Looking for a flight out of Charlotte, N.C.? You’ll have 26 percent fewer flight options by June 2009 compared to the same month last year. Excited to spend a few days in Myrtle Beach, S.C.? You’ll have 73 percent fewer flights for getting home than you would have had last summer. Even our nation’s capital has seen about 6 percent fewer flights departing from Washington Dulles International Airport this June compared to June 2008.

The main reason behind the capacity cuts at most of the country’s major airports, of course, is the recession. When the economy turns sour, people fly less. Since it doesn’t pay to fly empty planes, airlines cut capacity by running fewer flights or swapping big planes for smaller ones. “Right now there are too many seats chasing too few passengers,” says Vaughn Cordle of AirlineForecasts, an industry consulting group.

But any seasoned traveler knows the recession is just the latest in a series of shocks to hit the airline industry in this decade. Oil prices—a key determinant of jet fuel prices and, to a lesser extent, would-be travelers’ expendable cash—spiked to a record-breaking $179 per barrel in July 2008. The terrorist attacks of 9/11 led to huge costs for the industry in the form of security protocols, and they worried travelers, many of whom opted to just stay home. With airline industry profits as whole has been profitable for only two years during this decade, 2006 and 2007, they booked a loss again in 2008, and industry analysts are split on what’s in the cards for this year. Analysts do agree, however, that the recession of shocks the industry has experienced, and the emergence of a new breed of competitors, we may be at a turning point in the airline industry that could change how airlines operate in the future.

Turbulence On the Books

In order to keep this in perspective, it is important to note that the airline industry has never been consistently profitable. This is mostly a result of its structure. Airlines have large fixed costs related to their fleet of jets, so the cost of producing one product is seats on those planes. They charge a fare for each seat that is well above the marginal cost of flying one additional passenger in order to recoup those fixed costs over time.

With the exception of fuel, airlines’ costs are relatively stable. The real uncertainty that they face is exceptionally erratic demand resulting from business cycles, and they are more sensitive to weather patterns and geopolitical turmoil than perhaps any other industry in existence. The airline industry experienced its first-ever decline in world traffic volume in 1991, an outcome of anxiety over traveling during the Gulf War. Other notable extremes since have included airlines’ high-profit years during the dot-com boom, the subsequent decline in global air travel following 9/11 and the current financial crisis. The International Air Transport Association (IATA) predicts global passenger traffic will fall by 3 percent in 2009. Despite the industry's cyclical nature, it is the only time in the last 35 years that passenger traffic has fallen. This may be one reason why industry analysts are now speculating on whether the industry's oldest players will survive in their current form.

In an industry whose profits are so volatile, it is no surprise that the competitive landscape for airlines is constantly changing through mergers, bankruptcies, and liquidations. A small handful of airlines have stayed in the game since the industry was deregulated in 1978. These so-called “legacy carriers” include some of the country’s biggest names in air travel: American, Continental, United, US Airways, Delta, and Northwest (the latter two of which merged in October 2008 and are in the process of being fully integrated under Delta’s brand). They have seen their share of financial distress. When times are tough for airlines, new competitors tend to enter or expand in the market when aircraft, labor, and airport space are cheaper. They also gobble up any routes that have been abandoned by existing airlines. In the last two decades, the most intense competition has come from the so-called “low-cost carriers,” or LCCs. The LCCs are the group of airlines — the names Southwest, JetBlue, AirTran, Allegiant, and Frontier, for example — that have been able to significantly cut their costs. Key to the model is amassing lots of passengers into one common location, called a hub, and using that hub to fill outgoing flights. By accumulating passengers in one location, the legacy airlines are able to operate about 25 percent more cheaply than the legacies in absolute terms has also widened over time, despite avid cost- cutting measures by the legacies. As much as 65 percent of the cost advantage of the LCCs may be attributable to its simplified business model, according to consulting firm Booz Allen Hamilton.

