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US AIRLINE COST AND PRODUCTIVITY CONVERGENCE: DATA ANALYSIS

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- **US Network Legacy Carriers**
  - Mainline domestic capacity (ASMs) is almost 20% lower today than in 2000 – shifts to smaller aircraft and commuter airlines
  - Bankruptcies at US, UA, DL and NW have reduced excess capacity, allowed for labor cost reductions and increased productivity
  - AA and CO have re-structured to remain competitive without Chapter 11 (CO stock value doubled in 2006)
  - All network carriers have also shifted capacity to international routes
- **Low Cost Carriers**
  - LCC share of domestic passengers has increased to over 26%, from 16% in 2000 and only 5% in 1990
  - But unit cost advantages of new entrants tend to disappear as both aircraft and employees mature
  - Continued ASM growth is to maintain lower unit costs, but not clear there are enough market opportunities for all of the narrow body aircraft on order by LCCs.

Legacy and Low Cost Airlines

LEGACY AIRLINES

AA – American Airlines

UA – United Air Lines

DL – Delta Air Lines

CO – Continental Airlines

NW – Northwest Airlines

US – US Airways

- Legacy group carried 70% of total US airline traffic in 2006.

LOW COST AIRLINES

WN – Southwest Airlines

HP – America West Airlines

B6 – JetBlue Airways

FL – AirTran Airways

F9 – Frontier Airlines

NK – Spirit Airlines

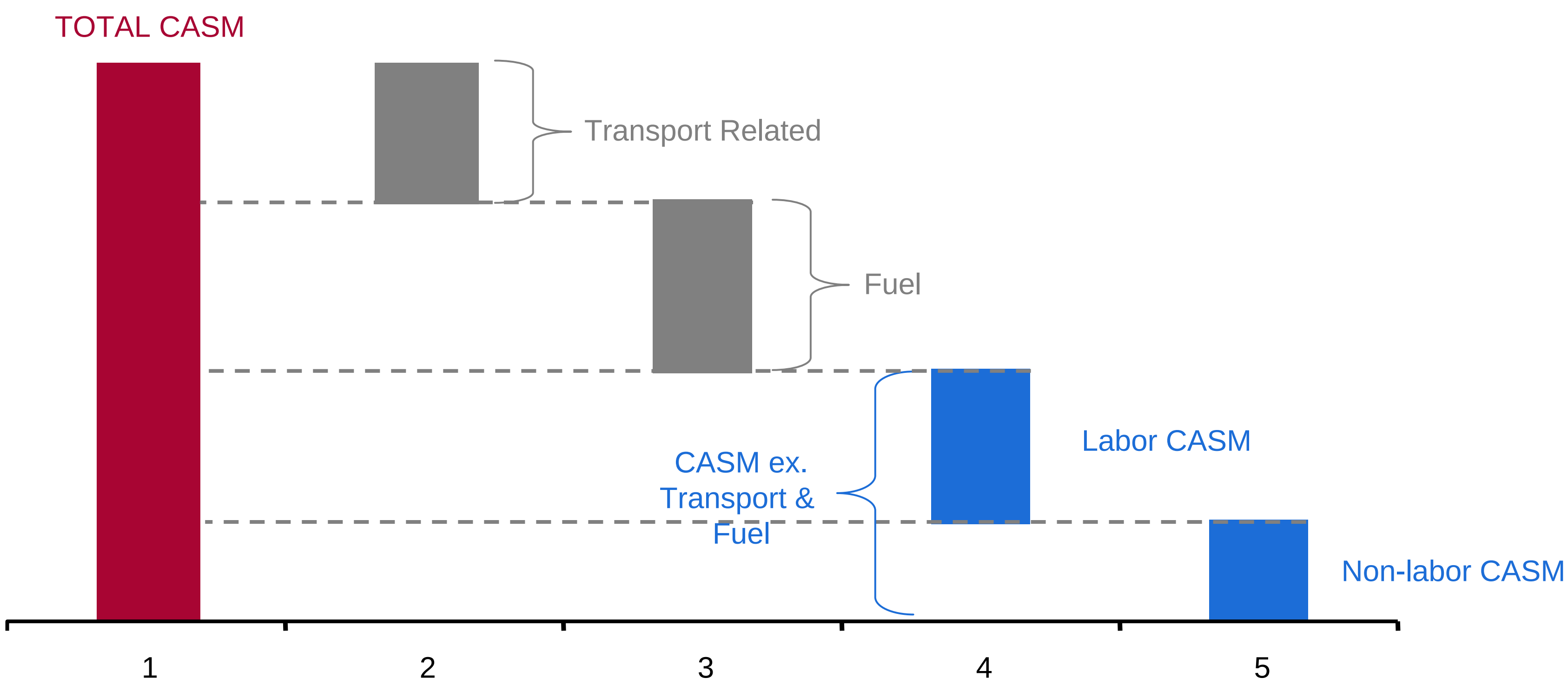
- These airlines carried another 19% of US traffic.

Unit Cost Convergence?

