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The incredible shrinking airline

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The airline industry has suddenly discovered that small is beautiful. Maybe even profitable.

Carriers long accustomed to elbowing their way to market share by adding planes and routes and destinations are now scrambling to see who can shrink the fastest, changing the entire business model for flying people from point A to point B — including, in many cases, the elimination of points A and B altogether.

Arne Haak, AirTran's CFO, captured the current mindset of the airline industry when he told analysts at this month's Merrill Lynch investors conference in New York that "minus-4% is the new growth."

While negative growth describes everything about the industry today, from routes to new plane orders, Haak was talking about capacity as carriers are now preparing to cut more deeply through the rest of this year than they had initially planned.

For example, Delta, which earlier had said it would cut capacity 6% to 8% this year, said in June that it planned to trim 10%. American, whose previous forecast had called for a 6.5% cut, is now saying it will be closer to 7.5%.

Even Southwest is cutting back further. "We won't go out of business if we have too few airplanes," CEO Gary Kelly told analysts at the Merrill Lynch conference.

A structural industry shift

While the industry has gone through capacity-cutting binges before, airline executives and analysts say that what makes these cuts different is that capacity will be very slow to return after the economy turns around.

Gone are the days of freewheeling growth built on unprofitable expansion designed to flood markets and capture market share. For the foreseeable future, a humbled U.S. airline industry will be playing it safe.

"This is a major structural shift for our industry," said Vaughn Cordle, an analyst with the AirlineForecasts consultancy.

A major part of that shift will be a rapid migration away from the legacy airlines' traditional hub-and-spoke networks.

"The hub model is just not working as well as it was 10 years ago," Cordle said. "There's been a greater penetration of the low-cost carriers, flying more point to point."

What is shifting along with diminishing capacity is the passenger experience. Fewer planes and fewer flyers has resulted in more flights arriving on time with less lost baggage.

"It's already had some small positive impact on congestion," said Robert Poole, director of transportation studies at the Reason Foundation, a public policy think tank.

Of course, carrier executives were not motivated by congestion relief or other improvements to passengers' experience when they decided to pull seats out of the system. In fact, the downsizing started last year as a response to the run-up of fuel prices, which created an urgent need to cut overall expenses.

Until that time, airlines had been coming off a good year in 2007, when traffic and capacity were on the rise, particularly in international markets. Carriers had been adding aircraft, routes, flights and capacity wherever they could to break into markets and broaden their networks and scope.

"We grew a little too aggressively," AirTran's Haak admitted.

Nobody realized just how aggressively until fuel prices threw the industry into a nosedive. The airlines immediately began planning capacity cuts and raising ticket prices to help absorb higher fuel prices.

Average domestic airfares in Q3 2008 rose 10.4% compared with the same period in 2007, reaching an average of $362, the highest quarterly average in 13 years, according to the Transportation Department's Bureau of Transportation Statistics.

In fact, the Q3 2008 average fare was 22% higher than the post-9/11 third-quarter low of $297 in 2004.

A la carte pricing, here to stay

When it became clear that capacity cuts and higher fares weren't enough, carriers started piling on fees for checked bags, assigned seats and other "enhanced services." Moreover, the emerging consensus within the industry is that this so-called a la carte pricing model is here to stay.

That's simply because it works. Continental, for example, projects it will pull in $200 million in ancillary revenue this year, up from an earlier estimate of $130 million.

Continental initially decided not to add fees, hoping that maintaining its inclusive fare model would pull passengers from other airlines. But in fact, CEO Larry Kellner told the Merrill Lynch conference, "We didn't see a customer shift."

Passengers, he said, are more willing to pay unbundled fees than they are a higher fare. Now, Continental is adding more fees.
"A la carte revenue is one of the most structural changes that has happened to our industry," US Airways President Scott Kirby said. "It will be here a decade from now."

Similarly, American Airlines CEO Gerard Arpey called unbundling "key" to the airline's financial survival.

