Assessing Losses for the Airline Industry and Its Workers in the Aftermath of the Terrorist Attacks

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OCTOBER 3, 2001

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SUMMARY

In response to urgent pleas from the airline industry and President Bush, Congress has enacted the Air Transportation Safety and System Stabilization Act (the 'airline bill') to help the airline industry deal with the financial ramifications of the September 11th attacks.

The bill provides $5 billion in direct cash grants to the industry to be distributed among airlines according to their share of total available seat miles before the attack. Loan guarantees worth $10 billion are also included in the package. For the next six months, the bill also provides compensation to airlines for increased insurance costs and limits the liability for third party damages resulting from an act of terrorism. At the same time, the possibility of punitive damages being awarded as a result of a terrorist act has been eliminated.

This analysis finds that the industry losses are probably not as high as industry analysts have suggested, either for the four-day government stoppage or for future losses. The actual loss from the four-day shut down was probably between $850 million and $1.1 billion, not the $1.4 billion estimated by the industry. Prior to the attacks, Wall Street was predicting losses for September of $540 million dollars, or about five percent of revenues per day. Subtracting the five percent that the airlines would have lost anyway would reduce the estimated costs of the government stoppage to between $815 million and $1 billion.

The industry estimate of losses for the last 19 days of September totals $5 billion; however, the JEC Democratic staff finds that actual losses are likely to be between $3.25 and $4 billion. Even this estimate is likely to be on the high side, as it does not account for the fact that fewer costs are fixed over time. In fact, Wall Street analysts are only projecting between $2 billion and $4.5 billion in additional industry losses through the end of 2001.

While the airline support package does not include any provisions for laid-off workers, a wide range of options exists for aiding workers. Given more realistic loss estimates, it's likely that the airlines could afford to be more generous to workers in providing severance. In addition, airlines also could be required to pay severance as a precondition for receiving government aid or loan assurances.

Congress is also considering separate measures that would address airline security concerns and aid to workers as the industry struggles to regain its footing.

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BACKGROUND ON THE AIRLINE INDUSTRY

The airline business is inherently riskier than many others. The industry is capital intensive, meaning that relatively large shares of its costs are fixed and, therefore, must be paid whether or not planes are full or flying. Such costs include leases or loan payments for planes, payments for gates at airports, etc. When business is good, this gives airlines the chance to make money, as their costs do not rise as quickly as capacity factor (the share of available seat-miles that are paid for) and income. When business is bad, airlines can find life difficult, as costs do not fall as quickly as revenues. This makes the airlines particularly sensitive to the business cycle.

In recent history, the industry as a whole has tended to have relatively low cash reserves, paying most of their operating costs out of concurrent revenues, with some additional cash generated by selling corporate bonds and other borrowing. During the four-day government-imposed shutdown, airlines had essentially no money coming in while they continued to pay their fixed operating costs, forcing them to rely on existing cash balances to pay their bills.

In lean times, airlines can operate for extended periods of time with negative cash flow because revenues will cover a large part of their costs (Pan Am lost money for about a decade before finally closing down). Airlines may have a much shorter survival period under the current, extraordinary circumstances – early estimates put the industry's cash reserves at about 30-days' worth of expenses.

Whether or not an individual airline will declare bankruptcy depends on what happens once it exhausts its cash reserves. If it had been on solid financial ground previously and was expected to return to profitability, it may be able to raise the cash it needs on the bond market or through some other means. If the shutdown had been caused by some extreme weather event that had no impact on future expectations, there would be little concern for the industry beyond weathering the short-term negative cash flow. This is clearly not the case now.

With consumers continuing to stay away, airlines will have a hard time convincing potential lenders that their investments are safe and, therefore, they are likely to face high interest rates. In fact this was already the case for much of the industry preceding the September 11th attacks, when much of the industry's bonds were rated in the high-risk "junk" category. US Airways was in particular trouble, facing possible restructuring or bankruptcy, especially after its failed merger with United Airlines.

AIRLINE BILL PROVISIONS FOR THE INDUSTRY

The Air Transportation Safety and System Stabilization Act (the 'airline bill') includes several different measures to help the airline industry deal with the financial ramifications of the September 11th attacks. In direct cash, the bill provides $5 billion in grants to the industry to be distributed among airlines according to their share of total available seat miles before the attack.

The bill also makes $10 billion of federal money available for airlines to use as collateral on loans. Because the airline business is more risky now than before, the cost of borrowing money could be very high. By providing federal collateral, lenders will be able to rely on the government to pay up to $10 billion in industry loans if the airlines should default. The board charged with overseeing the fund is empowered to require airlines to back this collateral with warrants (basically options) for the federal government to buy airline stock to recoup any actual payout of this $10 billion collateral.

Additionally, the bill provides compensation to airlines for increased insurance costs for the next six months. Liability for third party damages resulting from an act of terrorism is limited to $100 million per incident, with the federal government assuming liability for the rest, for the next six months. At the same time, the possibility of punitive damages being awarded as a result of a terrorist act has been eliminated.