- Depends on what costs are included in comparisons
  - LCCs still have lower total unit costs than NLCs at all stage lengths
  - But NLC reported costs include “Transport-related” payments to regional commuters
    - Important to get to true mainline to mainline comparison
- The unit cost gap has narrowed dramatically
  - If we exclude these “Transport-related” payments and fuel
  - NLCs have seen large drops in labor and other cost components
- Heading towards cost convergence with LCCs?
  - Legacy unit costs will continue to decrease in the short term, although new profits will make labor negotiations even tougher
  - Difficult for LCCs to keep costs from going up – aging fleets and employees

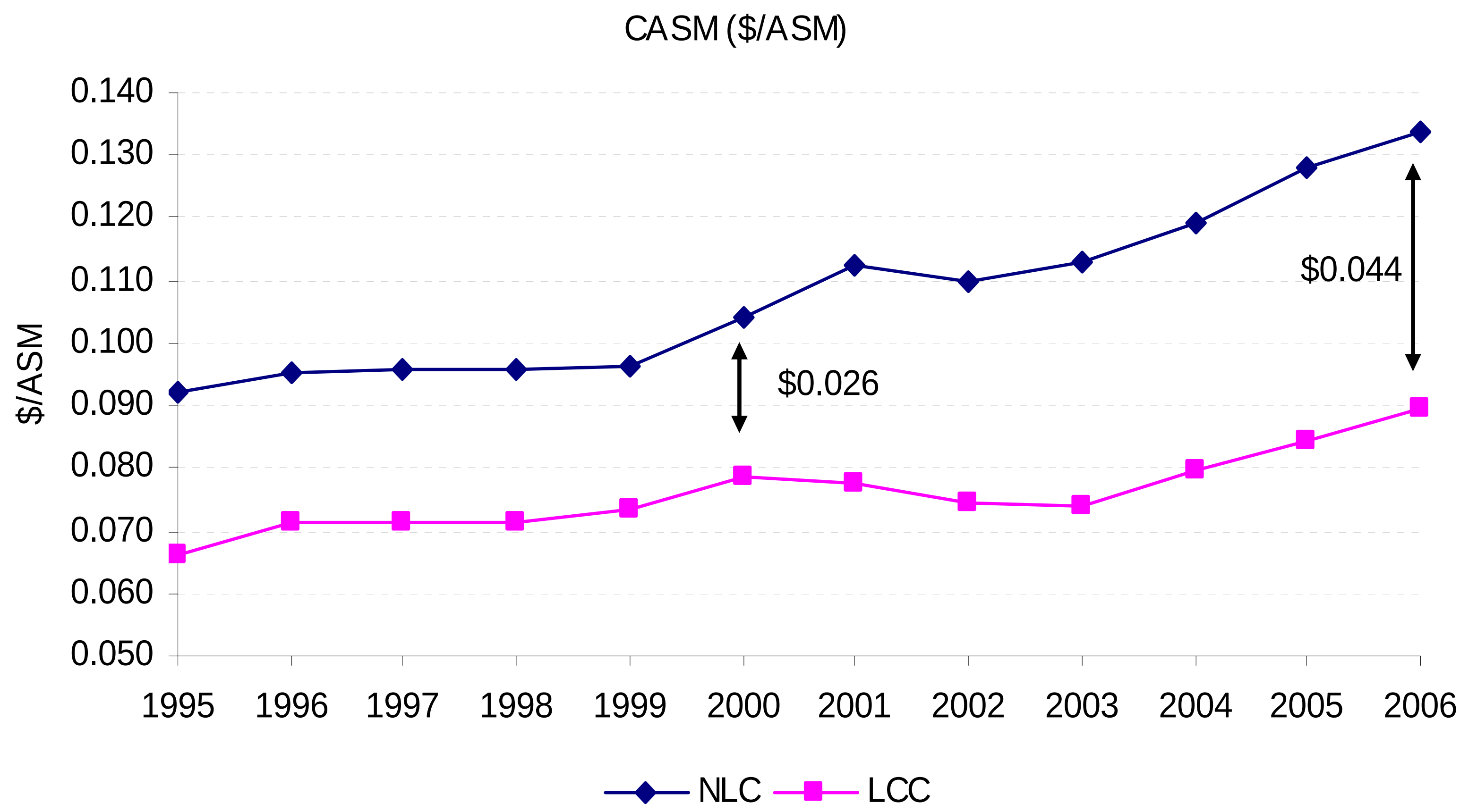
CASM Breakdown

- CASM can be broken down as follows:
  - Transport Related and Fuel expenses excluded for comparisons



