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COMMERCIAL AVIATION

Despite Industry Turmoil, Low-Cost Airlines Are Growing and Profitable

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Physical Infrastructure

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Highlights

Highlights of GAO-04-837T, a report to Subcommittee on Aviation, Committee on Transportation and Infrastructure

COMMERCIAL AVIATION

Despite Industry Turmoil, Low Cost Airlines Are Growing and Profitable

Why GAO Did This Study

Since 2001, the U. S. airline industry has confronted financial losses of previously unseen proportions. From 2001 through 2003, the industry reported losses of about $23 billion, and two of the nation's largest airlines went into bankruptcy. Since September 11, 2001, the U.S. government has provided struggling airlines with $7.0 billion in direct assistance and many billions more in indirect assistance in the form of loan guarantees, a tax holiday, and pension relief. Under the 2003 Emergency Wartime Supplemental Appropriations Act (P.L. 108-11) and Vision 100--Century of Aviation Reauthorization Act (P.L. 108-176), Congress mandated that GAO review measures taken by air carriers to reduce costs, improve their revenues and profits, and strengthen their balance sheets. Later this year, GAO will provide a report to Congress in response to these mandates. This statement provides a preliminary summary of that work and focuses on three main questions: (1) What have been the major challenges to the airline industry since 1998? (2) What cost-cutting measures have airlines reported taking to remain financially viable? (3) What is the financial condition of the airline industry?

What GAO Recommends

GAO is making no recommendations in this statement.

www.gao.gov/cgi-bin/getrpt?GAO-04-837T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact JayEtta Z. Hecker, 202-512-2834, HeckerJ@gao.gov.

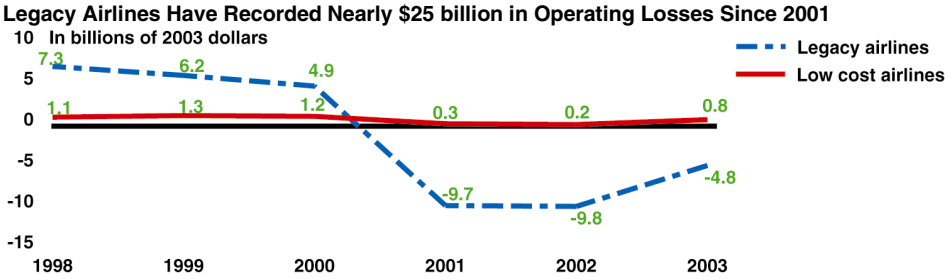
What GAO Found

U.S. airlines, particularly major network or "legacy" airlines, have faced an unprecedented set of challenges since 1998 that have reshaped the industry and reduced the demand for air travel. Within the industry, the growth of the Internet as a means to sell and distribute tickets and the emergence of well-capitalized low-cost airlines as a powerful market force have created unprecedented pressures on how airlines operate and price their products. Coincidently, a series of largely unforeseen events—among them a steep decline in business travel, the September 11th terrorist attacks, war in the Middle East, and global recession---have combined to seriously disrupt the demand for air travel.

To counter these challenges, airlines undertook very different strategies. Legacy airlines sought to cut costs, while low-cost airlines took advantage of legacy airlines' retrenchment and expanded. Legacy airlines collectively reported a reduction in operating costs of $12.7 billion (14.5 percent) between the October 1, 2001 (immediately after September 11th) and the end of 2003. The reductions occurred in nearly all areas of operations, but 43 percent of the savings came from labor. Legacy airlines reduced their seat capacity by 12.6 percent as they reduced operations and shifted service to their regional airline partners. Conversely, low-cost airlines increased seating capacity by 26.1 percent as they expanded their operations, and operating expenses actually increased by just over $1 billion (9.8 percent).

Since 2000, the financial condition of legacy airlines, as a group, has deteriorated significantly. Despite their cost-cutting efforts, legacy airlines' unit costs have not declined, and low-cost airlines enjoy even a greater cost competitive advantage. Meanwhile, neither legacy nor low-cost airlines have been able to significantly improve their revenues owing to weak fare growth and overcapacity in the system. As a result, legacy airlines have recorded nearly $25 billion in operating losses since 2001, while low-cost airlines have remained profitable throughout. Two major legacy airlines have already declared bankruptcy; others may follow.

Legacy Airlines Have Recorded Nearly $25 billion in Operating Losses Since 2001



Source: GAO analysis of DOT Form 41 data.

