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# Oil and gas in the capitals

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**SPECIAL FOCUS: NORTH AMERICAN OUTLOOK**

## Disaster in the air

It is hardly news to anyone who has traveled by air in the US over the past year that rising oil prices are wreaking havoc on the airline industry. However, it is not generally appreciated how bad things really are, how fast and drastically the situation is worsening, or what may lie ahead in terms of airline economics and policy-including a drastic restructuring of the industry and possible federal re-regulation.

Jet fuel costs are increasing faster than oil prices, having more than tripled in five years, and are forecast to increase by another 50% in 2008. In 2002, US airlines spent $13 billion on aviation fuel; in 2008 they will likely spend in excess of $61 billion, Fig. 1.

Historically, airline fuel costs represented about 15-18% of total operating costs-a distant second to labor costs, which accounted for 25-30% of total costs. In 2006, for the first time, fuel costs exceeded labor costs, and in 2007 fuel constituted 34 percent of total airline operating costs-twice the historical average. Furthermore, in 2008, fuel costs will likely account for 40-50% of airline operating costs, and for some airlines will constitute more than half of all operating costs.

**Bad and worse.** At present, the US airline industry is hemorrhaging money and, despite desperate efforts to reduce costs and capacity, is on an unsustainable downward trajectory. Few, if any, airlines have a business model that will allow them to make profits at anything like current or anticipated oil prices. Airlines are frantically raising prices, adding fees, and reducing service and capacity. How bad is it? Consider these examples of current airline distress:

- Flight reductions have been made at more than 400 US airports, and over 30 cities across the US have lost air service.
- More than 200 aircraft have been grounded.

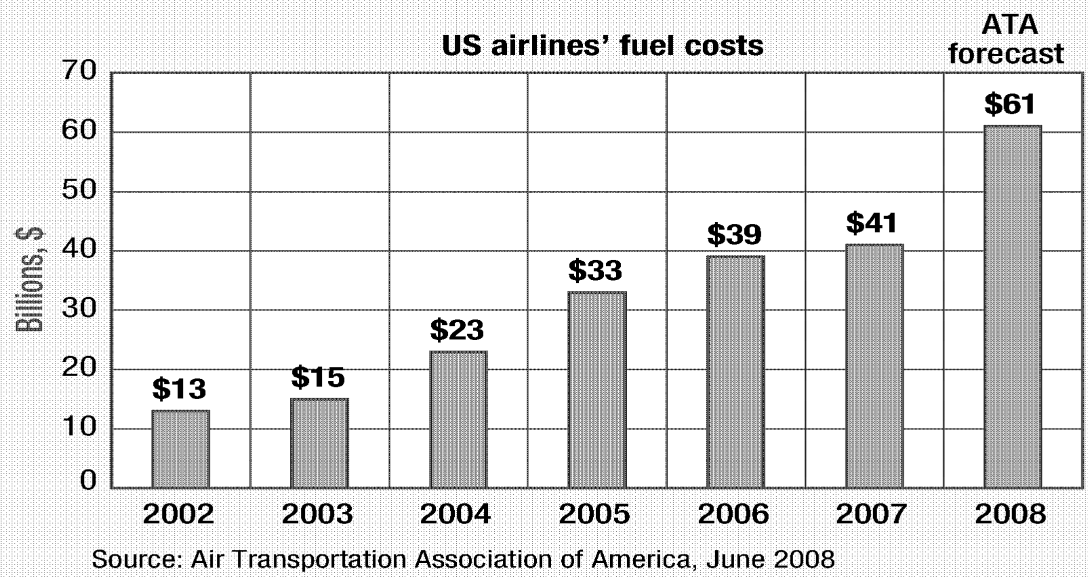


**Fig. 1.** US airlines will likely spend in excess of $61 billion on fuel in 2008.

- Standard & Poor's Ratings Services has placed 10 airlines, including all the major carriers, under the CreditWatch negative designation because of "potential severe financial damage" that could result from record fuel prices.
- The Air Transport Association predicts that 2.7 million fewer people will fly this summer than in 2007.
- US airlines are now predicting that they could lose $13 billion in 2008 due to skyrocketing fuel costs-the most in any year in history.
- Between January and May 2008, eight US airlines went out of business.
- Ticket prices on some routes this summer are three or four times as expensive as last summer.
- Fees for checking bags are now more the norm than the exception.
- Some airlines are now charging for soft drinks, pretzels and water.
- Some airlines are now charging extra for aisle seats, window seats and emergency exit rows.
- Airlines are reducing weight by eliminating magazines, pillows, blankets, etc., using lighter beverage carts, plates and utensils, and even reducing the amount of water carried for toilets.
- Nothing is off limits: Airlines are even considering charging passengers by weight-this actually occurred at some airlines in the early 1970s.

However, all of these measures are akin to rearranging deck chairs on the *Titanic* . At best, they can only reduce the scale of losses and delay the inevitable.