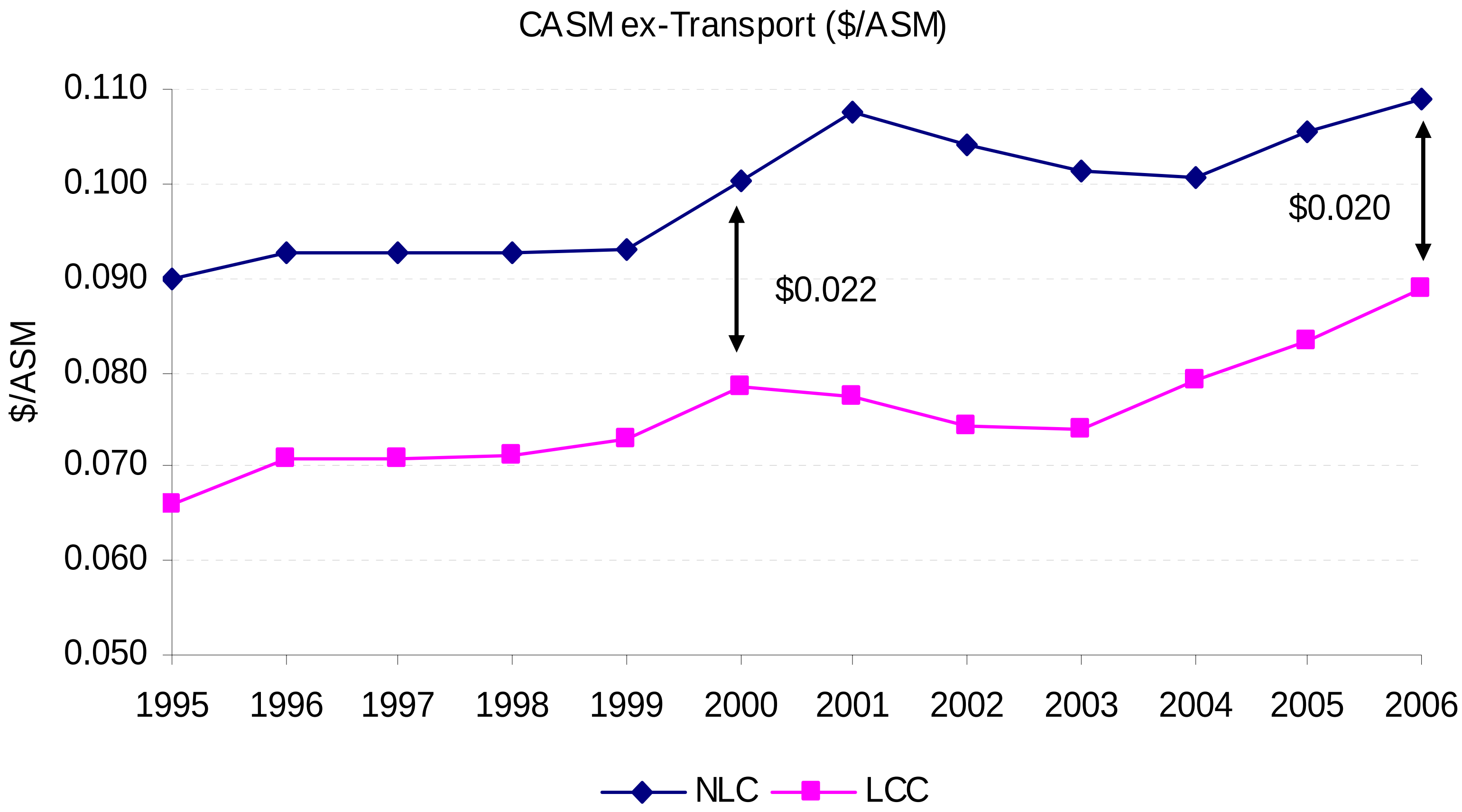
Unit Cost (CASM) by Airline Group

TOTAL Unit Costs appear to be diverging, but this comparison includes "Transport Related Expenses" paid by NLCs to commuters, and is misleading.



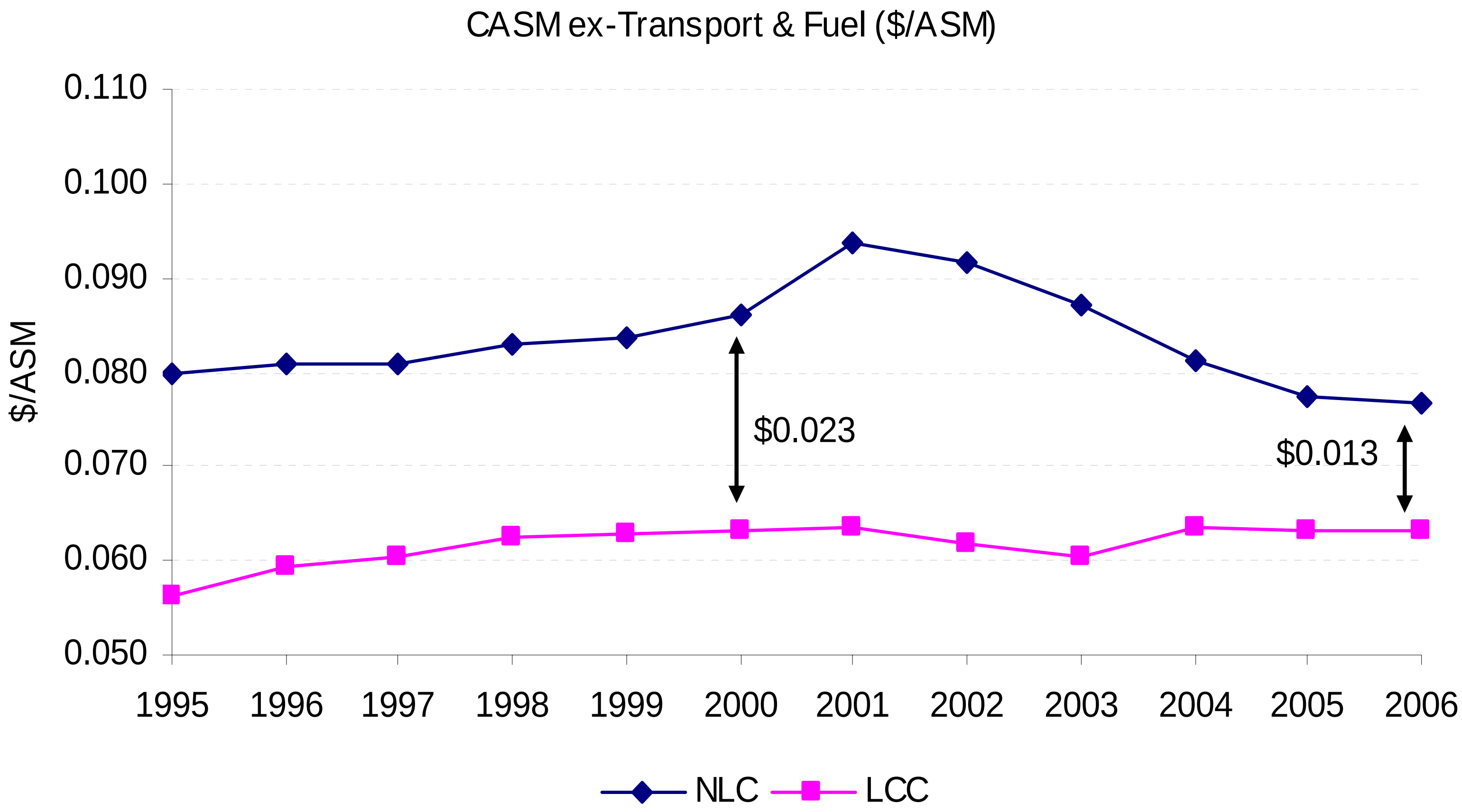
Unit Costs (excl. "Transport Related")

Exclusion of "Transport Related Expenses" paints a different picture in unit costs, and shows some recent convergence.



