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No More Parachutes:
Additional Financial Aid to Airlines Not Warranted

Executive Summary

The past year has been a difficult one for the airline industry. With several airlines facing serious financial difficulties in the summer of 2001, the terrorist attacks of September 11 dealt a further blow to an already weakened industry. In the days following the terrorist attacks, the United States Congress responded by passing the Air Transportation Safety and Stabilization Act which, among other things, provided financial aid to the airlines. However, the current and projected financial problems for the industry have led many to call for additional federal aid for the industry as a whole and for passenger airlines in particular.

The airline industry argues that it plays an important role in the economy, and that aid is needed to avoid bankruptcy and to keep planes flying. They further claim that since the security measures are required by federal law, airlines should be at least partly reimbursed by the federal government. However, the principal cause of airlines' financial woes is the persistent low levels of demand for air travel, caused by several factors, including traveler apprehension, the sluggish economy, and the increased "hassle factor" as airport security has tightened.

While additional funds would improve the bottom line of individual airlines, it would not forestall the contraction as the industry adjusts to lower levels of demand. This contraction, painful though it may be, is the natural reaction to current market conditions. While more carriers may fall into bankruptcy without further aid (as some will even with federal aid), and while increased security costs are taking a financial toll on the airline industry, there is no economic case for providing additional aid.

Post-9/11 Aid to the Airlines

Following the terrorist attacks, Congress passed the Air Transportation Safety and Stabilization Act, which provided financial aid to the airlines. This aid has come in two separate forms. The first was $5 billion in direct cash grants to airlines, apportioned according to size. Over 75% of the grants were given out before January 1 of 2002, with most of the rest being disbursed by mid 2002. The other form of financial assistance was up to $10 billion in loan guarantees.

As of December 2002, about $3.75 billion in loans had been requested, of which $1.5 billion was approved at least conditionally, and about $2 billion was declined, including the recent denial

of a $1.8 billion request from United Airlines. The deadline for applications has passed, and no new applications are expected, although airlines may be able to resubmit rejected applications.

Despite federal aid, the industry suffered losses of about $7.7 billion in 2001, and many predict losses of similar magnitude for 2002. The financial impact of the four-day "groundstop", along with a continued reluctance to fly and a stagnating economy has sent United Airlines and USAirways, the second and sixth largest passenger airlines, into bankruptcy.

Industry Outlook

Falling revenues

For the industry as a whole, profit margins tend to be relatively thin, averaging less than 1% between 1991 and 2000. Even with federal aid, the industry yielded a net loss margin of 6.7% in 2001 and an operating loss (not including the aid) of 8.7%. The principal cause of the loss was the dramatic reduction in revenues following the terrorist attacks, although the industry was widely predicted to earn a loss even prior to the attacks.

Over the first eight months of 2002, revenue seat miles (the total number of miles flown by paying passengers) declined by about 10% from the same period in 2001. Average airfares have fallen by about 13%. Taken together, this implies that revenues have fallen by about 22%. While airlines have cut their carrying capacity (as measured by available seat miles), by about 10%, the resulting cost savings will not be sufficient to return the industry to profitability. Loss projections for the industry range as high as $10 billion for 2002.

Declining demand

The main cause of the airlines' financial troubles are the steep reductions in demand. The combination of passenger apprehension since the terrorist attacks, languid performance of the economy as a whole, and increased hassle factor for airline passengers has resulted in a steep drop in demand for passenger air travel. In reaction to this, airlines have cut back on flights, so that the load factor (the share of flying seats that are filled with paying passengers) for the first eight months of 2002 is about as high as it was in for the same period of both 2001 and 2000, between 73 and 74%.

This reduction in capacity has allowed airlines to reduce their costs, most notably by cutting about 80,000 jobs (with another 30,000 cuts planned through 2003) and by renegotiating labor contracts. However, airlines are still saddled by the fixed costs of maintaining their fleets and other fixed costs. In 2000, flights, on average, needed to be about 70% full for an airline to break even. In 2002, they would need be about 81% full, reflecting the dramatic reduction in passenger demand (as well as reduced cargo revenues).

