airlines, especially low-fare carriers, are flying to more cities than ever, and a larger percentage of fliers than ever are finding cheap tickets, often online.

This is bad news for big airlines. American, United, Delta, Northwest, Continental and US Airways -- the Big Six carriers based on 2001 revenue -- have retrenched in the past decade, painfully so after Sept. 11. Their market shares are down. Airlines just posted $1.4 billion in combined losses in the worst second quarter ever. But while the Big Six lose money, aggressive discount carriers with lower operating costs are pulling down airfares as they move into markets the six giants once dominated.

"Competition for every customer has never been so intense," American Airlines Chief Executive Don Carty told the National Press Club recently.

It’s a very different picture from what many industry analysts foresaw a decade ago after Eastern and Pan Am folded and America West, Continental and Trans World Airlines sought bankruptcy-court protection. The surviving giants were expected to tighten their grip on domestic air travel with “niche” carriers like Southwest providing limited competition. In fact, the opposite has happened, as shown by an analysis for USA TODAY of airline competition since 1992. The study by Back Aviation Solutions reveals:

- The Big Six airlines' combined share of seats on domestic flights has dropped to 56%, down from 72% a decade ago.

- Low-fare airlines have more than doubled their share of the domestic air-travel market. Discount carriers like Southwest, America West, AirTran, JetBlue and Frontier now account for 23% of all seats on domestic flights, more than double their 10% share in 1992.

- Discount carriers have made giant inroads into the largest metropolitan areas. They now account for at least 20% of domestic seats in six major metro areas.

- Regional airlines -- often owned by or flying under contract for major airlines -- are playing a much bigger role. Regionals fly 21% of the total domestic-flight seats flown by them and their Big Six partners, up from 13% in 1992.

The Internet has helped drive these shifts in passenger behavior. A decade ago, travelers relied on information from travel agents and airline reservations agents when booking travel. Today, powerful search engines and popular travel Web sites such as Expedia and Travelocity have brought visibility to discount carriers that lack major airlines’ marketing budgets.

Take Felicia Bryant, one of the new generation of customers. The New York hospital worker was so rattled by the Sept. 11 attacks that she wanted her family to drive from their home in Manhattan to a church conference in Miami this summer, but husband Ernest dreaded the drive. She couldn’t afford $1,000 in airfare, the cheapest offered by US Airways from nearby LaGuardia airport.

So the couple and their two young children left home at 4:30 a.m., took a cab to Grand Central Station, caught the Long Island Railroad to Hicksville, N.Y., and then a $69 cab to Islip, Long Island, to catch a Southwest flight to Fort Lauderdale. Airfare for four: $476, booked on Southwest’s Web site.
**Discount airlines on the rise**

"We really went out of our way," she says, "but we came out ahead."

Travelers like her have the Big Six rethinking everything they do.

"Everyone's examining their business plan from top to bottom," says Glen Hauenstein, senior vice president at Continental Airlines. "The biggest challenge facing major carriers is figuring out what people are willing to pay for."

"We've seen a sea change," asserts AirTran CEO Joe Leonard, a former Eastern Airlines executive. "It was occurring even before Sept. 11. I think there's been a behavior shift. I don't believe passengers will go back to paying some of the fares they were paying in fall 2000. They've learned they can find affordable fares."

**Rise of discount carriers**

Low-fare carriers have grown in number and size far more than anyone foresaw a decade ago. Southwest is biggest by far. From a largely West Coast airline with 138 planes 10 years ago, Southwest now flies 366 planes, more than US Airways, and it blankets the East Coast from New England to Florida. Southwest was the only profitable major airline last quarter.

Several other smart and aggressive discount carriers have penetrated markets once owned by the Big Six, including New York, where JetBlue flies from Kennedy airport; Washington, where Southwest, AirTran and JetBlue serve Baltimore/Washington International and Dulles; Chicago, where American Trans Air (ATA) and Southwest fly from Midway Airport; Atlanta, where AirTran Airways makes its hub at Hartsfield, Delta's home; and Denver, where Frontier has 11% of Denver International, a United hub.

"Low-fare airlines have proliferated so much there's almost nowhere that's not impacted," says Hauenstein.

Now, discount airlines are breaking into the big airlines' profitable, once-private domain of coast-to-coast flying. Southwest, which for 30 years carried passengers mainly on short flights, will start a Baltimore-to-Los Angeles non-stop in September. Discount JetBlue already flies New York to Long Beach and Oakland. This is a major potential threat to the Big Six: Transcontinental flights are where they have been able to get high-margin fares -- in excess of $2,000 round trip in coach -- because there has been no genuine competition.

"Trans-con has been their bread and butter," says airline adviser Bill Swelbar with Eclat Consulting in Arlington, Va.

In keeping with their low operating costs, low-fare airlines have often gravitated to secondary airports, where less congestion and lower fees kept costs down. As those airlines and their competitors expanded, so did the airports, siphoning travelers away from Big Six airports and challenging or eclipsing big airports nearby. Fliers, like Felicia Bryant in New York, have shown they'll travel amazing distances to alternate airports to save money.