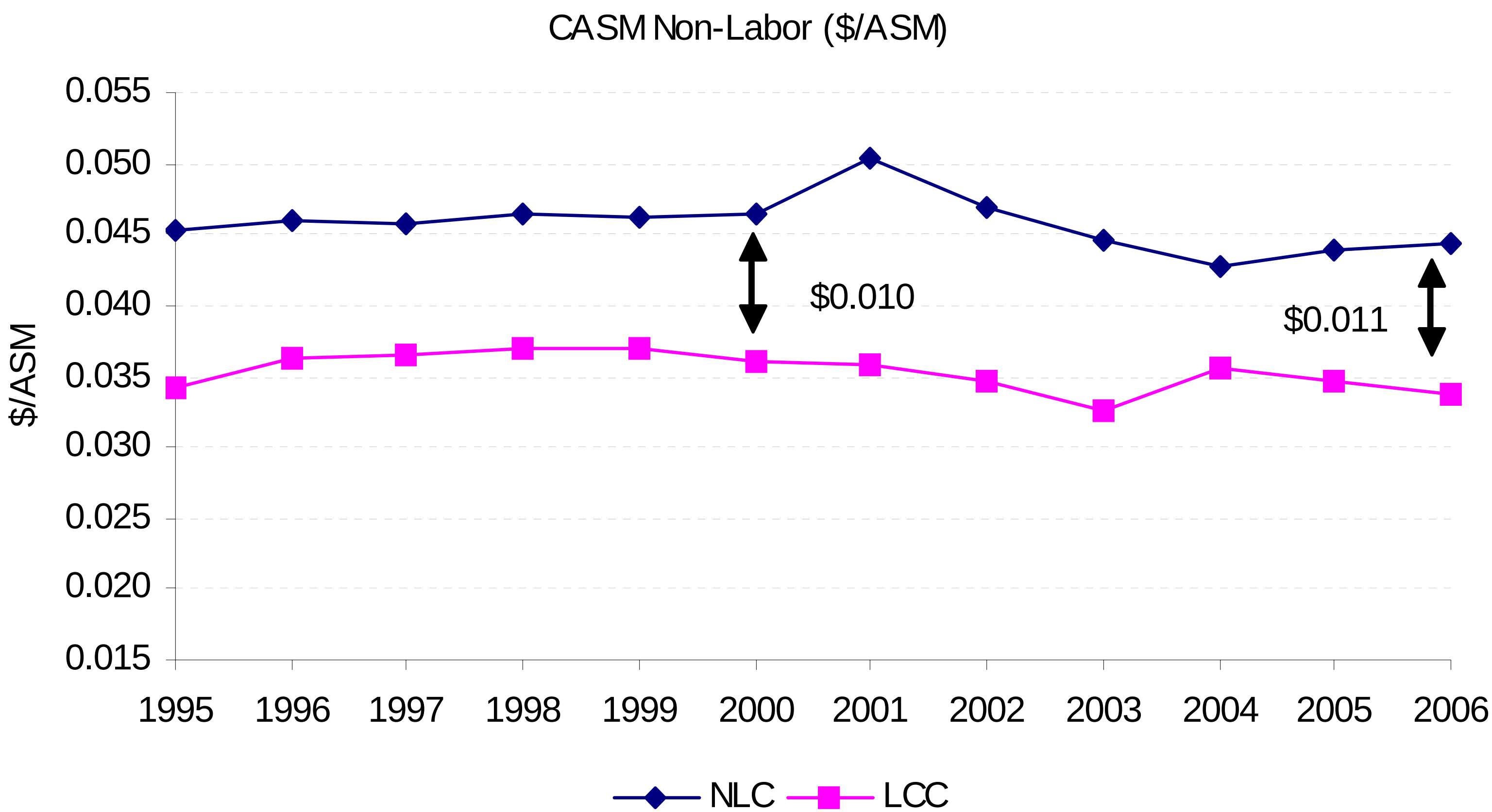
Unit Costs (excluding "Transport" & Fuel Expense)

Excluding both Transport Related and Fuel costs reveals greater convergence (Southwest's fuel hedging and NLCs older fleets).

