

Reply to:

Suite 502

1150 Seventeenth Street, N.W., Washington, D.C. 20036

Telephone: (202) 777-3000 Facsimile: (202) 777-3010

ECONOMIC NEWS UPDATE

IRWIN M. STELZER

16 September 2005

Half of all passengers flying around America are now sitting in airplanes operated by bankrupt airlines, flown by pilots about to see their wages and pensions cut, and served by cabin staff worrying that a pink slip awaits them when they land. These carriers are part of an industry set to lose \$7.4 billion this year, reminding old timers of the joke, "Want to become a millionaire? Be a billionaire and buy an airline."

Delta (with \$10 billion in losses since 2001) and Northwest joined United, US Air, and a few small carriers asking the courts to protect them from their creditors, allow them to walk away from their labor contracts, and eventually pass a portion of the obligations of their underfunded pension plans to the Pension Benefit Guarantee Corp, the government insurer which, ironically, itself is already underfunded to the tune of an estimated \$142 billion. United has already handed a \$6.6 billion bill to the PBGC; now comes Delta with

an even larger, \$8.4 billion tab, and Northwest, with a more modest \$2.8 billion obligation. Congress, already faced with the President's request for a few hundred billion dollars to fix New Orleans, is trying to find some way to avoid adequately funding the PBGC, even if that means using some of the accounting techniques that will curl the hair of Messrs. Sarbanes and Oxley.

It is no coincidence that Delta and Northwest threw themselves into the arms of the bankruptcy court at the same time. Both were rushing to get before the judges before the new bankruptcy law comes into force on October 17, coincidentally, the date on which Alfred Kahn, the father of airline deregulation, will be celebrating his 88th birthday.

That law will limit to 18 months the length of time a company can operate under court protection from law suits by creditors and others: United has been operating in bankruptcy since late

2002. Perhaps of even greater importance to Delta and Northwest executives, the new law will place restrictions on the bonuses executives can vote themselves while operating under court protection.

All of this is bad news for American Airlines (profitable in the second quarter) and Continental (twice bankrupt in the past), since they now find themselves competing with companies that don't have to pay their existing creditors, and will be relieved of a lot of their so-called legacy costs, including payments to retirees, and pension contributions. Southwest, AirTran and JetBlue, the low-cost carriers (LCCs), will also face tougher competition. These LCCs have been winning customers away from the old-line airlines with low fares made possible by lower wage costs and greater efficiency, and now carry one out of every three passengers on domestic flights.

As will foreign carriers. British Airways chairman Martin Broughton calls the new bankrupts "the walking dead." These living corpses and the newly merged US Air-America West combine -- yes, although bankrupt, US Air finalized its acquisition of America West last week -- say they will drop service on unprofitable domestic routes in order to concentrate on trans-Atlantic and trans-Pacific services, which should heat up competition on those still-profitable long-haul routes.

The executives of Delta and Northwest were quick to blame their competitive woes -- or at least the worsening of their competitive positions -- on the recent run-up in jet fuel prices. That is nonsense: higher fuel costs did increase cash outflows, but have nothing to do with the legacy carriers'

inability to compete with the LCCs -- after all, even the low-cost carriers have to buy jet fuel, and there is no reason to believe their suppliers give them discriminatory discounts. The fundamental problem might well be that the old-line carriers' business model is broken, and that funneling passengers into hubs as the first step on a trip along "spoke" routes to final destinations no longer makes business sense.

When all is said and done, we are watching the playing out of the deregulation regime put in place by President Jimmy Carter in 1978. Deregulation opened entry to all comers, and the new airlines were not burdened with labor contracts negotiated in the era in which regulators allowed carriers to use their monopolies to pass their costs on to captive travelers. Nor were they run by managers brought up in the cosseted world of regulated monopoly, where the game consisted of satisfying regulators and politicians rather than customers. Of course, the airline managers were not the only ones who found the marketplace a less congenial operating environment than the halls of the regulatory agencies: old-line executives in the telecoms and utility industries also found the transition impossible, witness the disappearance, among other companies, of the once-mighty AT&T.

Perhaps most important, the new carriers were not burdened with staffing levels that make those that exist in some government agencies seem ungenerous. The legacy carriers have shed workers by the thousands -- United cut 25,000 jobs, and US Air used two bankruptcy filings to pare its work force from 46,500 to 22,000. The carriers have also cut wages, in the case of Northwest provoking a strike by its

mechanics, who seem to believe that the good old monopoly days are still with us, and who are being shunned by unions representing other workers in the airline industry.

These job and wage cuts are by no means completed. Delta, which has already shed \$5 billion in wage costs, is seeking still more savings from its pilots, while Northwest is trying to persuade its striking mechanics to give back some \$1.4 billion. Both airlines hope that they can shrink their costs to levels that allow them to compete with the new carriers. One rumor has it that Delta and Northwest will seek additional savings by merging, on the theory that two minuses equal a plus.

Meanwhile, passengers packed into seats on planes filled to capacity wonder how airlines that are now selling all or almost all of their seats can manage to lose money. The answer is that it is one thing to find buns for all those seats, quite another to sell the seats at remunerative prices.

How all of this will play out is difficult to tell. We will know more when United emerges from bankruptcy in about five months. Its labor and leasing costs will be cut almost in half, but it will still be highly leveraged, and with a business plan (or wish) based on \$50 oil.

All we know at this point is that we are witnessing a massive wealth transfer -- from workers, retirees, and creditors to consumers. That is what advocates of deregulation hoped for some 27 years ago, and unions feared. Both the hope and the fear are being realized.

[ET



THE SUNDAY TIMES

A version of this Update appeared in
The Sunday Times (London)