A fund and process for distributing funds to the victims of the attacks both in the air and on the ground is established by the legislation. Anyone who files for a claim waives the right to sue either United or American Airlines for losses. The size of the fund has not been established, and the amount of compensation an individual receives will be determined based on the actual losses, earnings, and degree to which the claimant's losses are insured. Finally, the bill limits the total liability for United and American Airlines to the amount for which they were insured.

DIRECT IMPACT OF THE GOVERNMENT SHUTDOWN

During the four day 'groundstop' when domestic airlines were essentially completely grounded, the industry incurred substantial hardship. The industry estimated losses of about $1.4 billion, although this is likely to be on the high side. They calculated this number by simply multiplying their daily operational costs of $340 million by four under the presumption that with no money coming in, these expenses would not be recovered.[1]

That approach overestimates the costs for at least two reasons. First, while a relatively high share of the industry's operating costs is fixed, some costs are variable and

[1] Testimony of the Air Transport Association on the Financial Condition of the Airline Industry, Leo F. Mullin, Chairman and CEO, Delta Air Lines, before the U.S. House of Representatives Committee on Transportation and Infrastructure (9/19/01).

are thus not incurred if flights are grounded. What share of costs are variable is difficult to determine and depends on the time frame considered. In the short-run, costs often considered variable might actually be fixed.

Under some union contracts, workers will still get paid if flights are cancelled, so that some employee compensation must be paid. Similarly, salaried workers would also continue to be paid through the stoppage. (If the four days were counted against paid leave it would reduce the industry's liabilities because they would be carrying fewer paid employee-days on their books, but it would have no impact on their short-term cash flow.) If the industry expects lean times to persist, they may choose to lay off workers (as almost all U.S. airlines have), so that these costs become variable over longer periods of time.

Jet fuel, which makes up about 15% of operating costs, may be partially fixed in the short run. While airlines are not actually burning fuel as their planes sit on the ground, most airlines likely buy much of their fuel with long-term contracts. If they do not need the fuel, they can break the contract, for which presumably there is a penalty, or they can buy it and store it for use later.

Given that airlines are operating well below capacity and thus have much less need for fuel, it is unlikely that they have the storage capacity to hold four days of fuel along with increasing inventories of any unused fuel purchased since the groundstop was lifted. Whether they reduced fuel purchases by not taking deliveries during the groundstop or by attempting to manage inventories determines when their cash flows would be affected, but eventually the vast majority of expenses for fuel for the grounded flights will not be incurred. Including them in the loss figure is therefore inappropriate.

Together, employee compensation and jet fuel make up about 50 percent of operating expenses for the industry as a whole (compensation is 35 percent and fuel is about 15 percent). Given this and the fact that about 40 percent of industry employees were covered by collective bargaining agreements in 1998, it is reasonable to expect that 20-35 percent of operating costs during the groundstop were not fixed costs and will not be paid. Therefore, actual losses from the four-day shutdown are likely to be between $850 million and $1.1 billion. However, this analysis focuses only on employee compensation and fuel and does not count other variable costs such as passenger services and maintenance. Some Wall Street analysts estimate much lower costs, estimating that the groundstop cost airlines about $100 million in fixed costs per day.[2]

Additionally, the airline industry analysis assumes that the canceled flights on average would have at least broken even or earned a profit. Imagine, however, a flight that cost $100,000 to operate but that would have only been three quarters full, bringing $75,000 in revenues. The airline would have lost $25,000 on that flight if it had flown. Imagine now that the government, for whatever reason, canceled that flight. In this example, the cost of the government grounding to the airline would have been the $75,000 in lost ticket revenue. It would have lost the other $25,000 anyway.

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[2] See: http://www.dismal.com/thoughts/article.asp?aid=1369

Using the industry's calculation method, however, the full $100,000 would have been counted as losses caused by the government grounding. Given that the industry was widely expected to lose about $2 billion for calendar year 2001 (and was expected to incur a 5% loss for September prior to the attacks), it is likely that the average canceled flight would have lost money, so that counting 100 percent of operational expenses as costs of the shutdown overstates the actual cost.[3] Taking these projected losses into account would further reduce the costs of the four-day groundstop to between $815 million and $1 billion.

ONGOING INDUSTRY LOSSES

Obviously, as air travel remains at low levels, airlines will face mounting losses. The industry estimated its losses through the end of September to be about $3.4 billion (in addition to the $1.4 billion they claimed for the four-day groundstop) and losses of about $24 billion in total by the end of June 2002. This is based on the same methodology used by the industry to calculate the costs of the groundstop, and on assumptions that passenger travel will return to 60 percent of what it otherwise would have been by the end of 2001, increasing to 75 percent by the end of March 2002 and to 85 percent by the end of June 2002.