Source: GAO analysis of Department of Transportation Form 41 data

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to participate in today's hearing to discuss the financial condition of U.S. airlines. Since 2001, the U. S. airline industry has confronted financial losses of unprecedented proportions. From 2001 through 2003, the industry reported losses of $23 billion, and two of the nation's largest airlines went into bankruptcy. Following the tragic terrorist attacks of September 11, 2001, the U.S. government has provided struggling airlines with $7.0 billion in direct assistance and many billions more in indirect assistance in the form of loan guarantees, a tax holiday, and pension relief.[1] The most recent assistance to airlines came in April 2003, under the 2003 Emergency Wartime Supplemental Appropriations Act (P.L. 108-11). The federal government provided $2.4 billion to the airline industry, and Congress mandated that the GAO review measures taken by airlines to reduce costs, improve their revenues and profits, and strengthen their balance sheets. Subsequent to P.L. 108-11, in December 2003, Congress provided a similar mandate under the Vision 100—Century of Aviation Reauthorization Act for GAO to report on the financial condition of the U.S. airline industry. Later this year GAO will provide a report to Congress in response to these mandates. Although we are still gathering and analyzing information in response to these mandates, my statement today provides a preliminary look at some of our findings. My remarks today address three main questions: (1) What have been the major challenges to the airline industry since 1998? (2) What cost cutting measures have airlines reported taking to remain financially viable? (3) What is the financial condition of the airline industry?

My statement today focuses on the seven legacy and seven low-cost airlines that accounted for 90 percent of all domestic airline industry seat capacity in 2003.[2] Legacy airlines are essentially those airlines that were in operation before airline deregulation in 1978 and whose goal is to provide service from "anywhere to everywhere." To meet this goal, these airlines

[1]For more information on prior GAO work related to these issues, see *Summary Analysis of Federal Commercial Aviation Taxes and Fees*, GAO-04-406R, March 12, 2004, *Aviation Assistance: Information on Payments Made under the Disaster Relief and Insurance Reimbursement Programs*, GAO-03-1156R, September 17, 2003, and *Financial Management: Assessment of the Airline Industry's estimated Losses Arising From the Events of September 11*, GAO-02-133R, October 21, 2001.

[2]The legacy airlines included in our analysis are Alaska, American, Continental, Delta, Northwest, United, and US Airways. The low-cost airlines are AirTran, America West, ATA, Frontier, JetBlue, Southwest, and Spirit.

support large, complex hub-and-spoke operations with thousands of employees and hundreds of aircraft (of various types) with service to domestic communities of all sizes as well as international points at numerous fare levels. Legacy airlines contract with, or separately operate, smaller regional airlines to provide service to smaller communities. Low-cost airlines, except Southwest,[3] entered the market after deregulation and generally operate point-to-point service using fewer types of aircraft. These airlines typically offer a simplified fare structure and generally do not offer international service outside of Canada, Central America, and the Caribbean. Although there is variation among the airlines in each of these groups, there are far more similarities than differences. Most importantly, the seven low-cost airlines consistently had lower unit costs than the seven legacy airlines between 1998 and 2003. To determine the major challenges that airlines have faced, we examined prior GAO work and research by various industry experts. To determine the cost-cutting measures airlines took and to assess the industry's financial condition, we analyzed financial and operating data reported by airlines to the Department of Transportation (DOT). To assess the reliability of those data, we reviewed the quality control procedures that DOT applies and subsequently determined that the data were sufficiently reliable for our purposes. We performed our work in accordance with generally accepted government auditing standards.

In summary:

- U.S. airlines, particularly legacy airlines, have faced a sweeping set of challenges since 1998. These challenges are both internal factors reshaping the airline industry and external events that sharply reduced the demand for air travel. Within the airline industry, even before September 11th, the growth of the Internet as a means to sell and distribute tickets and the emergence of well-capitalized low-cost airlines as a powerful market force created tremendous competitive pressures on airlines. At the same time, a series of largely unforeseen events—among them the September 11th terrorist attacks and associated security concerns, war in the Middle East, the SARs epidemic, global economic downturn, and a decline in business travel—seriously disrupted the demand for air travel.

- To overcome the many challenges of the last several years, the two groups of airlines undertook very different strategies. Legacy airlines sought to cut costs, while low-cost airlines took advantage of legacy airlines'

[3]Southwest operated within Texas before deregulation.

retrenchment and expanded. Legacy airlines collectively reported a reduction in operating costs of $12.7 billion (14.5 percent) between the October 1, 2001 (immediately after September 11th) and the end of 2003. The reductions occurred in nearly all areas of operations, with the single largest reduction coming from labor costs that were reduced $5.5 billion. During this time period, legacy airlines reduced their seat capacity by 12.6 percent by shifting traffic to regional airline partners and grounding aircraft. Conversely, low-cost airlines' operating expenses increased by just over $1 billion (9.8 percent); and their seat capacity increased by 26.1 percent as they expanded their operations.

- Since 2000, the financial performance and viability of legacy airlines has deteriorated significantly compared with low-cost airlines. Legacy airlines have collectively lost $24.3 billion over the last 3 years, while low-cost airlines made $1.3 billion in profits. Despite the cost-cutting efforts of legacy airlines over the last couple of years, legacy airlines are even less cost competitive relative to low-cost airlines than in 2000. Low-cost airlines still maintain a significant unit cost advantage over legacy airlines despite legacy airline cost cutting. Meanwhile, neither legacy nor low-cost airlines have been able to significantly improve their revenues owing to weak fare growth. As a result of their weak performance and mounting losses, legacy airlines' financial condition has also deteriorated, and they face considerable debt and pension obligations in the next few years. At least one other legacy airline has announced that, like USAirways and United Airlines in 2002, it may enter bankruptcy this year.