Rising security costs

In addition to reduced revenues, airlines face substantial new security costs. The airline industry estimates that security expenses including the security tax of $2.50 per segment, reinforced cockpit doors, and lost seat revenues for air marshals, will cost the industry as a whole as much as $3.5 billion in 2002. In addition to the direct costs of security are the indirect losses due to the hassle factor and its impact on travel demand. The combination of reduced revenues and increased

costs has put many of the large airlines deep into debt and their financial viability into question.

Airline Economics

High fixed costs

One of the factors that distinguishes airlines from other businesses is the relatively high levels of fixed costs they face. Airlines face expenses such as the leases or loan payments on airplanes whether or not those planes are flying. Whereas airlines pay for inputs like fuel only when they consume it, airplane payments and other such fixed costs are due even if the airline ceases operations entirely. While all businesses face some fixed costs, airlines require equipment investments that represent a substantial share of operating costs.

According to the Air Transport Association, fleet and interest costs alone account for about 13% of operating costs. These costs are often spread out over a long period of time; twenty years for a lease or airplane loan is common. This means that when an airline decides to buy or lease an airplane, it is committing itself to a series of relatively high payments over a long period of time. This can make it difficult for airlines to adjust to a rapid fall in travel demand. If demand drops suddenly, as it has over the past year, airlines can reduce their flight schedules and reduce their labor force, as they have done, but they still must make payments on airplanes that sit idle for lack of demand.

For these reasons, the business of airlines depends in large part on managers' ability to schedule flights effectively. Once a route (i.e. ongoing service between two points) is scheduled, the airline's goal is to maximize the revenue it can earn from ticket sales. Since airlines have to pay for their planes whether or not they fly, the decision to maintain a flight schedule depends on whether or not it can cover the variable costs of the flight. If ticket revenues are sufficient to pay for the fuel, labor, and other variable costs completely, the flight is viable. Revenues above this level contribute to fixed costs and, if sufficiently high, to profits. Whether or not an airline flies a particular route is relatively independent of the airlines' fixed costs.

Cash flow and capital markets

A large reduction in demand creates two types of financial problems for airlines, one short-term and one long-term. In the short run, it can cause cash-flow problems. Ticket revenues are used to cover ongoing fixed costs as well as the variable costs of flying (such as fuel, baggage handling, and passenger services). When demand and revenues fall, airlines may not have enough cash on hand to cover both the fixed and variable costs of operations.

Airlines are sometimes able to cover the shortfall with cash reserves or by taking out loans, either backed by the equity they hold in assets (such as their airplanes) or backed only by the prospect of future profits. These loans can help airlines weather relatively short-lived reductions in demand and revenues, as they need to increase earnings to pay back the loans.

Over longer periods of time, however, continuing cash flow problems can turn into insolvency. The longer an airline remains unprofitable, the more loans it will have to take, and the more of its future profits it will have to commit to creditors. If capital markets perceive

that it will take a long time for an airline to return to profitability, they will be less inclined to loan it money and more inclined to charge higher interest rates. If existing debt loads are high and/or the business outlook is bad enough, airlines will be forced to secure loans in the high-risk high-interest "junk" bond market. Many airlines bonds were rated as junk status prior to September 11, and of the 11 "major" airlines (with revenues of $1 billion or more), all but Southwest are now rated as junk.

Bankruptcy

When the debt burden becomes unsustainable, or when an airline can not obtain enough financing to cover ongoing cash flow shortfalls, it generally files for bankruptcy protection. This relieves it, at least temporarily, of the responsibility to repay some or all of its loans. Bankruptcy protection thus frees up some cash that would have to go to loan payments to be used for operational costs, allowing the bankrupt airline to continue to fly as it attempts to return to profitability.

For this reason it is relatively common for airlines to continue to operate through protracted periods of financial losses and bankruptcy. Trans World Airlines, for example, continued operations through multiple bankruptcy filings and at a loss for over a decade before being bought by American Airlines in 2001. Currently, both United and USAirways continue to operate the bulk of their routes in bankruptcy as they attempt to return to profitability.

It is important to note that even when airlines face difficulties, they continue to fly routes for which demand is sufficient to cover operating costs. Even in cases where financial troubles are severe enough that an individual airline may cease operations, other airlines tend to take over viable routes either through expansion of service or through a merger or acquisition of the troubled carrier.

