

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

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The alchemists that run America's airlines are at it again, attempting to turn base metal into gold. US Airways' almost \$9 billion hostile bid for bankrupt Delta, if successful, would create the industry's largest carrier and might be followed by the long-rumored merger of United with Continental, and American with bankrupt Northwest. Such consolidation would be the latest in a long line of proposed solutions to the industry's perpetual losses: cartel-type regulation, deregulation, bankruptcy court protection, and government bail-outs.

America West, before absorbing US Airways, but keeping its name, filed for bankruptcy protection after the first Gulf War, and avoided a second such filing after September 11 only by arranging a government bail-out. US Airways twice filed for bankruptcy reorganization, in 2002 and 2004. Alfred Kahn, the former airline industry regulator who is considered the Godfather of airline deregulation, says, "It is ironic ... that what has always been considered the financially weakest of the major carriers (US Airways) is proposing

to take over what was once widely believed to be the strongest (Delta)."

If the proposed deal does survive congressional and antitrust scrutiny, and win the necessary backing of Delta's creditors, the new merged line plans to retain the Delta name, in the apparent belief that even in its tarnished state, and in bankruptcy, Delta is a better brand than US Airways, which tops its rivals in passenger complaints and lost baggage.

It is Delta's condition as a bankrupt that makes it an attractive takeover target. Doug Parker, chairman and chief executive of US Airways, says that one-half of the \$1.65 billion savings he alleges will result from the merger would come from using the bankruptcy court to void onerous labor contracts and airplane leases.

Delta responds that it would emerge from bankruptcy in far better shape as an independent than it would be burdened with the operational problems created by a merger. Gerald Grinstein, Delta's chairman and chief executive, is, to put it mildly, unsympathetic to Parker and his proposal. He plans to use

Delta's Atlanta hub and a cost structure that he reckons will be 25% below those of Lufthansa, Air France-KLM, and other international carriers to become a major force in international markets.

Meanwhile, the financial markets are on Parker's side, with buyers bidding up US Airways' stock to a 40% premium over the value of the creditors' claims on Delta. The big question is whether US Airways can overcome four hurdles.

The first is Delta boss Grinstein, who plans to step down in a few years, and wants to hand a healthy, independent carrier over to his successors, rather than exit the company under pressure, and while it is still a bankrupt. "The history of mergers in the airline industry is almost always one of failure," he wrote in an e-mail sent to all employees.

The antitrust authorities will have to be convinced that consumers will not be harmed by the reduction of competition, especially on East Coast routes. They prevented United Airlines from acquiring US Airways in 2000, and shot down a proposed merger between American Airlines and Northwest. They did approve the America West-US Airways merger, but only because the routes of these carriers did not overlap. Which 50% of the routes of Delta and US Airways definitely do. But the rise and rise of the low-cost carriers, which provide both potential and actual competition on the routes served by the proposed new and enlarged Delta, is now seen as sufficient protection against monopoly exploitation, even though Parker has a record of cutting capacity to drive up fares. Still, Delta made it tougher for Parker by announcing that it was instituting service from New York to Tempe, Arizona, in

competition with US Airways and JetBlue. That means that if the antitrust authorities approve the merger, the number of carriers serving this route will be cut from three to two, something that antitrusters never like to see.

Then there are the unions, who know that a good portion of the savings that Parker is talking about will come out of their pockets. They are not yet reconciled to Parker's plans to handle difficult seniority and other labor problems associated with America West's acquisition of US Airways. True, the unions face a similar fate at the hands of the bankruptcy court, but still would rather deal with the devil they know. So they will lobby Congressman Jim Oberstar, the Minnesota Democrat who will become chairman of the House Transportation Committee when his party takes control of congress in the new year, to hold hearings on the impact of the proposed merger. Oberstar opposed the United-US Airways merger in 2000, and told the press, "Mergers reduce opportunity for competition and thereby increase costs to travelers." So his should be a union-friendly forum.

Finally, Parker will have to convince half of Delta's unsecured creditors, representing at least two-thirds of the value of outstanding claims, that his offer of cash and stock is better value than sticking with Grinstein and ending up with shares in an independent Delta when it comes out of bankruptcy. These creditors, including among them Boeing, US Bancorp and General Electric, are a hard-nosed bunch, and will follow the money. If Parker has got his arithmetic right, he should clear this hurdle. But he will still have to convince another creditor Coca Cola, to go along. That won't be easy. Coke, like Delta, is

headquartered in Atlanta, and regards itself as a co-pillar, along with Delta, of the Atlanta community. Its executives will be under substantial social pressure to block the takeover.

If the merger is approved, look for at least temporary upheaval. The glitches in the US Air-America West merger have yet to be worked out. Throw in the need to coordinate operations, pay scales, and frequent flyer programs with Delta, and Parker's management team will be tested to the limit as it works with an undoubtedly sullen Delta group.

One way or another, the problems of the industry will remain largely unchanged. Badly managed carriers will still be able to keep flying under the protection of the bankruptcy courts; airlines will be able to control only a portion of the travel experience, the balance being at the mercy of monopoly operators of airports and security-obsessed bureaucrats; America will still protect its carriers from the foreign competition that might improve service on domestic routes, even at the cost of sacrificing the open skies agreement recently negotiated with the EU; and airline managements will continue to cut costs and quality, attempting to discover, in the words of one executive, just how much cheese you can take off the pizza before customers stay away.



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