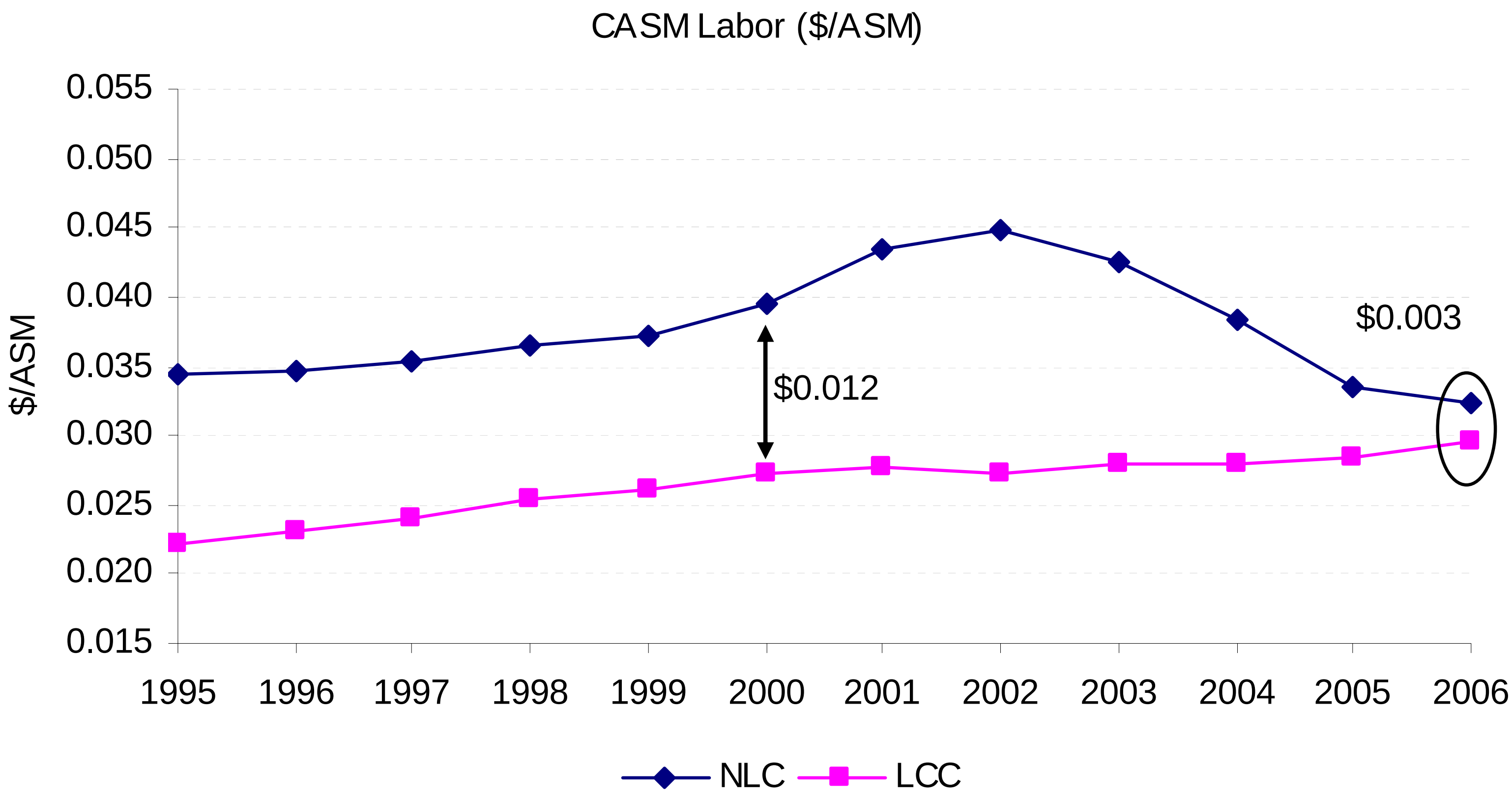


Non-Labor Unit Costs
(excl. Transport, Fuel and Labor)

Gap in Non-Labor, Non-Fuel, Non-Transport unit costs remains…



…while Labor Unit Cost gap has almost been eliminated by NLC cuts and LCC labor cost increases.

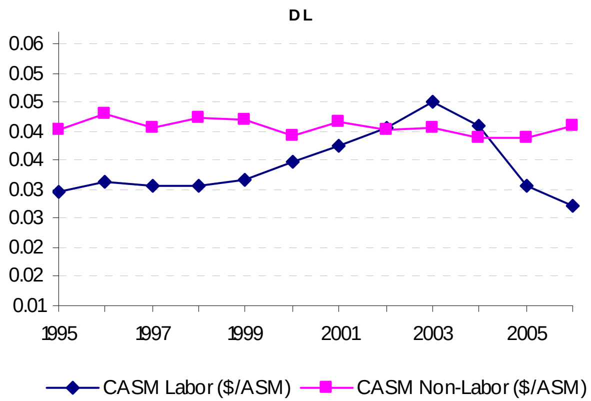


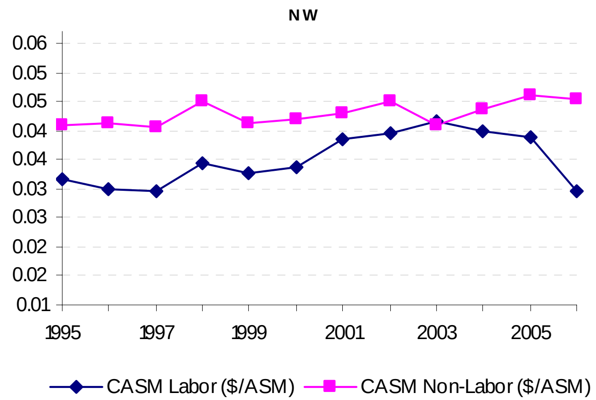
Labor v. Non-labor Unit Cost Reductions

- Fuel is now the largest single expense to an airline
  - Not limited to the US
  - Increase in fuel expense over the past 5 years has dwarfed the savings gained from labor
- The relationship between labor and non-labor costs will certainly be an important economic discussion as labor negotiations restart
  - Very different stories for each carrier
- Concern is whether cost reductions in each area can be sustained
  - Again very different stories for each carrier
- Significant questions remain as to just how much more non-labor cost cuts can be made given network configurations, infrastructure/airspace issues and finding the supply/demand balance that can sustain industry profitability