U.S. Airline Industry Is Facing Significant Challenges

A series of significant changes and unforeseen events during the last several years has presented the airline industry with its most significant challenges since it was deregulated 25 years ago. These challenges have come from within the industry as well as from external factors affecting the demand for air travel.

Internal Challenges Lead to Structural Changes

Since the late 1990s, the U.S. airline industry, especially legacy airlines, has faced several internal challenges that have altered the way it operates. Foremost among these challenges is addressing declining yields brought on by price transparency and competition. The airlines' increased use of the Internet to reduce ticket distribution costs.[4] However, the price

[4] *Airline Ticketing: Impact of Changes in the Airline Ticket Distribution Industry*, GAO-03-749, Washington, D.C.: July 31, 2003.

transparency the Internet provides has empowered consumers searching for the lowest fares and depressed fare levels. The emergence of well-capitalized low-cost airlines has also been a significant challenge. Although earlier new entrant airlines quickly disappeared, this recent group is better capitalized and offers a good overall product. Between 1998 and 2003, these low-cost airlines increased their presence in the 5,000 largest city pair markets (e.g., New York – Boston) from 32 to 46 percent and increased overall market share of passenger enplanements from 23 to 33 percent.

External Shocks Have Depressed Demand for Air Travel

Demand for air travel began weakening in 2000, well before the September 11th terrorist attacks. An economic downturn that began in 2000 depressed airline revenues, and the terrorist attacks of September 11th, the Iraq war, and the outbreak of Severe Acute Respiratory Syndrome (SARS) have compounded this trend. These events have contributed to a change in the demand for air travel that is likely to suppress revenues for the foreseeable future, including the inability of airlines to charge premium business fares. Although it is impossible to isolate the effect of various events, demand as measured by revenue passenger miles (RPMs), was down 6.5 percent and 11.4 percent for 2001 and 2002, respectively, from the Federal Aviation Administration's (FAA) June of 2001 forecasts.

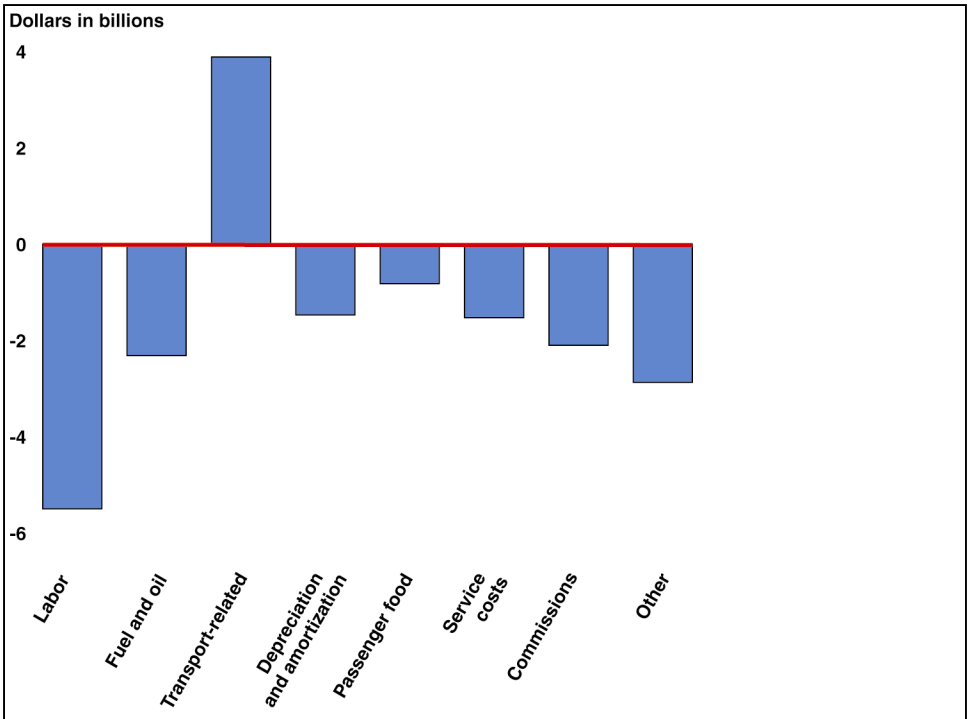
In Response to Challenges, Legacy Airlines Reduced Costs and Cut Capacity, While Low-Cost Airlines Grew

Airlines responded very differently to the challenges of the last few years. Legacy airlines faced with mounting losses and curtailed demand for air travel sought to reduce capacity and along with it their operating expenses. Low-cost airlines, already enjoying a cost advantage over legacy airlines, used their competitive cost advantage to grow.