These estimates are also likely to overstate costs, because the airlines are not operating the same number of flights as they had planned, further reducing their variable costs. This is reflected in the fact that the airlines have announced nearly 100,000 layoffs since the attack. Assuming that the airline estimate for the rest of September is off by about the same proportion as their four-day estimate would reduce the estimate of losses through October 1 from about $5 billion to between $3.25 billion and $4 billion. Even this estimate is likely to be on the high side, as it does not account for the decreasing fixed nature of costs over time, nor does it take into account other variable costs, including maintenance and passenger services. In fact, Wall Street analysts are projecting between $2 billion and $4.5 billion in additional industry losses through the end of 2001, as opposed to the industry estimate of $5 billion for just the last 19 days of September.[4]

Looking beyond September 30th, the industry's method of calculating losses is even less appropriate, since more of the costs that had been fixed in the short run become variable as time passes. While the industry may have had to pay unionized and salaried workers during the four-day groundstop, labor costs will fall after the announced layoffs.

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[3] Merrill Lynch as quoted by Reuters on 9/5/01. Available at http://biz.yahoo.com/rf/010905/n05281679.html

[4] Merrill Lynch as quoted by CNNfn on 8/5/01. Available at <http://cnnfn.cnn.com/2001/08/21/companies/airlines_downgrades/index.htm>; and UBS Warburg as quoted by the Associated Press on 9/22/01. Available at <http://news.excite.com/news/ap/010922/22/airlines-outlook.

With average annual costs of about $65,000 per employee, the announced layoffs alone will save the industry roughly $4.5 billion through June 2002. This estimate does not include the cost of severance, because it is unclear which airlines will pay severance and how many of their workers will benefit.

Again, Wall Street estimates are far less dire than those of the industry. Previous estimates had projected the industry would earn a slim profit of about $630 million in 2002. Since the attack, Wall Street is projecting losses of about $400 million, meaning that they expect the industry will lose about $1 billion in 2002 as a result of the attack and ensuing economic weakness.

Estimates of Airline Industry and Workers' Losses

(Billions of Current Dollars)

	Calendar Year (CY) 2001-2002			
Airline Industry Losses	Sep 11 to Sep 15	Sep 11 to Sep 30	Sep 11 to Dec 31	Sep 11 to Jun 30
ATA	1.4	5	n/a	24
JEC	0.82-1.1	3.25-4.0	n/a	n/a
Wall Street	n/a	n/a	2.0-4.5	3.0-5.5*
Worker Losses	n/a	n/a	1.5	4.5

* Wall Street estimates are for all of 2002

Source: ATA: Air Transport Association; JEC: Joint Economic Committee, Democratic Staff.

Two other factors need to be considered as well. The first is the possible federalization of airport security and the other is the increased insurance cost that the airlines are likely to face. Both of these remain fairly uncertain. If security were completely federalized, as proposed in S. 1447, the Aviation Security Act, the airlines would save about $700 million annually. On September 26th, President Bush proposed only partial federal control of aviation security. The proposal would require federal management of airport screening, but the actual screening would be conducted by private companies. In addition, training would also be required. However, on October 2nd President Bush indicated that he would accept the federalization of airport security if Congress deems it necessary.

The insurance question is far more complicated. As mentioned above, the recently signed airline bill provides relief for United and American Airlines from liability for damages both on the ground and for passengers of the hijacked flights. Their current insurance provides coverage for the planes they lost as well as liability coverage for up to $1.5 billion per incident, though this will likely not cover the potential liability for the two New York crashes. (The coverage cannot be combined, so that if one crash cost less than $1.5 billion the extra coverage could not be applied to another crash that exceeded $1.5 billion.) The bill limits the airlines' liability to the amount for which they were insured, so that they will not have to pay for damages out of future operating revenues.

As a result of the crashes, airlines are losing their current coverage for acts of terrorism. Insurance companies have proposed that terrorism insurance be covered with an add-on policy, paid for by an additional $1.25 surcharge per passenger. This additional coverage would cost about $1 billion per year. As mentioned above, the airline bill will provide funds to the industry to cover these expenses for the next 6 months. Beyond that, how much of the surcharge will be borne by the airlines in the form of lower ticket prices is unknowable at this point. However, it is unlikely that consumer demand would respond much to such a small surcharge, which would allow airlines to recover much, if not all, of the surcharge.

THE IMPACT ON WORKERS

As mentioned above, the airlines have announced almost 100,000 layoffs since September 11th. Some airlines have also announced that they will be offering no severance packages to these workers, invoking the *force majeure* clause in union contracts that allows them to unilaterally declare an emergency and not pay severance.

While the airline support package also does not include any provisions for laid-off workers, a wide range of options for aiding workers exists. One would be to require airlines to pay severance as a precondition of receiving government aid or loan assurances, although this would not help those who would not be eligible for severance under existing contracts (a particular problem for the roughly 60 percent of employees not covered by union contracts).

A proposal has been offered to extend unemployment insurance (UI) for an additional 52 weeks for laid-off airline employees. It is hard to estimate the cost of this since it depends largely on the rate at which laid off workers find new jobs beyond the initial 26 weeks of standard UI coverage. Given that UI replaces, on average, about 35 percent of lost wages with no provision of health or other benefits, workers will likely need additional aid.

A government funded severance package that covered 100 percent of wages and benefits would cost approximately $500 million per month. If coverage were provided through June of 2002, when the industry expects air travel demand to rise to 85 percent of previously expected levels, this would cost approximately $4.5 billion.