

By: Michael Fabey

That swooshing sound you hear is the arc of the pendulum as it swings back to predicted profits for airlines in light of suddenly lower oil prices.

Which begs an obvious question: Will airlines now have to revisit their plans for deep capacity cuts and possible fare increases? Despite dismal second quarter earnings reports that featured losses for most carriers, and despite dire forecasts for more of the same through this year and well into 2009, Wall Street analysts at firms like Morgan Stanley and JP Morgan are now saying that major airlines should return to profitability soon.

The reason? Fuel prices dropped from about \$137 a barrel in July to about \$115 a barrel by mid-August.

But airline executives remain less optimistic. Bill Clough, manager of strategic programs for American Airlines, for example, warns that one little hiccup could push oil prices into the stratosphere again.

Other industry experts agreed there's no certainty just where oil prices are going to reach an equilibrium over the long term. "China was ordering a lot of fuel to prepare for the Olympics to make sure there was no shortage," said Raphael Bejar, CEO of AirSavings.net, which specializes in fuel and ancillary purchases for airlines. "It was very short-term."

Joakim Karlsson, professor of aviation at Daniel Webster College, wondered, "Is \$100 a barrel the new normal? It may be, but there's no predicting that for certain."

He added, "I think there's a chance oil will go back down, although not to \$100 a barrel. It is extremely difficult to predict something like oil prices."

With that in mind, airline executives are keeping capacity-cutting plans in place. What's more problematic, though, might be their hopes to raise fares, since passengers might be less understanding with lower fuel prices.

The planned capacity cuts are substantial.

The Official Airline Guide is predicting a 7% worldwide capacity drop in the fourth quarter, which translates to 59.7 million fewer seats, with the U.S. domestic market accounting for about a third, just under 20 million seats.

OAG said the drop could bring on "the most widespread crisis to hit the aviation industry in recent memory."

Retreating from expansion

Airlines that had been planning to expand are now in retreat.

For example, Continental Airlines CEO Lawrence W. Kellner told analysts in July, "Our initial target was to grow mainline 2008 capacity by 5% to 7%." The carrier quickly changed its strategy, Kellner said: "By the fall of 2007 we'd already pulled the growth down to 3% to 4%. Then, as the cost of fuel continued to rise, we further adjusted the schedule down to only 2% to 3% growth. The first half of 2008, the cost of fuel continued to soar, so along with many other steps we're taking we announced that we're significantly cutting our fourth quarter capacity, so that for 2008 we now expect full-year mainline capacity to be down slightly as compared to 2007."

It's the same at smaller airlines, too.



JetBlue CEO David Barger said, "We expect a third-quarter capacity decrease between 1% and 3% year over year, with most of the capacity reductions falling in September, where our capacity will be down about 10% on a year-over-year basis. We expect our fourth-quarter capacity to be down roughly 6% to 9%."

Alaska Air CFO Brad Tilden told analysts, "The reduction in the fourth quarter will be even more pronounced, with capacity coming down 5% on a 10% decline in departures. And it may be much, much more than the 5% or 10% that Alaska is talking about."

Southwest Airlines said the range would be higher for its markets. "Our competitors are in full retreat mode," CEO Gary Kelly told analysts. He predicted a 15% reduction in competitors' routes "just after Labor Day."

One of the reasons for the capacity cuts has been the slowdown in demand for air travel. Many airlines reported a drop or little growth in traffic in recent months. IATA was less than impressed with the reported slight growth in passenger traffic for June.

"Although the passenger demand grew by 3.8%, this is the slowest growth that we have seen since the industry was hit by the SARS crisis in 2003," said Giovanni Bisignani, CEO of IATA. "With consumer and business confidence falling and sky-high oil prices, the situation will get a lot worse."

It might take some time for the airlines to find solid financial ground again. Steve Casley, OAG's chief operating officer, said: "It took a good three years for the industry to recover from the downturn in 2001 when it had a 5% drop in capacity and a 7% drop in flights. Steady annual growth since 2002 looks set to plummet in the fourth quarter this year with an unprecedented global decline."

It's not just fuel, Casley said; it's the economy, too.

"Commercial aviation marches in lock-step with the global economy, closely reflecting growth and declines in GDP, with on average a steady 3% to 4% growth year over year," Casley said. "In the last 10 years this steady growth has been interrupted twice. First, by the meltdown of the global economy in 2001 following the bursting of the Internet bubble, which was compounded by a year of crises with the 9/11 terrorist attacks, the Gulf war and the SARS epidemic within Asia. And second, on the immediate horizon, by the extraordinary impact that the rising cost of oil is having on the global economy. We tend to focus so much attention on the growth of Asian markets, but the projected 13% drop in Asian seat capacity is a significant metric that may have wider impact."

'Severe global downturn'

Darin Lee of LECG said during a July teleconference on the airline industry, "There have been only five or six times over the last 30 years where the industry has contracted like this. We're witnessing something unique here."

This crisis could be more difficult to survive, Casley said, noting that "from OAG's statistics, it looks quite possible that we may be facing a far more severe global downturn than we have experienced before."

It's uncertain, then, what impact the deep capacity cuts will have on service and fares.

"We do not know yet what kind of benefit that will provide us, either with fares or with passengers," Southwest's Kelly told analysts.

Raising fares proved difficult enough, even with the higher oil prices.

Continental's president, Jeffery A. Smisek, said, "A problem that our low-cost competitors have is that their largely leisure customer base is quite price sensitive, so they have trouble raising fares even in the face of high fuel prices."

And Southwest CFO Laura Wright acknowledged to analysts, "We are cautious about the economy and what our consumers' reaction is going to be to high fares."