Legacy airlines cut operating expenses by $12.7 billion between October 1, 2001, and December 31, 2003. This 14.5 percent reduction in operating expenses exceeds the percentage reduction in seat capacity of 12.6 percent during the same period. According to airline financial reports to DOT, legacy airline labor costs were reduced $5.5 billion annually, or about 16 percent during this time period (see fig. 1). Both USAirways and United signed new labor agreements while in bankruptcy, and American Airlines also achieved new agreements while on the verge of bankruptcy. Legacy airlines also achieved $2.1 billion savings from a 59 percent reduction in the commissions paid to travel agents, because those commissions were sharply reduced. Finally, legacy airlines reduced fuel costs by 18.7 percent during the period, although the recent upsurge in fuel prices has reversed these savings. The only cost category to increase

for legacy airlines was transport-related expenses, which doubled during the period, an increase of $3.9 billion. Increases in transport-related expenses for legacy airlines are largely because of fees paid to regional airline partners for providing regional air service. In the aftermath of September 11th, legacy airlines shifted some of their routes over to regional airlines in an attempt to reduce seat capacity on these routes.

Figure 1: Change in Legacy Airline Costs, Oct. 1, 2001 to Dec. 31, 2003

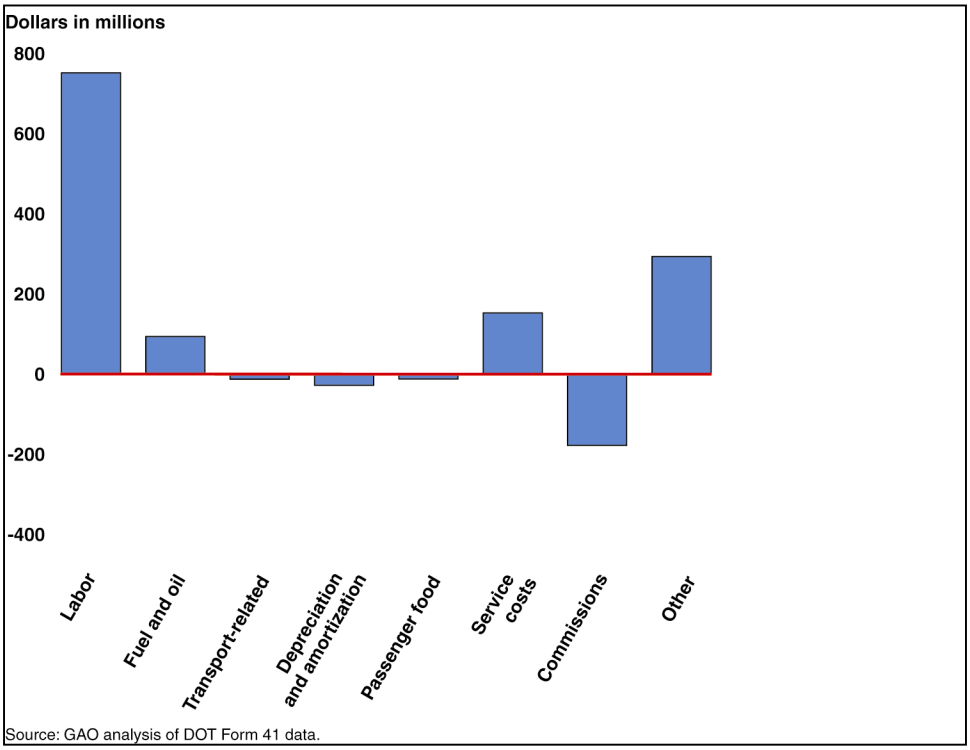


Source: GAO analysis of DOT Form 41 data.

Note: Other includes fees, taxes, and other charges; filing costs, membership dues, and losses.

Meanwhile, low-cost airlines used legacy airlines retrenchment as an opportunity to expand. The seven low-cost airlines increased seat capacity by 26.1 percent during the same period that legacy airlines cut capacity by 12.6 percent, but total operating costs for low-cost airlines increased by a more modest 9.8 percent, or a little more than $1 billion. Low-cost airlines' labor costs, these airlines' largest single cost component increased over $750 million, or 21 percent (see fig. 2). Despite their growth, low-cost airlines were able to achieve small reductions in some of their other costs, including commissions, passenger food, depreciation and amortization, and transportation related expenses.

Figure 2: Change in Low-cost Airline Costs, Oct. 1, 2001, to Dec. 31, 2003



Note: Other includes fees, taxes, and other charges; filing costs, membership dues, and losses.

Legacy Airlines' Financial Performance Trails Low-cost Airlines

The financial performance of U.S. airlines since 2000 has followed two very different paths. Despite significant cost-saving initiatives and industry-wide traffic volumes approaching pre-September 11th levels, legacy airlines continue to lose money. Legacy airlines' unit costs (cost to fly one seat 1 mile) have increased since 2000 while fares have declined; as a result, these airlines have yet to regain profitability. Meanwhile, low-cost airlines continue to expand market share, enjoy a greater unit cost advantage over legacy airlines than they did in 2000, and in all but one quarter have collectively earned a profit. The weak performance of the legacy airlines over the last 3 years has significantly diminished their financial condition; as a result, some of these airlines are vulnerable to bankruptcy, especially if there are additional shocks to the industry.