Airlines have gained market share in major metro areas by developing alternative airports: Providence instead of Boston, Midway instead of O'Hare, Baltimore instead of Reagan Washington National, Oakland instead of San Francisco. At five New York-area airports, discounters account for 15% of airline seats; at Chicago's two airports, 23%; at Washington's three, 25%.

Even where low-fare airlines share an airport with a Big Six carrier, the low-fare carriers tend to grow faster. At more than 80 airports shared by discounters and Big Six airlines, low-fare carriers have gained six times as many passengers in recent years as Big Six carriers, Swelbar's research shows. To cut costs and in some cases fight back against discounters, Big Six carriers have been moving an increasing percentage of flights to fast, economical little jets
operated by regional carriers. Their shift from turboprops to larger, 50-seat regional jets (RJs) also has made possible new, longer routes between large and midsize cities. This fall, Continental Express RJs will start non-stop flights between Oklahoma City and Newark, N.J. — Oklahoma City’s first non-stops to the New York area in memory. Cincinnati, a Delta hub, has added non-stop flights to 33 destinations since 1992, and 90% of that flying is on regional jets operated by Delta Connection, not Delta Air Lines.

The RJ phenomenon

Regional jets -- which many passengers like better than slower, noisy turboprops -- have proved they can siphon customers away from airlines with turboprops on the same routes. But RJs are being used in more creative ways now. American, for example, launched American Eagle RJ service between Baltimore-Washington International and Chicago O’Hare to compete against Southwest’s BWI-Chicago Midway flights on Boeing 737s. Now, the demand justifies American MD-80s on that route.

Conversely, the Big Six are also using an increasing number of RJs to supplant big jets at lower cost. Regional Skywest Airlines, flying as United Express, took over many Shuttle by United routes in California when United ended the operation after Sept. 11 to cut losses. Today at Los Angeles International, Skywest operates more flights than any airline except United.

If the discounters’ plans bear fruit, they could pose even more of a threat to the Big Six in coming years. Southwest, with the strongest balance sheet of any major airline, will have as many as 500 jets in its fleet in five years. Two-year-old JetBlue went public in April in a record-setting initial public offering and wants to quadruple its 27-jet fleet in five years.

The discounters’ expansion will put more pressure on fares at the Big Six. America West, American Trans Air, National and Frontier recently have cut their top coach fares in a bid to draw more business travelers from the Big Six. Those travelers increasingly are revolting against airlines’ long practice of charging them $2,400 to sit in the same coach section with leisure travelers who paid $200. Unless the Big Six can permanently pare labor and other costs, their leisure fares will have to climb for business fares to come down.

As the Big Six move more fliers to small jets, passengers also can expect more flights and longer flights on RJs. Delta, whose regional-airline division operates more RJs than any other Big Six carrier, is buying $1.1 billion in regional jets this year even as it postpones deliveries of big jets. US Airways Express’ regional carriers operate more flights now than US Airways’ main airline. United just negotiated a deal with its pilots union allowing use of more RJs; American is seeking a similar agreement with its pilots union.

“This is a new day,” Swelbar says. “Are the Big Three going to be American, United and Delta — or American, Delta and Southwest? The whole system is under attack.”

Contributing: Barbara Hansen provided database analysis
Low-fare airlines get creative for frequent fliers

Strategies include buying tickets from some rivals

By Chris Woodyard
USA TODAY

Earn enough frequent-flier miles on United Airlines, and you can fly free to Honolulu, Berlin or Tokyo.

Take lots of trips on Southwest Airlines, and you can vacation in Buffalo, Lubbock, Texas or Omaha.

The frequent-flier programs of low-fare airlines might lack glamorous destinations. But the discounters are trying to make up for the glitz vacuum by finding creative ways to emulate the majors.

“The low-cost carriers have gotten smarter,” says air miles guru Randy Petersen, publisher of InsideFlyer magazine. "Now, the big guys are trying to figure out how to compete against the little guy."

For discounters, frequent-flier programs are a way to lure corporations away from major airlines while seeking to please employees locked into their old frequent-flier programs, says Tad Hutcheson, a spokesman for AirTran Airways.

JetBlue Airways, which started its program last week, calls it a "gratitude" program. "We’re not doing it to engender travel," says spokesman Gareth Edmondson-Jones. "We’re doing it to say thanks."

Low-fare airlines are trying to make their frequent-flier programs competitive against those of the major airlines by:

► Compensating for limited routes.
With most routes concentrated in the South, AirTran looked for a way to make its frequent-flier travel awards more competitive with those offered by major airlines with vast route networks. The solution: offer frequent fliers with enough flight credits a round-trip ticket anywhere in the continental USA on another airline. Last year, AirTran spent $300,000 purchasing airline tickets for its frequent fliers, most of them on Delta.

Only about 5% of AirTran’s frequent fliers take the airline up on the offer -- and about 90% of those fly to five cities in the West: Los Angeles, San Francisco, San Diego, Seattle or Las Vegas, Hutcheson says. But the program helps AirTran woo business accounts by keeping its menu of frequent-flier award destinations on par with the major airlines, he says.

► Forming partnerships with international carriers.
National and Frontier airlines have deals that let their frequent fliers spend miles on Virgin Atlantic. That way, frequent fliers can go to London and into the heart of Europe.