**Labor Day through December.** A major inflection point will occur at the end of the summer travel season. Airlines are actually reluctant to reduce service and raise prices in the summer. Furthermore, many summer leisure travelers purchased tickets well in advance and, despite the fact that they were often losing money on many flights, there was relatively little the airlines could do. All of that changes in early September, when significant further reductions in the airlines' fleets and schedules will begin taking effect, making for a particularly unpleasant end to summer travel. This is when the real impact of the crisis will unfold.

Across the US, airports from La Guardia in New York to Oakland in California will be affected by flight reductions, bringing the industry down to a size last seen in 2002, when travel fell sharply after the 9/11 attacks. Over all, the cutbacks will reduce flights this year by US carriers by 10%, with even deeper cuts in store for 2009. And if oil prices keep rising, airlines may have to keep shrinking their schedules, as they struggle to find ways to make money.

Leisure fliers may first encounter the harsh new reality of flying during the Thanksgiving holiday, with fewer flights, higher prices, additional fees, and less frequent and less convenient connections. By January, as many as 100 US cities may be left without scheduled commercial air service, and that number could double in 2009. American Airlines, United Airlines, Continental and others plan to retire many planes beginning in September.

All of the domestic industry's growth over the last decade will most likely be lost. At least one major carrier could liquidate. Whatever happens, the downsizing of the airlines is unlikely to be reversed anytime soon. Carriers are selling off hundreds of older, less efficient aircraft, so the industry would have trouble growing rapidly again even if oil prices were to decline and the economy were to rebound quickly. Even before aviation fuel costs escalated, the US industry suffered from overcapacity, and a round of mergers was needed to consolidate the industry. Starting in September, travelers will experience rapid deteriorations in service and the deleterious effects of mergers-reduced operations to save costs-without mergers actually occurring. (Only one merger is occurring, the combination of Delta and Northwest.)

**January 2009 and beyond.** Through December, most airlines will be able to live off the cash reserves they have accumulated over the past several years and additional capital they can raise by selling off assets or borrowing more against aircraft. However, that can last only so long. While few major bankruptcies may occur by the end of this year, in 2009 the cash will really start running out. It is very difficult for airlines to simply raise prices to levels that cover their higher fuel costs. Raising prices reduces demand: If tickets get too expensive, business travelers make alternate plans, choose cheaper airlines or buy discounted tickets further in advance. For leisure travelers, if prices get too high, they do not buy or they switch to cheaper destinations, and airlines can price themselves out of a sale.

Furthermore, if carriers file for bankruptcy again, some could ultimately be forced to liquidate because they have already reorganized and have little more to trim. Most US airlines have few unencumbered assets, and once they exhaust their cash reserves, they do not have much to fall back on. They have aggressively cut costs and restructured, so if they go into Chapter 11, there is a significant risk they might not come out and will have to cease operations.

Unlike other modes of transport, aircraft have no alternative source of fuel and must simply pay the higher prices of oil-derived aviation fuel. Airlines have no choice but to make additional huge cuts in capacity, eliminating flights that just are not profitable with oil at $140+ a barrel. Fewer flights mean reduced availability and leaner schedules for many travelers. More importantly, it means much higher fares: The price of flying has to increase if airlines are to survive. Flying will quickly become less democratic, as cost-sensitive and leisure travelers are priced out of the market.

**Re-regulation?** The airlines' financial problems are leading to pressure for the federal government to re-regulate the industry. The hundreds of cities and towns where air service is being reduced or eliminated all have US representatives and senators, and both houses have already held hearings on airline service and potential re-regulation. Reduction and termination of service can be a deathblow to small and medium-sized cities and their economic development plans. It also places them in a financial bind, since they will not be able to use the enhanced airport terminals and infrastructure they have invested in or to pay for the improvements made thus far.

The Essential Air Service program was created in 1978, when the airline industry was deregulated, to ensure that communities in rural and remote areas would be connected to the nation's air system. Under the program, the government provides subsidies of about $100 million a year to the airlines, resulting in service to 102 cities. But the subsidies have not risen fast enough to cover the increase in jet fuel costs, and passengers have resisted paying higher prices for plane tickets, prompting carriers to pull out of many cities. While temporary extensions to the program have been enacted, they have been overwhelmed by the magnitude of airline retrenchment, and Congress has little appetite for the many-fold increase in continuing subsidies that would be required to continue the program.

Thus, the pressure for re-regulation is coming from many of the same people who originally supported deregulation in 1978.

The industry that we hear the most noise about re-regulating is not the airline industry, but the energy commodity futures market, to control “excessive oil speculation” and reduce oil prices. US and international airline lobbying groups are among those calling for commodity market regulation, and they are also recommending the rollback of airline taxes and environmental regulations. However, if Congress could pass a law that would reduce oil prices, it would have done so long ago.