Is More Federal Aid Warranted?

The threat that airlines will be forced into bankruptcy is a very real one. However, this threat is principally a financial issue. Whether or not a particular route will be flown is separate from the decision to file bankruptcy. As mentioned above, airlines have a history of operating for protracted periods while losing money and through bankruptcy. An airline will declare bankruptcy if it does not feel it can meet its debt obligations. On the other hand, a flight will take off if enough seats can be sold at high enough prices to cover the costs of the flight.

In bankruptcy, airlines continue to make flight decisions based on these revenue considerations, rather than their debt issues. If a flight can cover its operating costs, it will fly. If a bankrupt airline ceases operations altogether, other airlines will pick up the slack on routes for which sufficient demand exists. The implied threat that passenger air service will disappear if airlines do not get federal aid is not credible.

The main problem airlines face is lack of demand. While the average flight is slightly more full this year than it was last year, the number of flights has been greatly reduced as has the average ticket price, both in reaction to reduced demand. Because demand is so weak, the costs of increased security are being borne largely by airlines rather than being passed along in the form of higher ticket prices.

Aid Will not Stimulate Demand

The contraction the industry is currently facing is the natural market response to a reduction in demand. For economic and safety reasons, people are less willing to fly than they previously were. Fewer flights, and perhaps fewer airlines, is the appropriate response to the new market conditions. While additional federal aid to airlines would certainly boost their bottom lines, it will do nothing to stimulate demand.

Lump-sum payments such as the ones given out last year do not provide incentives to alter airline behavior; unprofitable routes will still be cut, and employees will be laid off. Financial assistance would merely allow unprofitable airlines to continue operating longer than they would have and increase earnings of the profitable ones.

While there are several instances when markets cannot function properly, requiring corrective action by a government, that is not the case here. In fact, the financial markets seem to be operating quite well in relation to the airline industry. Creditors clearly feel that demand for air travel is likely to continue to suffer and that the industry must shed capacity to become profitable. Banks and other creditors are not inclined to lend money for production of a service that people are not interested in buying.

If and when travel demand begins to increase again, airlines may find it easier to secure funds from financial markets. Until then, private lenders are likely to shy away from the industry, and there is no reason why the government should take their place.

Paying for additional security costs

While increased security costs are placing a difficult burden on airlines, federal reimbursement for these costs is not economically appropriate. While the government at various levels provides basic security, many industries are inherently risky and require additional measures that can be costly.

Banks hire additional security guards, and jewelry stores install complex security systems. Airlines have employed a number of security measures both before and after September 11. It is appropriate for inherently risky industries to bear the costs of their risk-generating activities. Just as we would not expect a federal tax to cover security cameras at jewelry stores, there is no economic rationale for the public as a whole to cover the risks of air travel and transport.

Little was made of this issue prior to September 11, perhaps because security costs were acceptably low. It is now clear, however, that in the current environment, previous security measures were inadequate. From an economic standpoint, too little security led to inappropriately low operating costs for airlines and an over-supply of air services. Now that the need for additional security is clear, the industry is going through a difficult transition to a scale more appropriate to today's economic and security landscape.

The additional security costs should be borne by the market in order to ensure that the industry scales itself to the appropriate size. In this way, direct and indirect users of air services will decide if the value of those services outweigh their costs. In the case of airlines, these costs include not only the obvious inputs such as labor and fuel, but also the cost of providing the service safely. Otherwise, the government would have to

impose costs on the public at large to subsidize the risky behavior of a relative few.

Conclusion

The airline industry was hit hard by the terrorist attacks of September 11. Already facing financial difficulties, the attacks and continuing weak demand for airline services has put considerable financial strain on the industry. While several airlines are either in or appear near bankruptcy, recent calls for additional federal financial support are unwarranted.

The industry had excess capacity before September 11, a problem which has subsequently worsened. Federal subsidies would not eliminate this excess and thus can not solve the principal problem the industry faces. While increased security costs have put additional strain on the industry, it is appropriate for those costs to be borne by those who create them.

There is little economic rationale for providing additional aid to the industry; rather it should be allowed to continue the process of adjusting to meet new market conditions without federal intervention.

[Financial and employment data: Air Transport Association]

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