National also lets miles be spent on tickets on the LatinPass program, a group of primarily South American air-

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lines that offer travel throughout the Americas.

Credit card deals. Frontier Airlines’ frequent fliers earn miles by charging purchases to their Diners Club card. Southwest has a tie-in with a Visa card that carries its brand name. Travelers who book a trip with an American Express card on AirTran receive double flight credits.

Despite those solutions, low-fare airlines face some disadvantages that they haven't been able to overcome. Discounters still can’t offer their loyal customers a trip to Hawaii, traditionally a top vacation destination for those cashing in miles, which none of them serve.

Frontier has an agreement to let its members spend their miles on Continental, which serves Hawaii, but the deal ends in September.

And business travelers have gotten hooked on the programs of full-service airlines, accumulating hundreds of thousands or millions of miles, and are reluctant to leave.

"Once you get locked into a United or American (frequent-flier program), it gets tougher to switch loyalties," says Scott Hamilton, editor of AirlineMonitorWeekly.com, an airline news site.

Try as they might, discount airlines have a hard time convincing veteran fliers that their programs are better. For one thing, they’re hard to compare.

Low-fare airlines often use points or segments in accruing credit toward free trips. The majors use miles flown.

Southwest grants a free ticket for every eight round trips flown in any 12-month period, doubling the credit for trips booked online. Unlike full-service airlines, it doesn’t limit how many seats are allocated for award trips on a particular flight. When frequent-flier club members want to use an award ticket, any flight with empty seats is available to them.

AirTran grants the free trip for six round trips, or three if paid with an American Express card.

National, based in Las Vegas, counts 10% of a ticket price as points in its frequent-flier program to give larger credit to those who pay the most for their trip.

JetBlue awards two points for short-distance round trips, four for medium and six for long one-way flights; 100 points earn a round trip to any of its 19 cities. There’s double credit for booking online.

Among discounters, only Frontier uses miles. Fliers need 15,000 miles for a free ticket, vs. 25,000 for most major airlines.

Frequent fliers on the smaller airlines say they were lured by the chance to get cheap fare and earn free trips fast. Joe Leader, 31, has become AirTran’s top frequent flier with 135 free trips in the past four years. He earned them by flying AirTran twice a week between Orlando and Atlanta. He’s had to find some creative ways to use his free trips. He flew eight friends to Orlando for his birthday party last year. He’s flying in another group for wife Jeanette’s birthday this year.

He took AirTran up on its offer to buy tickets on other airlines to the West Coast. The Leaders took free trips on Delta to Las Vegas and on United to San Francisco, and picked up mileage on those airlines’ programs in the process.

"I’ve earned so many free tickets on other airlines that I’ve earned free tickets with my free tickets," Leader says.
Behind the Story: A Reporter's Notebook
Dan Reed, Money Section

Both of these stories originally were conceived as part of a package of stories that would accompany a Chapter 11 bankruptcy filing by United Airlines, or that would run just slightly ahead of such a filing if a news even warranted it. Our business travel team met on this several times via conference call (we’re in DC, Miami, LA, and Fort Worth - I’m in Fort Worth) in late October and early November with Judi Austin (our auto team editor who was temporarily handling us too while our editor was on special assignment leading the corporate accounting scandals coverage team). In those meetings we hashed out both United’s specific problems and the broader issues facing the entire airline industry. From that we each proposed stories we thought would best answer questions we believed our readers would be asking around the time of a United bankruptcy filing. The stories of mine were part of that package. The writing of both was completed the day after Thanksgiving (actually the Q&A was done a week before that but was way too long, so I chopped it down on the slow day after Thanksgiving). Editing and rewrite followed on the next Monday. The stories ran on Friday Dec. 6, with almost no changes required as a result of breaking news.

The first of the two, "Why Airlines have trouble turning a profit" is a simple Q&A, not tied to any specific news event. We figured that a United bankruptcy, and other airlines’ widely-reported financial struggles, would be wanting to know the answer to this one basic question, and its subsidiary questions. And since I’ve been covering the airline industry for nearly 20 years and have written a book on the subject, Judi figured I was the go to do this story. And, truth be told, I really had to do very little additional research. Most of the specific data cited in the story was already in hand or had appeared in the paper previously. All of the information that went into the answers were from interviews already done over the previous weeks for other stories or for general backgrounding and reporting purposes. And some of it, frankly, just came from my own knowledge gained from two decades of covering the industry. It pays, sometimes, to have experts assigned to beats, and this is an example of that. We at USAT talk a lot about writing authoritatively. And this is a prime example of that. The paper’s credibility, and mine, carry this story, not the named sources in the story (there are none).

The second story, "Don’t Expect Rivals to Pounce on United," wasn’t quite so easy. But again, this was built on basic reporting done in the course of covering a beat, not a lot of new reporting done specifically for this story. The idea of the story was obviously simple: What will competitors do in response to a United bankruptcy and any shrinkage of service?” Yet it’s exactly that kind of story we want to be able to write, because it answers one of the prime questions readers typically have after reading a news story that says “XYZ corp. is going bankrupt,” especially if they depend on XYZ to meet their needs. Again, most of the information in the story were already in hand when we decided to do the story. That info was gathered from just plain ol’ daily beat coverage, which these days includes reading every report and study that comes out and evaluating its meaning and calling up the analyst/consultant/whoever with follow-up questions and making him/her defend their position. Based on that already available information, I did 5-6 additional interviews to make sure the points being made were valid and shared, to some degree, by a reasonable number of experts... and to get fresh, lively quotes.