More seriously, there is an increasing drumbeat for federal re-regulation of the airline industry itself. Not surprisingly, some of the top airline industry players are in the forefront. Robert Crandall is the legendary former CEO of American Airlines, who is credited with developing the hub-and-spoke system and inventing the frequent flier program. He considers the deregulation of commercial aviation to be a huge failure and contends that it is time to bring back government oversight of fares and pricing. According to Crandall, “It’s time to acknowledge that airlines are more like utilities than ordinary businesses. We have failed to confront the reality that unfettered competition just doesn’t work very well in certain industries, as aptly demonstrated by our airline experience. I think a dollop of regulation, along with new government policies and appropriate investment, would help the carriers get back on the right track.”

Also not surprisingly, labor unions-including the International Association of Machinists (IAM) and the Air Line Pilots Association-argue that the federal government has to intervene to bring stability to the industry. For example, the IAM is calling for re-regulation of fares and capacity as the only way to ensure safe and reliable air transportation in the US. IAM General Vice President Robert Roach Jr., at a recent Senate Commerce Committee hearing, said, “Limited re-regulation is the only long-term solution for an industry that is continually seeking government assistance. This industry is simply unable to turn away from pricing its product below the cost of providing it, further perpetuating the chaotic spiral that brings us here today. When an industry essential to the national economy can no longer function, it is the responsibility of elected representatives to step in and provide the necessary guidance and stability.”

Even Alfred Kahn, the godfather of airline deregulation who as chairman of the federal Civil Aeronautics Board presided over deregulation in 1978, is having second thoughts. Kahn feels that the current situation in the airline industry is similar to what he witnessed in 1977, and according to him, “At a time when we were increasingly worried about the energy problem, I didn’t view it as my highest aspiration to make it easy for people to jet all over the world cheaply. The only way to preserve the level of airline service the public has come to expect is to subsidize it. And I’m not ready to subsidize it, especially given our energy problems.”

Prodded by the airline industry and its unions and besieged by mounting complaints from the flying public and its constituents, Congress is listening.

Rep. James Oberstar (D-Minn.), the powerful chairman of the House Committee on Transportation and Infrastructure, has warned that pressure is mounting to re-regulate the airline industry. Oberstar, who said he only voted “with reservations” for the Airline Deregulation Act in 1978, said during the recent hearings, “The leash is a very short one. Public patience is running out. There is a palpable sense of outrage in the public.”

Sen. John D. Rockefeller IV (D-W.V.), chairman of the Senate aviation subcommittee, has noted that current trends in the airline industry are “all strictly downhill.” Rockefeller said that, while he does not want to return to the days of regulation, if things get “desperate enough” he can be counted on to support a vote to re-regulate the industry.

Many other politicians including US Rep. Steve Cohen (D-Tenn.) and Sen. Ted Stevens (R-Alaska) have advocated re-regulation.

So what might a re-regulated industry look like? Under regulation before 1978, the Civil Aeronautics Board dictated everything from who could enter the market to which routes carriers could fly, and also set the fare structure. Re-regulation would likely be somewhat less comprehensive and could include the following elements:

- Giving the federal government a role in pricing
- Prohibiting new airlines from offering below-cost fares that make flying unprofitable for most airlines
- Equalizing fares for direct and connecting flights and de-emphasizing the hub-and-spoke system
- Amending the Railway Labor Act so that unions and management both “adopt more moderate positions”; e.g., force unions into binding arbitration
- Pressuring airlines to use larger jets instead of less profitable regional jets-but with reduced flight frequency
- Developing a replacement for the antiquated US air traffic control system-which needs to be done irrespective of the regulatory regime.

Make no mistake: For passengers, re-regulation would mean fewer flights and higher fares, and for airline employees, it may mean less flexibility in negotiating wages and benefits. However, there may be advantages to re-regulation. Some government-imposed schedule discipline could go a long way toward reducing bottlenecks at the large US airports, such as JFK in New York City, Hartsfield in Atlanta and O’Hare in Chicago. Fares would increase substantially, but they would be consistent and predictable.

Re-regulation could actually provide the industry with some much-needed financial stability. Passengers may even eventually be able to fly on clean planes that are not decades old and enjoy some semblance of respect and customer service-perhaps even get served a snack and a drink on cross-country flights. However, those cross-country flights will be less frequent and will cost a lot more. Airline travel will become much more the domain of the rich and well-to-do, and will be driven by travelers’ business needs, emergency travel requirements and much less frequent leisure and vacation trips.

But then, passengers cannot have it both ways: They will either have to pay more or get less. Observing that in the current era of high and rising oil prices the free-market, survival-of-the-fittest model has left a lot to be desired for both the airlines and the flying public, perhaps re-regulation is not the worst solution proposed to address the problem.

## THE AUTHOR

**Dr. Roger Bezdek** is an internationally recognized expert in energy market analysis, R&D assessment and energy forecasting, and President of Management Information Services, Inc., in Washington D.C. He has 30 years’ experience in research and management in the energy, utility, environmental and regulatory areas, serving in private industry, academia and the federal government. He has served as Special Adviser on Energy in the Office of the Secretary of the Treasury, as US energy delegate to the European Community and to the North Atlantic Treaty Organization and as a consultant to the White House, federal and state government agencies, and various corporations and research organizations.