That's because the revenue on the table is substantial. Delta and United each figure to take in $1 billion or more in revenue this year from the extra fees.

And while JetBlue CEO David Barger said his airline doesn't want to be known as a company that is nickel-and-diming its customers, passengers seem amenable to paying for extras, seeing the fees as a chance to purchase up.

"There's been no pushback from passengers against airlines for charging these fees," Cordle said. "All airlines are going to move to this a la carte revenue even more so than before."

Indeed, the airlines have continued expanding their menu of additional fees since fuel prices dropped during the latter half of last year; the fees expansion has continued this year even as carriers began discounting base fares to lure more passengers compensating for the drop in demand.

Raphael Bejar, CEO of AirSavings, a consultancy that helps airlines develop programs for boosting their ancillary revenue and purchasing items such as fuel, said, "Carriers thought the crisis was going to be better this year, and obviously this is not happening. I'm not sure it will improve in the next six to nine months."

Macroeconomic data verify what everyone in the travel industry has experienced thus far this year: As the economy tanked, consumers cut back on nonessential expenditures, including travel, which in turn has been driving the airlines to cut capacity.

Personal Q1 consumption expenditures in the U.S. fell by about $550 billion quarter over quarter, a drop of 5%, federal data show.
The amount that consumers spend for airline travel as a percentage of overall personal consumption dropped by about half, Cordle said.

Business travel hits the skids

But where the belt-tightening has really hit airlines has been the business sector, where corporate travelers are downgrading to the back of the plane or refraining from traveling altogether.

That appears to be the case for international travel in particular, according to IATA, which reported that corporate and other premium traffic in the front of the plane, where airlines make their most profitable margins on passenger revenue, is down 19.2% for the first quarter and 22% for April.

As a result, IATA has recently revised its forecast of 2009 industry losses, more than doubling it to a $9 billion loss for airlines worldwide.

IATA predicts that $1 billion of that loss this year will be for U.S. airlines, which have been particularly hard hit by the drop in international travel. Passengers on U.S. carriers' international flights dropped 12.3% in March, the largest year-over-year decline since December 2001, the Bureau of Transportation Statistics reported.

Domestic routes have performed only slightly better, with U.S. airlines carrying 8.6% fewer domestic passengers this past March than in March 2008.

Just as IATA expressed concerns about the drop in premium traffic for the industry on a global scale, U.S. airline executives voiced fears about the free-falling demand for corporate and higher-yield air travel, which has forced the carriers to discount ticket prices, exacerbating the problem.

Continental's Kellner said that as business travel and yields dropped, airlines had to fill their planes with leisure passengers. The only way to do that, he said, was by cutting base fares.

At Southwest, which has announced plans to cut capacity 6% by the end of the year, CEO Kelly said revenue divided by capacity was weaker in June than in May, when unit revenue fell about 9% from a year earlier. Moreover, Kelly said, weaker business travel has cut into the number of last-minute, full-fare tickets and traffic on shorter routes.

According to Kirby, US Airways is finding that "not only are there fewer business travelers; those that are traveling are more able to purchase leisure fares," which has been further depressing revenue.

"Post-Memorial Day, the bookings have been extremely strong, but the pricing environment has remained weak," he said.

Arpey defended American's discounting by arguing that "you have to be competitive on price or you are going to lose traffic," while Delta President Edward Bastian asserted: "The competitive intensity is rather extreme. It is going to put pressure on pricing. But we're not going to put seats out there in markets that are not going to get returns."

The world, on sale

Revenue per enplanement, which Cordle considers a good proxy metric for fares, was down 20% for the first quarter, year over year, he estimated. Meanwhile, yields were down about 13% for the same time period.

Not surprisingly, airline executives are finding the mix of deeply discounted fares and dropping demand to be extremely toxic on marginal routes.

"The industry landscape is considerably on sale," JetBlue's Barger said. Zeroing in on transcontinental fares, he observed, "When competitors are offering walk-up fares of $99 to $109, it's just not prudent to be in that landscape."