In short, these are not great examples of investigative, ground-breaking reporting. Rather, they are, I think, good examples of exhaustive beat reporting can bring to the table in helping readers understand events and their broader impact on their own lives. And that’s good newspapering, and good journalism, I believe. Everybody loves breaking the big, new investigative story. And we do our share of that. But these kinds of stories do wonders in solidifying readers’ perception of USAT as THE place to turn for the best, most informative, most accessible news about business travel and the airline industry.

Dan Reed joined USA TODAY’s MONEY staff in July 2002, as the fourth and newest member of the paper’s business travel/airlines reporting team. Prior to joining USA TODAY, he worked at the Fort Worth Star-Telegram for 21 years. For the last 18 of those years he covered the airline industry. In that time he earned a reputation as one of the top airline beat reporters in the nation, and a number of national, state and local reporting awards. With nearly 20 years of covering airlines, Reed is the dean of airline beat reporters at the nations’ major dailies. He also is the author of the award winning "The American Eagle: The Ascent of Bob Crandall and American Airlines (St. Martin’s Press, 1993), and is currently working on a second book about the airline industry. Early in his career Reed was a sports writer for the Arkansas Democrat in Little Rock, wrote The Sentinel Record in his hometown of Hot Springs, Arkansas, and served in a variety of positions including entertainment and sports editor and senior editorial writer for his college newspaper at the University of Arkansas. Reed earned a Master’s of Divinity degree in theology and ethics from Southwestern Baptist Theological Seminary in Fort Worth, and a Bachelor of Arts degree in journalism from the University of Arkansas in Fayetteville. He is married, the father of three teenage sons and is active in church and youth sports work in Fort Worth.
Unsuccessful in raising fares this year and still facing steep losses, some major airlines are taking away dis-
counts for grandpa and grandma.

American, Delta, Northwest and United airlines have fol-
lowed US Airways, which two weeks ago cut a senior dis-
count that lopped 10% off most fares. Some are still mak-
ing senior coupon books available, while others are adopt-
ing more restricted discounts.

United now offers qualifying seniors a 10% discount for
fares bought at least 14 days in advance that include a
Saturday-night stay and a maximum stay of 180 days. The
airline also changed the eligible age to 65 from 62.

The move is airlines’ latest step to boost revenue. Some
have raised fees for paper tickets, excess checked baggage
or alcoholic drinks on trans-Atlantic flights. Some airlines
have raised advance-purchase airfares four times this
year, withdrawing them when competitors failed to adopt
the increases.

"The airlines have been attempting to raise leisure fares
and have been unsuccessful," says Bob Harrell of Harrell
Associates, a New York firm that tracks airfares. "When
this happens, they often go after smaller or perhaps more
achievable objectives by tightening discounts or loopholes
in fares."

Major carriers are struggling to curb staggering losses, in
part from tight corporate travel budgets and businesses’
refusal to pay as much as 10 times what leisure travelers
pay for the same flight. To spur travel, most airlines have
been discounting their fares.

"Obviously, we need to try and raise revenues in the
environment we’re in right now," says United spokesman
Joe Hopkins. "We think it makes economic sense to do so,
but we’re continuing to give senior citizens a break to
those who are 65 and over."

The major airlines lost up to $1.4 billion in the second
quarter -- the industry’s worst April-June period on
record, says UBS Warburg analyst Sam Buttrick.

Some travel experts question the wisdom of aiming
price increases at a market they say will grow stronger as
more baby boomers turn 56.

"One of the things we know about seniors is they have a
real belief that they deserve a discount," says Doug Shifflet
do D.K. Shifflet and Associates, a travel research firm. "If
there are two airlines competing head-to-head for their
business, the one that has a discount will certainly get
favorable consideration."

Kansas City, Mo., travel agent Parris Johnson says even
seniors who can afford a $50,000 trip want their senior
airfare discount. She sells about five senior discount tickets
a week and more around holidays.

Johnson says she’ll steer more of her customers to
Southwest and some of the smaller carriers that still offer
a senior discount.

One of them even improved its senior discount this
week. Denver-based Frontier Airlines says it’s enhancing
its 10% senior discounts by letting passengers ages 62 and
older apply them to its lowest Internet fares.

Some travel experts wonder whether traditional dis-
counts are as useful for today’s older travelers.

"They’re savvy, experienced travelers," says Marilyn
Hummer, travel products manager for AARP, which offers
members special fares on US Airways and Virgin Atlantic
Airways. "I think they know how to find the best rates. A
lot of them use the Internet."

"If the discount off a full-coach fare was 10%, you’re bet-
ter off going to the Internet and finding a better price,"
says Cathy Keefe, spokeswoman for the Travel Industry
Association.
More airlines cut back on 'favors' for fliers

Continental, Delta join others passing costs onto travelers

By Chris Woodyard
USA TODAY

Staggered by losses, airlines are looking to share their pain with passengers.