Meeting in the Aisle

Another key difference between legacies and LCCs is the routes they fly. The LCCs were heavily regulated prior to 1978, with the Civil Aeronautics Board determining what routes airlines could fly and what fares they could charge. Thus, in effect the government determined the market share of each airline. Decisions were typically made based on what would best serve the “public interest.” (The holdover from this regulatory regime is the painstaking merger approval process that still exists for airlines today.)
Clear Skies?
The fight for dominance in the airline industry

BY RENEE COURTOIS

Looking for a flight out of Charlotte, N.C.? You’ll have 1.6 percent fewer flight options by June 2009 compared to the same month last year. Excited to spend a week at Myrtle Beach, S.C.? You’ve got 3 percent fewer flights for getting home than you would have had last summer. Even our nation’s capital has seen about 6 percent fewer flights departing from Washington Dulles International Airport this June compared to June 2008.

The main reason behind the capacity cuts at most of the country’s major airports, of course, is the recession. When the economy turns sour, people fly less. Since it doesn’t pay to fly empty planes, airlines cut capacity by running fewer flights or swapping big planes for smaller ones. “Right now there are too many seats chasing too few passengers,” says Vithga Cordele of AirlineForecasts, an industry consulting group.

But any seasoned traveler knows the recession is just the latest in a series of shocks to hit the airline industry in this decade. Oil prices — a key determinant of jet fuel prices and, to a lesser extent, would-be travelers’ expendable cash — spiked to a record-breaking $147 per barrel in July 2008. The terrorist attacks of 9/11 led to huge costs for the industry in the form of security protocols, and they worried travelers, many of whom opted to just stay home. The airline industry as a whole has been profitable for only two years during this decade, 2006 and 2007. They booked a loss again in 2008, and industry analysts are split on what’s in the cards for this year. Analysts do agree, however, that because of the succession of shocks the industry has experienced, and the emergence of a new breed of competitors, we may be at a turning point in the airline industry that could change how airlines operate in the future.

Turbulence On the Books

In order to keep this in perspective, it is important to note that the airline industry has never been consistently profitable. This is mostly a result of its structure. Airlines have large, money-losing fleets of jets, and the commodity nature of seats means that price is king. The commodity nature of seats means that price is king. The commodity nature of seats means that price is king. The commodity nature of seats means that price is king. The commodity nature of seats means that price is king. The commodity nature of seats means that price is king. The commodity nature of seats means that price is k

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In an industry whose profits are so volatile, it is no surprise that the competitive landscape for airlines is constantly changing through mergers, bankruptcies, and liquidations. A small handful of airlines have stayed in the game since the industry was deregulated in 1978. These so-called “legacy carriers” include some of the country’s biggest names in air travel: American, Continental, United, US Airways, Delta, and Northwest (the latter two of which merged in October 2008 and are in the process of being fully integrated under Delta’s brand). They have seen their share of financial distress.

When times are tough for airlines, new competitors tend to enter or expand in the market when aircraft, labor, and airport space are cheaper. They also gobble up any routes that have been abandoned by existing airlines. In the last two decades, the most intense competition has come from the so-called “low-cost carriers” or LCCs. The LCCs are the group of airlines — the names Southwest, JetBlue, AirTran, Allegiant, and Frontier, to name a few of the LCCs, might ring a bell — known for offering cheaper fares for flights all over the country. The LCCs aren’t always the cheapest flight option, but most passengers in particular is so good at keeping costs down that it completely compensates for the fact that it has the most expensive labor force of the major airlines as a percentage of its CASM. Its labor force is 57 percent unionized, and its staff and pilots make among the highest incomes in the industry, with the biggest benefits packages — yet Southwest still has among the lowest CASM in the industry.