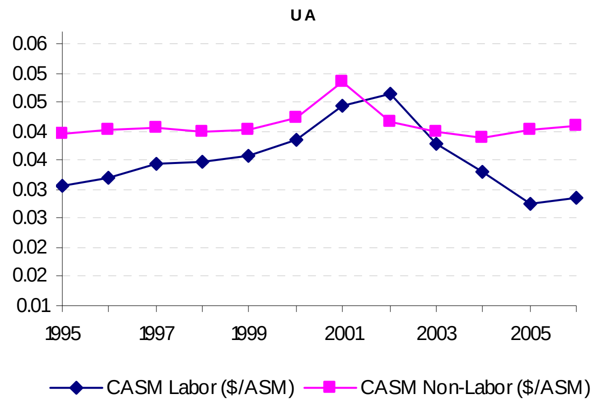
Labor & Non-labor CASM – Network Legacy Carriers (NLCs)

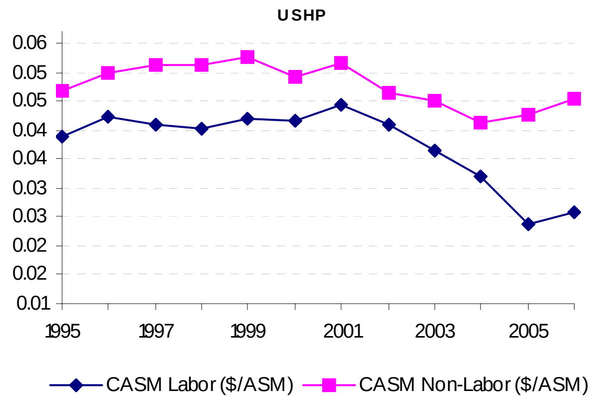
Most recent bankruptcies: DL & NW



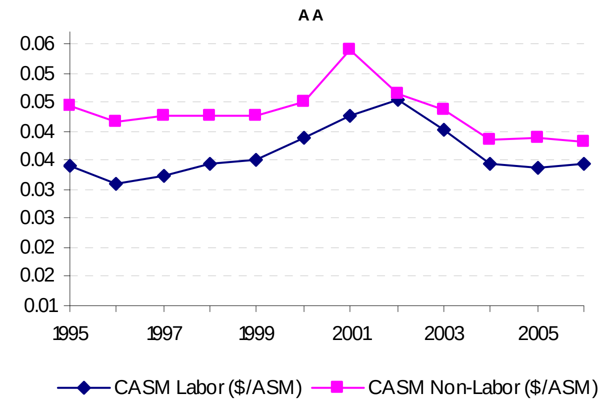


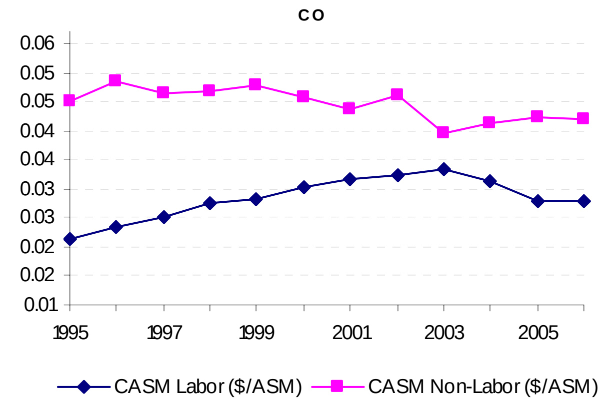
Prior bankruptcies: UA & USHP





No bankruptcies: AA & CO





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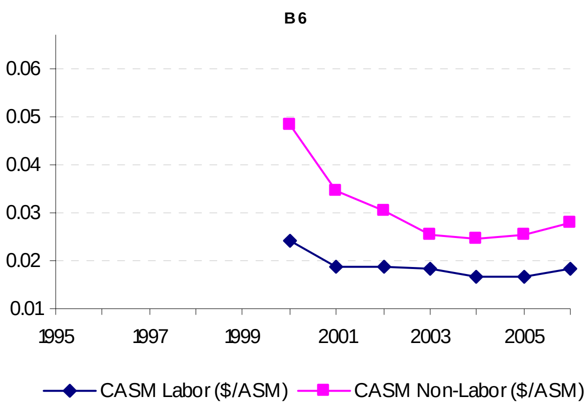
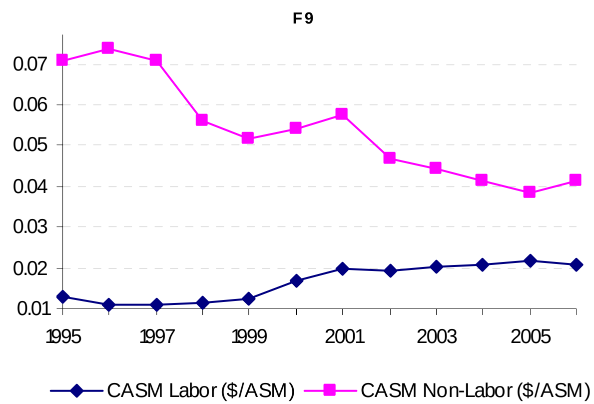
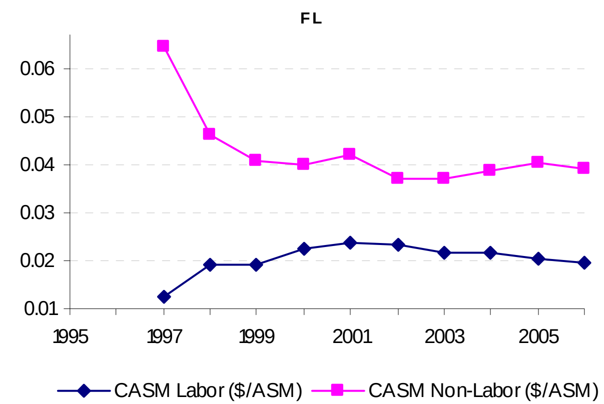
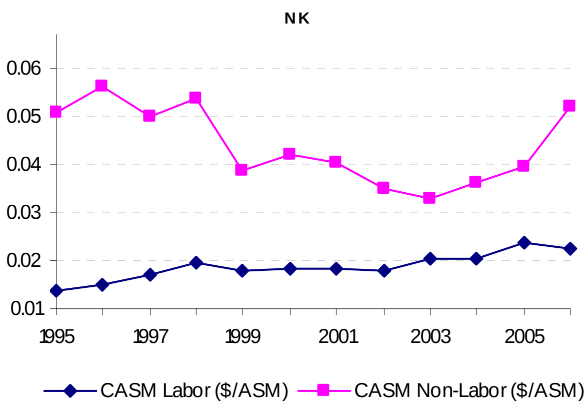
Labor & Non-labor CASM – Low Cost Carriers (LCCs)