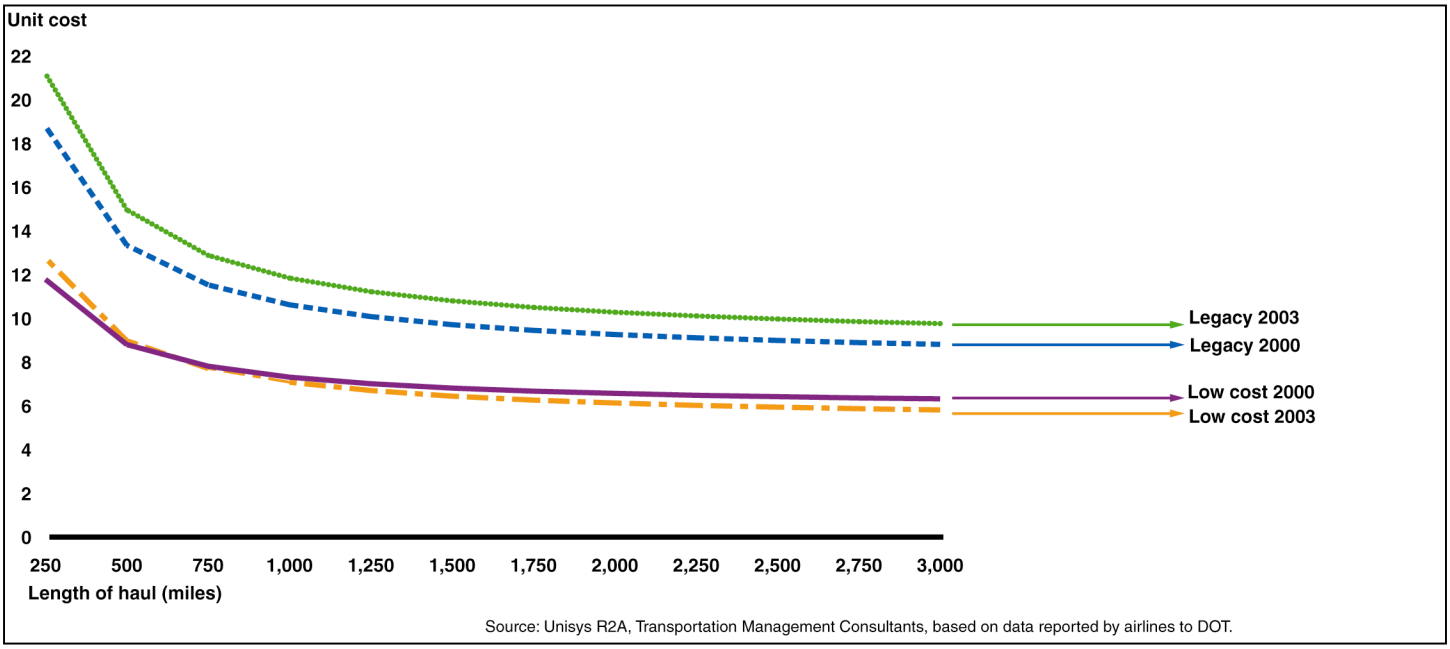
Low-Cost Airlines Have Significantly Lower Unit Costs Than Legacy Airlines

Legacy airlines, as a group, have been unsuccessful in sufficiently reducing their costs to make them more competitive with low-cost airlines. Unit cost competitiveness is key to profitability for airlines because airlines

have found it extremely difficult to increase their revenues in the current environment. While legacy carriers reduced their overall operating expenses over the last three years, these cuts largely paralleled legacy airlines' capacity reductions. Conversely, low-cost airlines have been able to reduce their unit costs through expansion. Low-cost airlines' ability to maintain lower labor costs and lower asset-related costs accounts for the majority of the unit cost differences between low-cost airlines and legacy airlines.

Wall Street analysts suggested that one of the best measure for examining airline unit cost performance is to compare airline unit cost curves. These curves relate airlines' unit costs to the stage length (distance) flown. Figure 3 shows legacy and low-cost airline unit cost curves for 2000 and 2003 and shows that the gap between legacy and low-cost airline unit costs has widened across all distances. For example, in 2000, at a 1,000-mile stage length legacy airlines' unit costs were 45 percent higher than low-cost airlines; by 2003, legacy airlines' unit costs were 67 percent higher. Some of the legacy airline unit cost increase is due to the capacity purchased from regional airlines—an increase in operating expenses (the numerator) but without a corresponding increase in available seat miles (the denominator) in the unit cost calculation. However, this does not account for all or even most of the gap between legacy and low-cost airlines' unit costs.