Coming to a Hub Near You

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After deregulation in 1978, American Airlines pioneered a new method for determining routes. They funnelled all their passengers through one common location, called a hub, bundled them into common connecting flights, and shipped passengers out from there to the final destinations. By accumulating passengers in one location, the legacy airlines could schedule a greater number of flights, serve more cities, and earn more revenue. This became known as the “hub-and-spoke” setup, and all the airlines at the time quickly adopted it. The hub-and-spoke model does come with some costs. Key to the model is amassing lots of passengers into the hub at peak points during the day to fill outgoing flights and minimize the amount of time that planes are idle waiting for passengers. Idle time means lost revenue. “You wind up piling up empty seats and trying to get them in and out at the same time,” says Greenelst. It also means the airlines must build in time between flights to move bags, staff, and passengers from one flight to the next. The US Airways revolutionized commercial flying by providing direct flights under a “point-to-point” model, with no hub at all. The LCCs provide more flights that run directly from one city to another, even in remote areas. Southwest in particular is so good at keeping costs low that it completely compensates for the fact that it has the most expensive labor force of the major airlines as a percentage of its CASM. Its labor force is 57 percent unionized, and its staff and pilots make among the highest incomes in the industry, with the biggest benefits packages — yet Southwest still has among the lowest CASM in the industry.

Meeting in the Aisle

In some ways the business models of the LCC and legacy airlines are merging. As LCCs grow and the two groups fight
It looks as though hubs are here to stay, even though, by some measures, they’re more expensive to run. Hubs may be the only way to serve a country’s size and composition. “A country like ours, with a large population centers, generates a lot of travel demand even for relatively small cities, but not always enough traffic to support a direct flight to another medium-sized town. The only way to serve all those points is to hub the traffic,” says Greenfield. “The train system does that in Europe. The hub-and-spoke system does that in this country.”

As the LCCs saturate their existing markets, they have two options if they want to keep growing. They can branch into small-city short-haul traffic currently served by the regional airlines — the small, 50- to 70-seat airlines that serve very small cities, often as a subsidiary of a legacy carrier. Or, they can branch into long-haul (generally defined as six or more hours) and international travel like the legacies. The LCCs can’t expect to continually branch into these areas while maintaining only one or two types of jets. However, buying an array of new jets departs rather dramatically from the business model that has kept their costs so low to begin with. “Right now they’re too big to go to Montgomery, Ala., and too small to go to Shanghai,” Boyd says.

What this means is that the low-hanging fruit for the LCCs may be just about gone. They used their novel business model to connect markets in a way that didn’t previously exist — point-to-point service between mid-sized cities. It’s not obvious what more they can do to win market share from the legacies. For example, specifically calls itself a “point-to-point” airline, and it has only seemed to get stronger. Regarding its perceived success to begin with may be dwindling. Their planes aren’t obvious what more they can do to win market share from the legacies. Their planes are too small to go to Shanghai,” Boyd says. “Right now they’re too big to go to Montgomery, Ala., and too small to go to Shanghai.”

**Landing on Common Ground**

The legacy and low-cost carriers will face some issues that both will find hard to ignore. One is the possible adoption of a federal “cap and trade” emissions control program that threatens to dramatically raise their cost of jet fuel. Another is an outdated air traffic control system that forces costly delays. Of course, economic cyclicality will continue to plague the airlines. The industry expands and contracts in line with, and at roughly twice the pace of, the overall economy. When the economy slows, so does travel demand as businesses tighten their travel budgets and individuals opt for fewer recreational trips.

In the future, Cordle expects an airline industry that is smaller overall. “Because of excess spending and consumption in the United States since the early 2000s, with twin bubbles in stocks and housing, expenditures on air travel were inflated above long-run trend,” he says. “Now we’re getting back to the reality of what the consumers can actually manage. When you strip away all the noise, it really means that the airlines are serving a smaller population.”

Cordle believes there appears to be a single “hybrid” airline model emerging. “The idea that some airlines have the ‘right’ business model is nonsense. I think we’ll see LCCs more intensely targeting hubs, and I think we’ll continue to see the legacy carriers move in the opposite direction and streamline,” he says. “We’re definitely seeing the two models merge.”

Impact on Consumers

Impact on consumers depends on the airlines involved. For example, if the two airlines have largely overlapping routes, then consumers can be harmed because the airlines will eliminate the overlap which reduces the total network available to passengers, according to Berry. However, if the airlines have complementary networks, then mergers have the potential to create a broader network overall for consumers. “The government looks out for this and impedes mergers where the potential harm for consumers is greater,” Berry says.