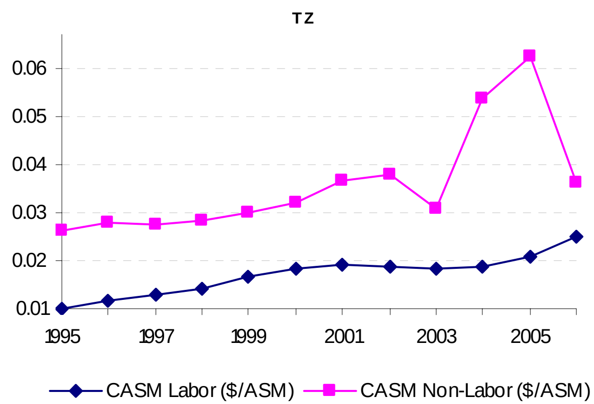
What Happens to Southwest, JetBlue and AirTran as Growth Slows?

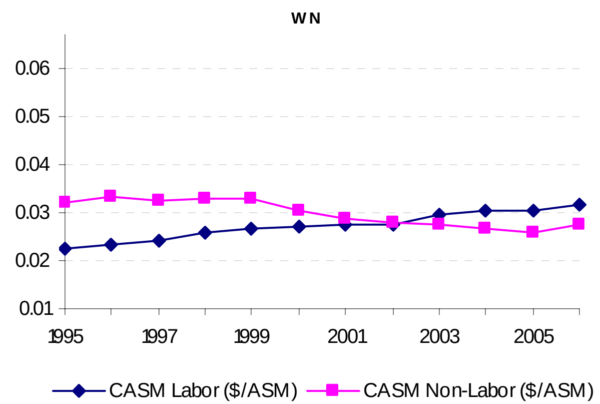












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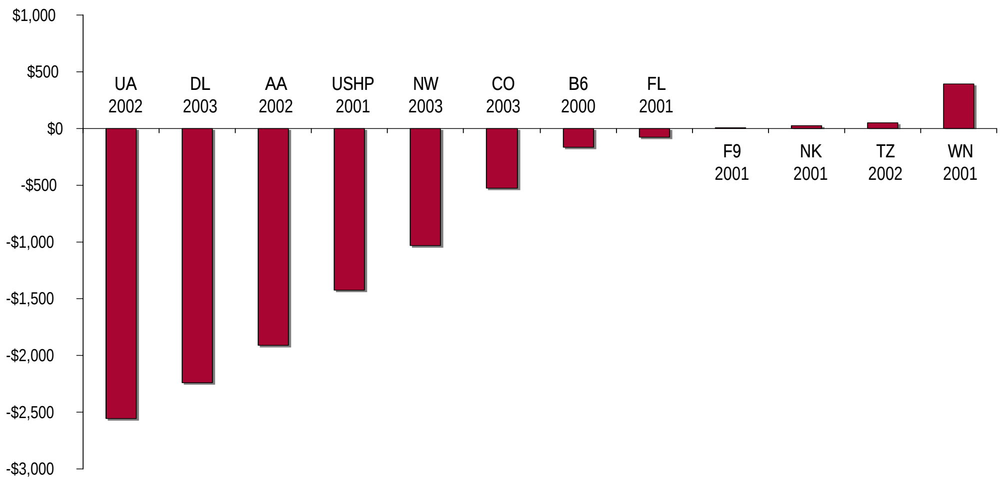
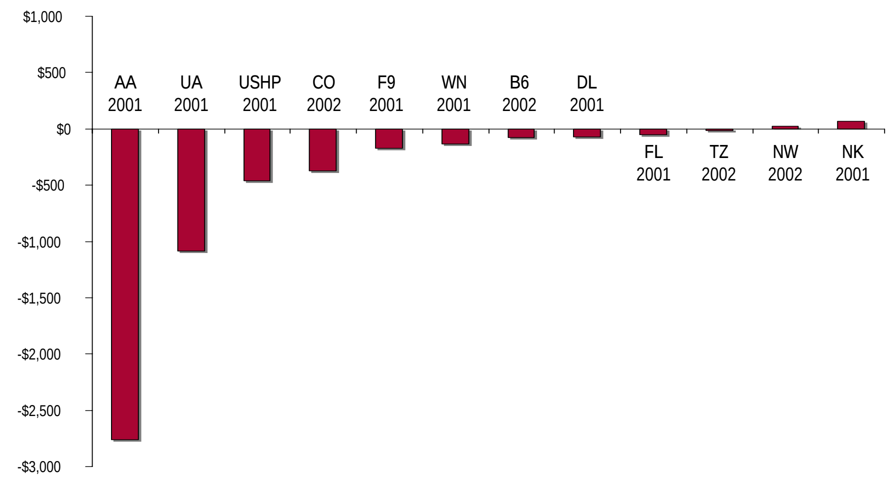
A Different Story for Each Carrier