Continental Airlines announced plans Tuesday to start charging low-fare fliers for services that were previously free.

Continental also says it will no longer bend rules for any customer -- big or small.

Delta Air Lines told travel agents last week that it, too, is cracking down on what are known in the industry as "waivers and favors."

Continental says it will still be a full-service airline for "higher-revenue" customers. But some question the changes.

"Continental appears to be separating and shifting its costs directly to the consumer," says Richard Copland, president of the American Society of Travel Agents. "This action shows that the airline is driven by its own needs, not by what consumers want."

How passengers will be affected:

► Paper tickets will cost $20 on Continental, the same amount other airlines have started charging.

► Continental vows rigid enforcement of excess baggage charges and change fees.

Delta says it will no longer bend rules when it comes to refunding non-refundable tickets, waiving minimum-stay requirements or advance-purchase periods.

"These practices were originally intended to provide a remedy for ticketing errors and certain situations beyond a travel agent's control," wrote Lee Macenczak, a Delta senior vice president, in a memo. But now they are "being used routinely to circumvent the pricing structure."

Travel experts say they doubt that airlines will totally end the favors system for top customers.

"I'll bet you some still get done," says Thom Nulty, president of Navigant International, a big travel agency chain. "It's so hard to come out with a blanket 'We'll never do it again.'"

Some business travelers say a no-favors crackdown could push them to another carrier.

Robert Lewis Thompson, a 2 million-mile flier on Continental, says he was already having enough trouble getting seat upgrades and using his miles for free trips.

He wonders if Continental CEO Gordon Bethune may be going too far and says he may switch his allegiance to Northwest.

Contributing: Dan Reed
Rebuffed by a federal loan board, United Airlines is struggling with its toughest decision ever: make massive budget cuts immediately to appeal the government's decision or enter bankruptcy court.

United parent UAL is expected to seek Chapter 11 bankruptcy protection within days. Fifteen months after losing two jets to terrorists, United would become the largest U.S. carrier ever to go into bankruptcy.

Chapter 11 would get United a breather from payments to creditors and enable it to borrow fresh money to keep operating. Routes, reservations and frequent-flier miles would not be affected immediately.

But as it takes steps to halt its dangerous cash drain, United and its passengers could see dramatic changes, including the cutting of more routes, reduced flights and more worker layoffs, says Boston bankruptcy lawyer Jon Schneider of Goodwin Procter, who has represented creditors in past airline bankruptcies.

The biggest issue driving whether and when United files is its cash stockpile. The airline has been burning about $7 million a day and could run out of money by January.

United flies 180,000 passengers daily and operates hubs in Chicago, its hometown, as well as Denver, Los Angeles, San Francisco and Washington. It has extensive routes throughout Europe, South America and Asia.

Like most airlines, it has cut back on flights, eliminated some routes and laid off workers since the Sept. 11 attacks. Today, United operates 1,800 daily flights, 25% fewer than before Sept. 11, 2001, and it has 20,000 fewer employees.

To get out of bankruptcy, it would need to eliminate more of its unprofitable or marginal routes, park more planes, furlough more employees and cut salaries.

That would leave United, the world's second-largest carrier by revenue, a smaller airline.

A bankruptcy also could force major changes in its management and board. People familiar with the situation say many major equity investors have expressed interest in taking a stake in a leaner, less-indebted United after a bankruptcy.

After US Airways filed Chapter 11 in August, for instance, Texas Pacific Group offered $200 million in fresh capital in return for stock and five seats on the board of a restructured airline, only to be outbid by an Alabama state-employees pension fund. Today, the Retirement Systems of Alabama is seeking more seats on US Airways' board, and says the airline has agreed in exchange for possibly borrowing another $75 million from the pension fund.

Bankruptcy experts say United could stay in bankruptcy for as long as two years because its reorganization would be so complex. Developing a business plan based on reliable revenue numbers could take a year.

Much work has been done to prepare for a Chapter 11 filing. United has worked for months to line up debtor-in-possession lenders and get concessions from suppliers, lenders and lessors, including Boeing Capital and GE Capital. It is known to have approached J.P. Morgan Chase and Citigroup about $1.5 billion in debtor-in-possession loans. United retained bankruptcy attorneys at Kirkland & Ellis a year ago. It hired bankruptcy expert Rothschild North America as a consultant earlier this year.
The airline moved a lot closer to bankruptcy court Wednesday when the Air Transportation Stabilization Board voted to deny United’s application for a $1.8 billion loan guarantee, saying its business plan wasn’t sound. United said it needed the guarantee to get cash because it has been shut out of private finance markets.

The rejection wasn’t completely unexpected. United’s application had been under intense attack from competitors for months. People familiar with the application say executives from American, Northwest and Continental flew to Washington to make detailed face-to-face presentations to the board to dispute United’s numbers. If United enters bankruptcy and shrinks, the three could gain passengers in domestic, European, Latin and Asian cities where they compete with United.

At the New York Stock Exchange, trading in UAL stock was halted Thursday after shares opened down 59% at $1.28. When trading resumed, shares fell to $1. Standard & Poor’s cut its credit ratings on United and UAL debt to default grade, its lowest rating.