No matter what changes influence the new business models, it’s hard to imagine a world without airlines. For U.S. consumers, there are 30,000 scheduled departures ferrying an average of 2.1 million passengers each day. The Federal Aviation Administration predicts global air traffic will double by 2034. The FAA also estimates that the industry adds more than 5 percent to U.S. gross domestic product through its direct and indirect economic impacts, and is responsible for nearly 10 million jobs in industries (other than airlines) related to the entire travel sector — even though U.S. spending on air travel is less than 1 percent of GDP and airlines directly employ just over half a million people. “There is tremendous spillover that ripples through the entire economy,” Cordle says.

From the passenger’s perspective, ongoing capacity cuts by the airlines will mean “more crowded aircraft, less quality service, service tightening performance because there are fewer capacity bottlenecks,” Cordle sums up. Boyd is also keen to put the ever-changing airline industry into perspective. “Flying will continue to be as uncomfortable as ever in the same seat space,” Boyd says. “We can count on continuity in that sense.”

**Readings**

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As the LCCs saturate their existing markets, they have two options if they want to keep growing. They can branch into small-city short-haul traffic currently served by the regional airlines — the small, 20- to 70-seat, jets that serve very small cities, often as a subsidiary of a legacy carrier. Or, they can branch into long-haul (generally defined as six or more hours) and international travel like the legacies. The LCCs can’t expect to continually branch into these areas while maintaining only one or two types of jets. However, buying an array of new jets departs rather dramatically from the business model that has kept their costs so low to begin with. “Right now they’re too big to go to Montgomery, Ala. and too small to go to Shanghai,” Boyd says.

What this means is that the low-hanging fruit for the LCCs may be just about gone. They used their novel business model to connect markets in a way that didn’t previously exist — point-to-point service between mid-sized cities. Now that there are all kinds of options, the LCCs operate strictly with a point-to-point model, according to Mike Boyd of Boyd Group International, an airline consulting firm based out of Colorado. Southwest, for example, specifically calls itself a “point-to-point” airline, even though Boyd estimates as much as a third of its flights are connecting traffic. The LCCs don’t make a concerted effort to market themselves as hub carriers, and many are still much less reliant on hubs than the legacies.

Resorting to a partial hub system has allowed the LCCs to offer the greater connectivity that the legacies do. This has expanded the number of markets they serve. They have also begun to target “the most lucrative passenger, the business traveler,” by offering more perks and frequent flier programs, “and that’s the bread and butter of the legacies,” Greenlist says. “We will see LCCs moving increasingly toward hubbing, and I think we’ll continue to see the legacy carriers move in the opposite direction and streamline,” he says. “We’re definitely seeing the two models merge.”

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In the future, Cordle expects an airline industry that is smaller overall. “Because of excess spending and consumption in the United States since the early 2000s, with twin bubbles in stocks and housing, expenditures on air travel were inflated above long-run trend,” he says. “Now we’re getting back to the reality of what the consumers can actually manage. When you strip away all the noise, it really means there’s not that much larger a market that would otherwise drive 300 miles to their destination. In other words, the LCCs expanded overall demand instead of taking it away from the legacy carriers. As the legacy carriers, they’ve moved into big-city markets and have been largely successful at undercutting the legacies for many flights. But they won’t be able to keep growing without lighting theITO airlines and then that’s the broad and bitter of the legacies,” according to Cordle. He estimates that business travelers are 8 percent to 12 percent of the passengers for legacy carriers, but they are about 35 percent to 45 percent of their revenue, and in some cases as much as half.


It’s a big thing you’ll continue to see is that the legacy carriers will lose their advantage. The gainers are the LCCs. “It looks as though hubs are here to stay, even though, by some measures, they’re more expensive to run. Hubs may be the only way to serve a country of our size and composition. “A country like ours, with lots of high population centers, generates a lot of travel demand even for relatively small cities, but not enough traffic to support a direct flight to another medium-sized town. The only way to serve all those points is to hub the traffic,” says Greenlist. “The train system does that in Europe. The hub-and-spoke system does that in this country.”

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