

**January 15, 2008**

## **Airline Industry Consolidation Why it's coming and why it's necessary-**

When was the last time you flew with an empty seat next to you? How many times in the last year has your flight arrived on time? How was your airline "customer service" experience?

The facts are that each month the airlines are setting new records for the average number of seats sold on every flight. Late arrivals for last year set an all time record. Consumer complaints are at an all time high and increasing.

Since 2001, most of the legacy airlines have reduced non-fuel expenses by 20-30%. Unfortunately for the airline passenger, this cost reduction has been at the expense of labor and customer service.

If you fly often, it should come as no surprise airline "customer service" is at an all-time low. This negative change can be easily explained after considering since year 2001; the average ratio of airline passengers to employees has increased by 27-34% for the large legacy airlines.

Yet, even with all-time record load factors and reduced [non-fuel] expenses, the industry as a whole has dismal profit margins and an aging fleet of older inefficient aircraft badly in need of replacement.

Rising airfares are not able to keep up with the unpredictable future price of jet fuel, which has increased from less than 12% of operating expense to 35% over the past 8-9 years.



### **2008 – The Year of Airline Industry Transformation**

History has proven how drastic and quick changes to the airline industry can occur:

- 1960's Jet Age
- 1978 Airline Deregulation
- 2001 financial devastation of the industry caused by the 911 tragedy are the most recent three major events that changed the industry.

## January 2008 – Industry Consolidation

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American	Air Tran
Continental	Alaska
Delta	American Eagle
Northwest	ATA
Southwest	Frontier
United	Jet Blue
USAir	Spirit

It's my guess over the next 12-18 months, at least 2 airlines from each of the lists above will disappear and here is why:

Last month two significant laws were changed and are now in effect:

- The long-standing law forcing US airline pilots to retire at age 60 was changed to age 65. The United States now has the same mandatory retirement age limits for pilots as most other countries which operate flights to the US.
- A new law will now require the merger of all labor groups after an airline acquisition to abide by integration methodologies similar to the old Allegheny-Mohawk Labor Protective Provisions [LPP's] that were in effect prior to 1986.
- The "Open Skies Agreement" between the US and EU becomes effective this March 2008.

What this all means is that many of the costly and once restrictive obstacles to airline acquisitions and mergers are now gone.

In the past, pilots as well as some other labor groups had very restrictive contract language regarding how an acquired airline's pilots and employees were to be integrated into the newly merged company. Past history shows it has been common to take years to fully integrate different airline labor groups into one.

The new LPP's now provide only a few weeks for merged labor groups to reach an integration agreement before an arbitrator decides the outcome. This new law will not only force mergers of different labor groups to be considerably faster and predictable but also far less costly from what has occurred in the past.

The "Open Skies Agreement" removes most of the restrictions that long prevented US and EU airlines from flying beyond each country's "Gateway" cities. In addition, this agreement requires on-going discussions intended to eventually permit unilateral foreign ownership above the current 49% level and the 25% restriction on foreign [voting] control.

Conclusion- Only with considerable industry consolidation will the remaining airlines gain enough pricing - power - to achieve much needed financial stability.

Considering the lack of acceptable profit margin in the airline industry combined with the issues noted above, I expect considerable industry consolidation to include increasing foreign airline ownership over the next 12-18 months.

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