Illinois Gov. George Ryan, a Republican whose term expires next month, has said he supports lending $200 million to United. Governor-elect Rob Blagojevich, a Democrat, said he supports the idea, too. With 18,000 workers in the state, United is one of Illinois’ largest employers.

Chicago Mayor Richard Daley told reporters Thursday that he planned to bring up United’s plight with key Bush administration officials at a White House social event Thursday night.

But several leaders in the state legislature said they are opposed to corporate bailouts and concerned about Illinois’ growing budget problems.

For United’s supporters and employees, the loan board’s blunt denial was the worst single piece of news since two United jets were hijacked and crashed Sept. 11. Since early 2000, when United was still the world’s largest carrier, its course as a company has been a violent rollercoaster ride:

- In May 2000, United made a brazen $4.3 billion bid for US Airways to shore up its East Coast presence.
- Then came United’s summer from hell, when labor turmoil over contract talks caused thousands of flight cancellations and chaos across its system. In 1993, employees had agreed to forgo regular raises from

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Rising expenses, too few passengers cripple United

United Airlines edged closer to seeking bankruptcy protection as revenue slipped below operating costs:

**Operating expenses, revenue per available seat mile** (first half of each year):

<table>
<thead>
<tr>
<th>Year</th>
<th>Expense</th>
<th>Revenue</th>
<th>Seats not filled</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>9.38 cents</td>
<td>11.35 cents</td>
<td>Seats United filled: 73.3%</td>
</tr>
<tr>
<td>2002</td>
<td>10.07 cents</td>
<td>12.56 cents</td>
<td>Additional seats needed for 96.5% break-even load factor</td>
</tr>
</tbody>
</table>

Source: Back Aviation Solutions

By Quin Tian, USA TODAY

► In fall 2000, United’s pilots union signed a record contract, which set an expensive standard for pilots across the industry.

► In third quarter 2000, UAL began posting losses.

► By summer 2001, the Justice Department, convinced a post-merger United would dominate several East Coast airports, blocked the merger with US Airways, and the two airlines dropped the effort.

► A month later, terrorists struck. The resulting travel slump battered an already-suffering United, whose West Coast and Pacific operations had been hit by the Asian recession and the dot-com meltdown.

In the last nine quarters, United’s losses have totaled more than $4 billion.

**United, employees plot future**

In Chicago Thursday, United CEO Glenn Tilton met with union leaders to lay out the painful choices and likely next steps. Thursday evening, union officials were meeting to discuss whether to make a last-ditch offer of more employee concessions – $8 billion to $9 billion total — to bolster United’s application and appeal the government’s decision.

United is 55% employee owned, and the pilots and mechanics unions have representatives on the board.

Employee-owners at United stand to lose their equity, board seats, many jobs and pension benefits in a bankruptcy filing. Employees, union and non-union, pledged $5.2 billion in concessions over 5 1/2 years to help United qualify for the guarantee.

It wasn’t enough.

Even if there were the will to make billions of dollars more in cuts and rework the application, time is short. By Thursday, $875 million in debt comes due.

Union officials were grim — and bitter.

"I don’t care what anyone says -- a United bankruptcy would be a victory for terrorism," said Herb Hunter, a senior pilot and spokesman for the Air Line Pilots Association. "We’re still talking about our options. It’s not over till it’s over."

Contributing: Dan Reed in Chicago
Why airlines have trouble turning profit

By Dan Reed
USA TODAY

United Airlines isn’t the only carrier in financial trouble. The industry has been on a downturn since the Sept. 11 attacks. USA TODAY reporter Dan Reed takes a look at some issues that make it difficult to run an airline profitably.

Q: Why does it cost so much to operate an airline?

A: Moving hundreds of airplanes, tens of thousands of employees and hundreds of thousands of passengers around a vast service network -- safely -- is one of the world’s most complicated processes.

Think of it as an assembly line in which thousands of pieces must come together at precisely the right time. And each product produced -- a trip by an individual -- is unique. Altogether, there are about 700 million of those products each year.

The assembly line tools -- airplanes, airports and support facilities -- are expensive. On top of all that, the assembly line is subject to bad weather, mechanical failures, passenger emergencies in flight, even hijackings, all beyond the operator’s control.

It’s a wonder that fares aren’t far more expensive and that more than 80% of flights operate on time.

Q: How much impact do labor costs have?

A: Labor is the biggest cost item at any airline, and workers’ desire for ever-higher compensation is at odds with customers’ desire for ever-lower fares.

Airline employees are expensive to hire and train, and difficult to replace. It takes years of flying to qualify to apply for a pilot’s job at a major airline. The health, vision, education, background check and psychological requirements would disqualify more than 90% of adults. In the case of pilots, mechanics and flight attendants, federally mandated training is long and costly.

Airline managers know that if they’re struck, they would run out of cash in 30 days. That gives unions remarkable negotiating leverage.

The result? Pilots are the highest-paid union workers in the world. Mechanics don’t come cheap, either. Flight attendants and customer service employees are regarded as the cream of the crop among service workers and are paid accordingly.

Q: Will airline workers have to take big pay cuts?

A: Some pay cuts and benefit reductions are likely. But wage rates alone are not the problem. At most traditional airlines, complicated workrules and the airlines’ flight schedules create inefficiency. For example, pilots can get paid for 75 to 80 hours a month while actually flying 50 to 55 hours.