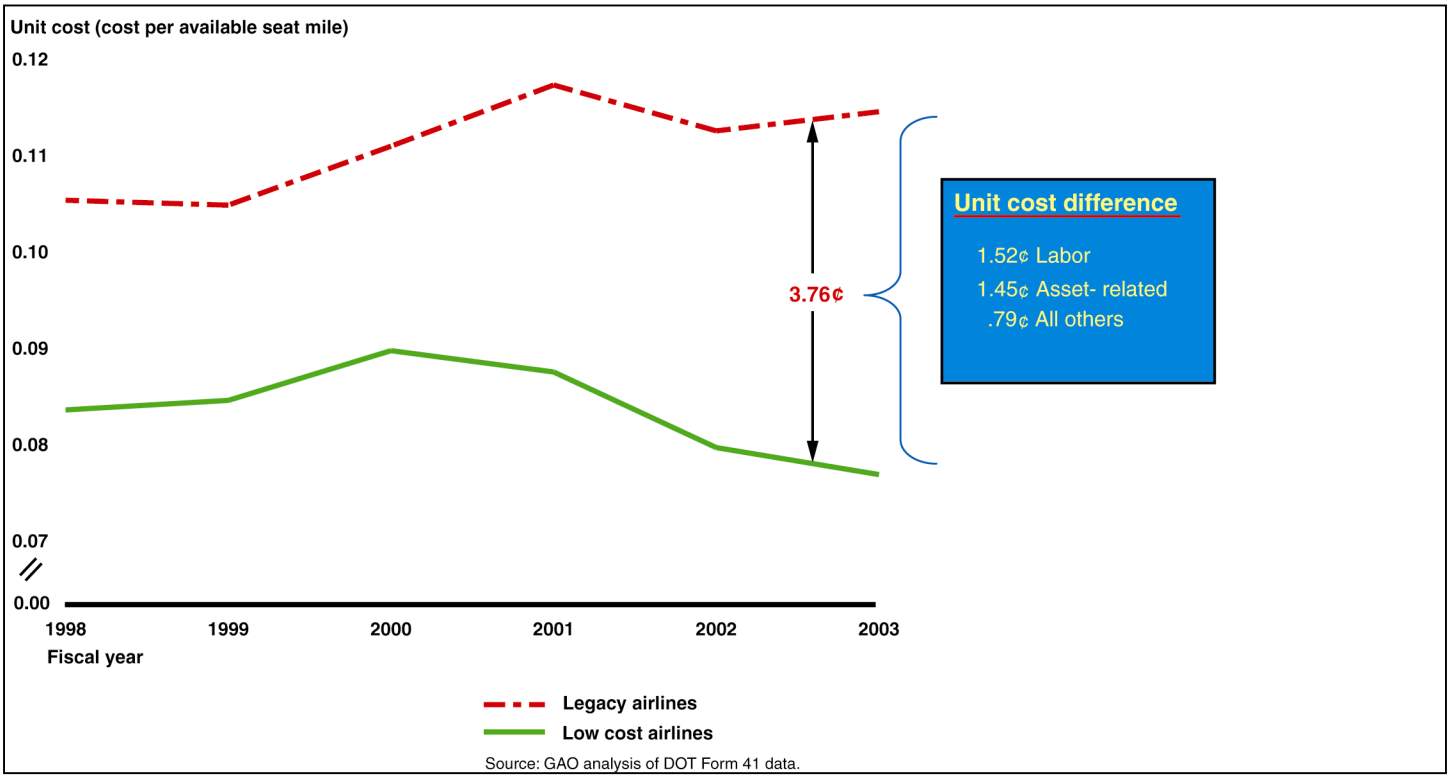
Figure 3: Stage Length Cost Curves, 2000 and 2003



Source: Unisys R2A, Transportation Management Consultants, based on data reported by airlines to DOT.

To account for this unit cost difference between legacy and low-cost airlines, we also examined legacy and low-cost airline unit costs over time and the various cost items that comprise total operating expenses. Overall, we found that the gap in aggregated (for all stage lengths) unit costs for legacy and low-cost airlines has widened since 2000, from 2.1 cents per available seat mile to 3.8 cents at the end of 2003. Figure 4 shows this widening gap and the cost components that account for the difference.

Figure 4: Unit Cost Differential, 1998 to 2003



The two primary cost components that comprise the unit cost difference between legacy airlines and low-cost airlines are labor costs and asset-related costs.

- Legacy airlines have high labor costs owing to a highly tenured, unionized workforce, while low-cost airlines are able to keep labor costs down because of a younger and lower paid work force but also by achieving higher levels of labor productivity than legacy airlines.