Kelly said that since February, Southwest has "seen a decline in our full-fare market. It's still a very low-fare environment, and competitors have a plethora of low fares out there in our markets."

What's more, the discounting is worldwide.

IATA reported a 15% drop in economy fares for March, compared with the same month last year, and it estimated that premium fares might be down as much as 44% in April, year over year.

In an environment where the lowest fare captures the consumer, Bejar predicted that low-cost carriers such as Ireland’s Ryanair or AirTran in the U.S. were the best bets to thrive and survive. "They have lower costs," he said. "Their cash flow is much more positive. They benefit more from ancillary revenue."

Haak said that from AirTran’s perspective, the key is commodity pricing. "There’s little difference in a seat," he said. "At the end of the day, people shop for price. And cost? It’s part of our DNA."

But some observers see things differently. The industry’s drive to cut capacity further this fall, they say, will level the playing field on the pricing front.

Industry analyst Darryl Jenkins predicted that as the carriers start to pull down more seats to balance supply with demand, prices will start rising, eliminating the appeal of the cheaper fare bands.

Lean, but not lean enough

The need for the further capacity cuts emerged this spring as traffic dips outpaced the cuts carriers had initiated during the first quarter.

Arpey said that although recent capacity cuts had made American leaner, "it’s insufficient to meet this year’s challenge."

That appears to be an industrywide problem. The nine largest U.S. airlines cut their capacity 8% in May but reported traffic declines of 9% for the month. Then, when the usual June bump in traffic failed to materialize, carrier executives said they knew they would need to do more cutting after the summer traveling season.

"June is one of our stronger travel months," Bastian said. But he noted that this year, Delta did not see the expected traffic increase for the month.

The resulting June jitters drove the carriers to examine routes for more cuts. Kelly said that Southwest was "trimming flights that are unpopular and unprofitable."

While Southwest is a strictly domestic carrier, the same thing is happening on other airlines’ international routes.

Analyst Darin Lee of the LECG consultancy said, "Unlike previous years, where we saw cuts coming out of domestic but international holding up well, we could see relatively more cuts on international, where the softness in premium passenger traffic has a bigger impact than on most domestic routes."

On the other hand, Lee said, when the economy turns around and capacity does come back, carriers may opt to dive back into the pricier international markets first.

Jenkins predicted the airlines would focus on their strongest hubs as they adjusted their capacity to match demand.

The capacity cuts are causing concern, even alarm, among travelers and their advocates.

"Small and midsize communities will lose important connectivity to important U.S. and global business centers," predicted Kevin Mitchell, chairman of the Business Travel Coalition. "Tourism and major destinations like Orlando and Las Vegas will be further pressured."

Cordle, too, warned that "these are all huge pull-downs. You are going to see a lot of leverage when it comes to fares."

'We have to charge more'

But carriers insist that capacity cuts have to continue because fare increases are long past due, and airlines simply cannot afford to operate if prices drop further.

"The market has bottomed out," Kirby said. "It costs somewhere near $500 to fly someone roundtrip. We're nowhere near that."

Arpey said that from American's perspective, "This is a business where pricing is guided by underlying supply and demand. We have got to charge more for our product."

Paradoxically, capacity-cutting actually increases carriers' per-unit costs, further driving the need to increase fares as the airlines pull even more seats out of the system. At Delta, for example, Bastian said capacity cuts were causing unit costs to rise between 4% and 6%.

Some of the higher pricing is already starting to creep back. US Airways this month brought back a domestic fuel surcharge and increased its fuel surcharge for transatlantic flights.

Starting the second week of June, Cordle and Jenkins said, airlines raised their fares $20 across the entire system. What's more, they predicted that further capacity cuts were going to quickly push the cost of travel even higher.

"Airlines are going to be able to squeeze passengers on fare increases and those extra fees," Cordle said.