Low-fare airline Southwest, the industry’s profit leader, has few of those workrules or flight-scheduling problems.

Management and labor leaders agree that most airlines could wring up to 30% more productivity out of pilots and other workers. But workers would have to give up some lifestyle advantages.

Also, increased worker productivity would mean fewer workers. Translation: more layoffs beyond the 53,000 jobs cut since the Sept. 11 attacks.

Q: Did Sept. 11 cause all this?

A: No, but Sept. 11 worsened a major shift in consumer demand for air travel already underway.

The booming high-tech, telecom and financial sectors of the mid- and late ’90s helped push airline load factors (the average percentage of seats filled) to records. That army of big spenders loved first- and business-class seats, creating a rare increase in a 70-year downward trend in yields (average fares per passenger-mile flown).

But by the late ’90s, midlevel corporate and small-business travelers had become increasingly price sensitive. Many went to Internet travel sites to get good deals and started scheduling business trips over weekends to qualify for discounts requiring Saturday night stays.
When the tech/telecom/finance bubble burst, demand for premium fares really cratered, sending yields to their lowest ever.

Pay increases negotiated during the boom kicked in at about the same time. And costly new airplanes ordered during the boom kept arriving.

**Q: Why do fares vary so widely?**

**A:** Every passenger values his or her seat differently. Grandma visiting the grandkids will adjust her schedule to get the best deal. To a businessman scrambling to get somewhere to keep a $100 million contract from being canceled, $2,400 for a one-way, first-class ticket seems cheap.

Airlines developed hub-and-spoke networks to cater to those high-fare-paying business travelers who want multiple departures each day to meet time-driven needs.

But even the smallest jets are too big for that demand alone. Airlines offer leisure travelers lower fares to help fill seats. Without those, business travelers’ fares would be higher.

That system made sense when full-price tickets cost no more than twice the cheapest discount fares. But carriers now have more seats than can be filled by natural demand, so they have to discount even more. The lowest-priced seats now can be 80%, even 90% off the full-fare price.

To make up for that reduced revenue, airlines charge ever-higher top-end prices, leaving the few who pay top dollar feeling cheated and angry.

**Q: Does that mean that leisure travelers eventually will end up paying more for their tickets?**

**A:** Probably, but not a lot more. And only as the economy improves and demand rises.

Even Southwest executives agree that the deepest discount prices available in the marketplace currently are too low. They also agree that demand for full-price fares will grow as the economy improves.

**Q: Can the big airlines salvage a business model that relies on business travelers for profit?**

**A:** The risks in doing nothing are huge. But the risks of changing too quickly, too much or in the wrong way might be even higher.

The traditional carriers have sunk billions of dollars into fleets, facilities and people to service their networks. Switching to a low-cost, low-fare model such as Southwest’s would be complex and costly.

The pain likely would include pay cuts and more lost jobs. Lenders and creditors could see reduced payments from carriers and even some defaults. Stockholders wouldn’t reap any rewards in the short term and would risk losing it all through bankruptcy filings. Consumers could see their travel choices reduced. Some smaller communities could lose service.
Don’t expect rivals to pounce on United

By Dan Reed
USA TODAY

Even if United Airlines files for bankruptcy protection, its competitors won’t necessarily be circling overhead, waiting to pick its bones clean.

United remains the world’s second-largest airline and a formidable industry presence. Its rivals, most of which face similar financial turmoil, are not likely to take it on. And a bankruptcy filing would temporarily bolster United, freeing nearly $1 billion in cash for operations while creditors are put on hold.

"For now, nothing much should change," says Ron Kuhlmann, vice president of Unisys R2A, an industry consulting firm in Hayward, Calif.

It has been 20 years since a major airline filed a Chapter 11 bankruptcy and simply stopped flying. Braniff International waited until it was out of cash before filing in May 1982. Its overnight collapse enabled American and Delta to solidify their new hubs at Dallas/Fort Worth, and Eastern Airlines became the dominant carrier at Kansas City.

Over time, if United files it would likely trim schedules beyond the 25% reduction it made after Sept. 11, 2001, and the 6% cut for first-quarter 2003, which it announced in November.

In response, competitors might make small increases in the amount of air service they offer on a handful of keenly competitive routes. But J.P. Morgan Chase analyst Jamie Baker discounts the possibility of big moves like American’s quick establishment of a Miami hub in the late 1980s after Eastern filed for Chapter 11.

The one exception could be discount king Southwest Airlines. As the only carrier to remain profitable since the terror attacks, Southwest has the financial strength and momentum to jump into new markets.

Even Southwest’s performance has been hurt by the industry downturn. And its executives aren’t eager to spend money to get market share quickly that they think they’ll get eventually anyway.

One fear other carriers have in a bankruptcy situation is a fare war.

Baker observes that hasn’t happened with US Airways, which entered Chapter 11 in August, and says it’s unlikely to happen with United, which hasn’t lost a lot of passengers despite months of publicity about its problems.

Besides, prices are as low as they’ve been in a decade, says Kuhlmann. "How much lower can they go?"