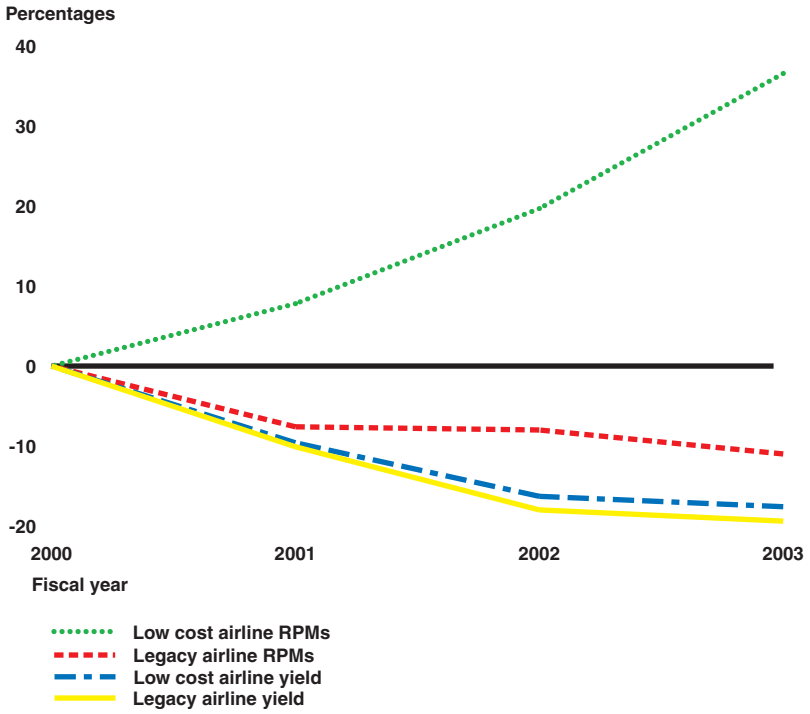
- Legacy airlines have higher asset-related costs than low-cost airlines because legacy airlines generally have older fleets and more types of aircraft in their fleets than low-cost airlines. Legacy airlines also put their planes in the air fewer hours per day than low-cost airlines. Finally, some portion of this difference is due to legacy airlines' purchase of regional airline capacity during the period.

- Other costs that currently are part of the remaining unit cost difference between legacy airlines and low-cost airlines include expenses for fuel, passenger ticketing commissions, and passenger food.

Depressed Fares Have Impeded Revenue Growth For Legacy Airlines

Both legacy and low-cost airlines have encountered weak revenues over last several years. The internal and external factors cited earlier have depressed fares and demand for air travel. Overall, industry-wide demand has nearly returned to pre-September 11th levels, but fares have not. Unit revenue, or yield, the amount of revenue airlines collect for every mile a passenger travels, has fallen 19 percent from the first quarter of 2000 through the fourth quarter of 2003, for the airlines examined in this study. The trends are similar for both the legacy airlines and low-cost airlines; legacy yields dropped about 19 percent, and low-cost airline yields dropped about 18 percent (see Figure 5). Although nearly as many passengers are flying as before September 11th, they are paying less to do so. In addition, legacy airlines are losing market share to the low-cost airlines. Demand, as measured in the number of miles paying passengers were transported, is down over 10 percent for the legacy airlines since 2000; demand for low-cost airlines has risen nearly 40 percent. Not only are legacy airlines collecting less fare revenue from the passengers they fly, they are also flying fewer passengers than they used to. Low-cost airlines are flying more passengers at lower prices.

Figure 5: Percentage Change in Airline Fares and Demand Since 2000



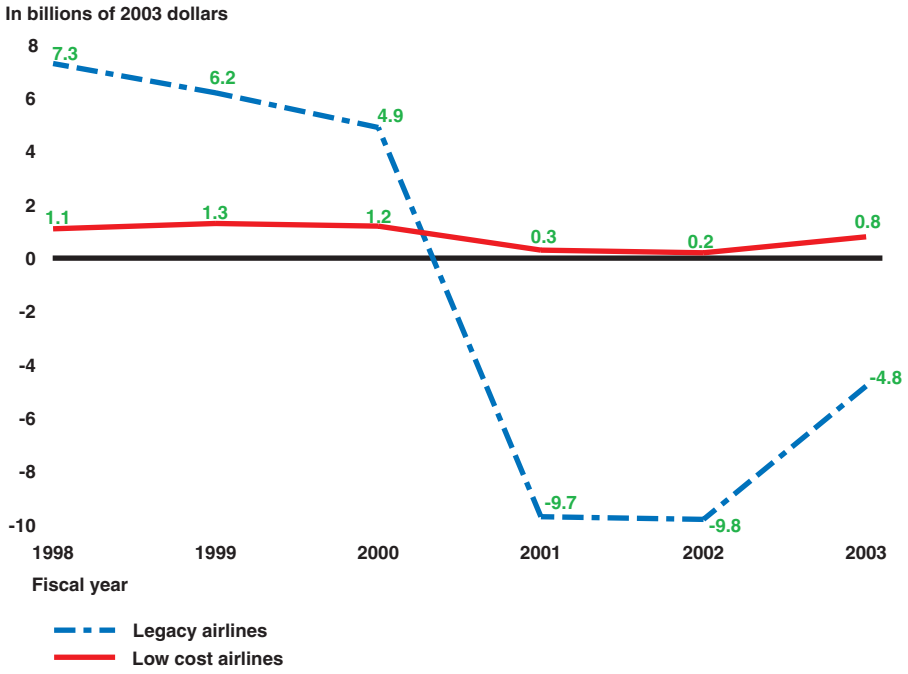
Source: GAO analysis of DOT Form 41 data.

Note: Yield is the amount of fare revenue collected for each passenger mile flown. Revenue Passenger Mile (RPM) is a measure of the number of miles each paying passenger is flown and a standard measure of airline passenger demand.

Low-Cost Airlines Are Profitable Owing to Lower Costs

Low-cost airlines have been able to use their relative cost advantage to remain profitable at a time when fares are down throughout the industry. As figure 6 demonstrates, legacy airlines have lost money in each of the last 3 years, for a total of $24.3 billion; low-cost airlines have made money in every year.

Figure 6: Airline Profits and Losses, 1998-2003



Source: GAO analysis of DOT Form 41 data.

Legacy Airlines' Financial Condition Has Deteriorated Since 2000

Since 2000, the financial condition of legacy airlines has deteriorated. Both legacy airlines and low-cost airlines increased their cash balances following the events of September 11th; legacy airlines did so primarily through borrowing, while low-cost airlines increased theirs by generating profits as well as borrowing. Since 2001, legacy airlines have taken on more debt, relying on creditors for more of their capital needs than they have in the past. Increased debt increases interest expenses and can make raising additional capital more expensive. Low-cost airlines have acquired some debt, but their solvency (or ability to repay the debt) has not deteriorated to the same extent as it has for legacy airlines. In the process of taking on additional debt, several legacy airlines have used all, or nearly all, of their assets as collateral, limiting their access to capital markets.

Legacy airlines face large debt repayment and pension funding obligations during the next 4 years. These fixed obligations greatly exceed the current cash balances for many of the legacy airlines. For example, legacy airlines had a collective cash balance of $6.8 billion at the close of 2003 versus

$19.2 billion of long-term debt and capital leases (a fixed obligation similar to long- term debt) coming due through 2007. In contrast, low-cost airlines had a collective cash balance of $3.5 billion versus long-term debt and capital lease obligations of $2.1 billion coming due through 2007. If legacy airlines' debt cannot be refinanced, some legacy airlines might be forced to enter bankruptcy. In addition, legacy airlines have significant defined benefit pension funding obligations that low-cost airlines do not. Recent pension reform legislation postpones a portion of legacy airlines' requirements to make payments to their defined benefit pension plans in 2004 and 2005,[5] but are still required to fully fund these plans in the years beyond.[6] Because legacy airlines' future access to capital markets appears to be limited, these airlines will need to begin generating cash from operations if they intend to fulfill their future financial obligations and avoid bankruptcy.

Concluding Observations

Although the airline industry was deregulated more than 25 years ago, some of the most significant competitive changes are only now occurring brought about by a myriad of challenges over the last 4 years. Before 2000, large legacy airlines, all of which predated deregulation, dominated the domestic airline industry. These airlines competed on the basis of their networks and in-flight amenities as well as fares; they earned profits by maximizing revenues from high value business travelers. Low-cost airlines competed in some markets, but as a whole did not account for much more than 10 percent of the market, and they rarely took on a legacy airline directly. However, in recent years, this pattern has changed, perhaps permanently. Significant structural change combined with severe demand shocks has presented unprecedented challenges to the airline industry, especially for legacy airlines. Legacy airlines, burdened by significant costs of labor contracts and pension plans negotiated during profitable years and an extensive and costly network infrastructure, have found it difficult to reduce costs quickly enough to become cost competitive and restore profitability. Meanwhile, low-cost airlines are using their cost advantage to expand their market share and challenge legacy airlines like never before.

[5]Pension Fund Equity Act of 2004 (Public Law 108-218, April 10, 2004). The law temporarily replaces the interest rate on 30-year U.S. Treasury Bonds with an interest rate based on the average rate of return on high-quality long-term corporate bonds and allows airlines to postpone part of their necessary contributions for 2004 and 2005.

[6]Defined benefit plans promise a fixed payment amount in the future. In contrast, the defined contribution plans employed by low-cost airlines fix the current contribution amount, but the future payment amount depends on returns on the pension assets.

Although airline industry traffic has recovered to pre-September 11th levels, profitability for legacy airlines has not, owing to higher costs and weak fare growth. Three years of losses have left legacy airlines in a weakened financial position with large debt and pension obligations looming in the next few years. The potential for airlines to earn the large profits of 1995-2000 does not appear possible. Instead, the airline industry is being transformed into two industries, profitable low-cost point-to-point airlines that continue to grow and extend their reach into ever more markets and the major network legacy airlines that account for the vast majority of the industry's losses. Although legacy airlines still control two-thirds of all domestic traffic, possess profitable overseas routes, and have a valuable domestic route structure, until these airlines are able to bring their unit costs closer to those of low-cost airlines and align their services with fares that passengers are willing to pay for "anywhere to everywhere" networks, they are unlikely to be able improve their financial condition.

This concludes my statement. I would be pleased to respond to any questions that you or other Members of the Subcommittee may have at this time.

For further information on this testimony, please contact JayEtta Hecker at (202) 512-2834 or by e-mail at heckerj@gao.gov. Individuals making key contributions to this testimony include Paul Aussendorf, Tom Gilbert, Grant Mallie, Steve Martin, Richard Swayze, and Pamela Vines.

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