### American expected to get most United fliers

J.P. Morgan Chase airline analyst Jamie Baker suggests that there will be relatively little “revenue spill” from, should it file for Chapter 11, United Airlines to other carriers. He expects American Airlines, United’s closest rival, to get the largest share of what does go to other airlines.

<table>
<thead>
<tr>
<th>Airline</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>American</td>
<td>25.5%</td>
</tr>
<tr>
<td>Delta</td>
<td>8.9%</td>
</tr>
<tr>
<td>Northwest</td>
<td>7.7%</td>
</tr>
<tr>
<td>Continental</td>
<td>6.4%</td>
</tr>
<tr>
<td>Southwest</td>
<td>5.9%</td>
</tr>
<tr>
<td>US Airways</td>
<td>4.4%</td>
</tr>
<tr>
<td>America West</td>
<td>3.8%</td>
</tr>
<tr>
<td>Alaska</td>
<td>1.5%</td>
</tr>
<tr>
<td>Others¹</td>
<td>9.4%</td>
</tr>
</tbody>
</table>

Note: Percentages do not add up to 100 because Baker assumes that some people who would have traveled on United will choose not to fly at all. ¹-others include low-cost carriers, unaffiliated regional airlines, charters and foreign airlines.

Source: J.P. Morgan Chase

By Marcy E. Mullins, USA TODAY
1. The relationship between the health of the macro economy and the health of the airline industry has been well established. But, beginning sometime during the last half of 2000, domestic GDP became, and remains, a less reliable indicator of airline industry performance. If the industry is now in uncharted water, and the revenue environment is forever changed, what other macro economic indicators have been better predictors of industry health during the last two years and why?

2. The growth of the Low Cost Carriers (LCCs) has been steady throughout the decade of the 1990s. Their growth during the past two years has been well documented while the more mature segments of the industry have cut back significant levels of service. The LCCs have exploited the large spread between their cost to produce a seat versus the more mature segment of the industry. As the mature segments reduce costs either through bankruptcy or through consensual negotiations with stakeholders, will LCCs growth remain at current rates of growth, increase in their intensity or slow down?

3. Regional jets have been an important tool in the arsenal of the network carriers. They have helped to expand the breadth of service at individual hubs and have fostered significant new levels of competition. Moreover, carriers have continued to deploy significant levels of regional jet capacity over the past two years when larger jet capacity has been reduced. This past week, Continental Express announced that it was going to defer a significant number of deliveries of regional jets. Are we reaching a level of market saturation with the 50-seat and less configuration, or is Continental Express just the exception? Can regional jets be used to combat Low Cost Carrier incursions into larger US markets?

4. There remains a high level of government involvement in the airline industry. What should the role of government be with regard to safety, security, air traffic control, labor relations and the financial health of the industry? Explain each.

5. Some say the hub and spoke system is broken and that point-to-point service (similar to pre-deregulation route systems) is the answer to restoring profitability. Southwest Airlines is often referred to as a point-to-point carrier and is the model for labor and fixed asset efficiency. Is Southwest strictly a point-to-point carrier or is it a network carrier in that it connects traffic? Can today’s traditional network carriers (American, United, Delta, Northwest, Continental and US Airways) achieve the same levels of asset efficiency as Southwest? If so, how would you advise them to rework their respective operations?

1. Bankruptcy has a disproportionate effect across major stakeholder groups - employees, communities dependent on air service, lending institutions, aircraft manufacturers, stockholders, strategic partners and vendors to name some of the major groups. What are the implications of an unsuccessful restructuring for each? Should another airline the size of United file for bankruptcy, should the government step in and what are the implications to the future of the industry as a free market environment? Should United and US Airways still be able to access loan guarantees from the federal government and what are the implications for each if they cannot?

2. If the Low Cost Carriers do ultimately “inherit the earth,” what are the implications for small community air service? If service continues to be lost, will communities that lose access to the air transportation system be erased from the trading map?

3. International alliances are the model for the current US domestic alliances. What are the implications for future competition? Why are they different from outright mergers?

About The Expert

William Swelbar is one of the founding partners of Eclat Consulting, a Washington DC based commercial aviation consultancy. Bill is currently a Managing Director in the firm that supports airlines, airports, the financial community, investors and labor.

Bill has more than 20 years of experience as an expert in the analysis of airline industry economic and financial trends. A significant amount of his career has been spent studying market behavior resulting from structural changes in the competitive environment, including mergers, alliances, new entrant carriers and new aircraft technology. Bill has been involved in some capacity in nearly every restructuring that has involved working with labor unions over the past two decades as well. In addition, Bill has been the chief architect of numerous forecasting and feasibility analyses that support Eclat’s strategic planning efforts across its broad clientele. Bill also works as an Adjunct Fellow with the Economic Strategy Institute and their dealings with the airline industry.

Bill holds a Bachelor of Science degree with honors from Eastern Michigan University and a MBA from The George Washington University.

Additional resources

AirlineMonitorWeekly.com
The Coalition of Airline Pilots Associations (www.capapilots.org)
D.K. Shifflet and Associates (www.dksa.com)

InsideFlyer Magazine (http://www.insideflyer.com)
National Transportation and Safety Board (www.ntsb.gov)
Unisys R2A (www.r2ainc.com)