Annual Run Rate Labor Cost Change
$ Millions
Peak Labor CASM



Annual Run Rate Non-Labor Cost Change
$ Millions
Peak Non-Labor CASM

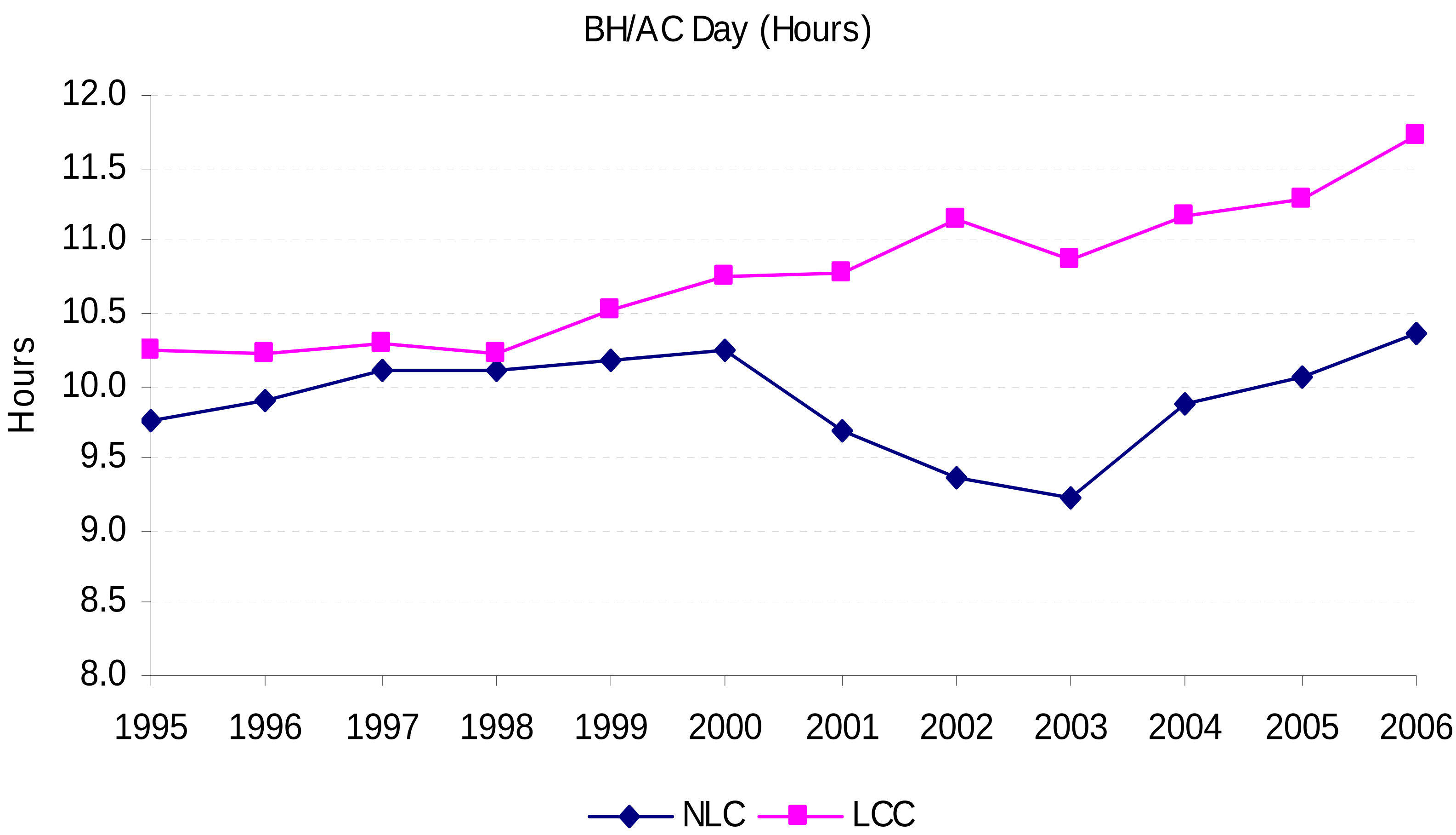


Peak CASM is defined as highest unit cost since 2001.
Annual expense reduction calculated using 2006 ASMs.

What a Difference 5 Years Makes

- Lower costs + improved productivity (+ revenue premium) = Return to profitability for NLCs
  - Network Legacy Carriers have been re-structuring, shifting capacity, and cutting costs while improving productivity
  - In 2006, the network legacy carriers were once again more profitable than the LCC sector (operating profits)
- Aircraft productivity gains are part of the explanation
  - Legacy airlines utilization (block hours/day) increasing after big decline, but LCC aircraft utilization still 12% higher
  - Legacy carrier aircraft ASMs/day have surged, due to use of larger aircraft on longer (international) routes
  - But Low-Cost carriers have also increased stage length and maintain advantages in turn times, non-hub services.

AIRCRAFT UTILIZATION



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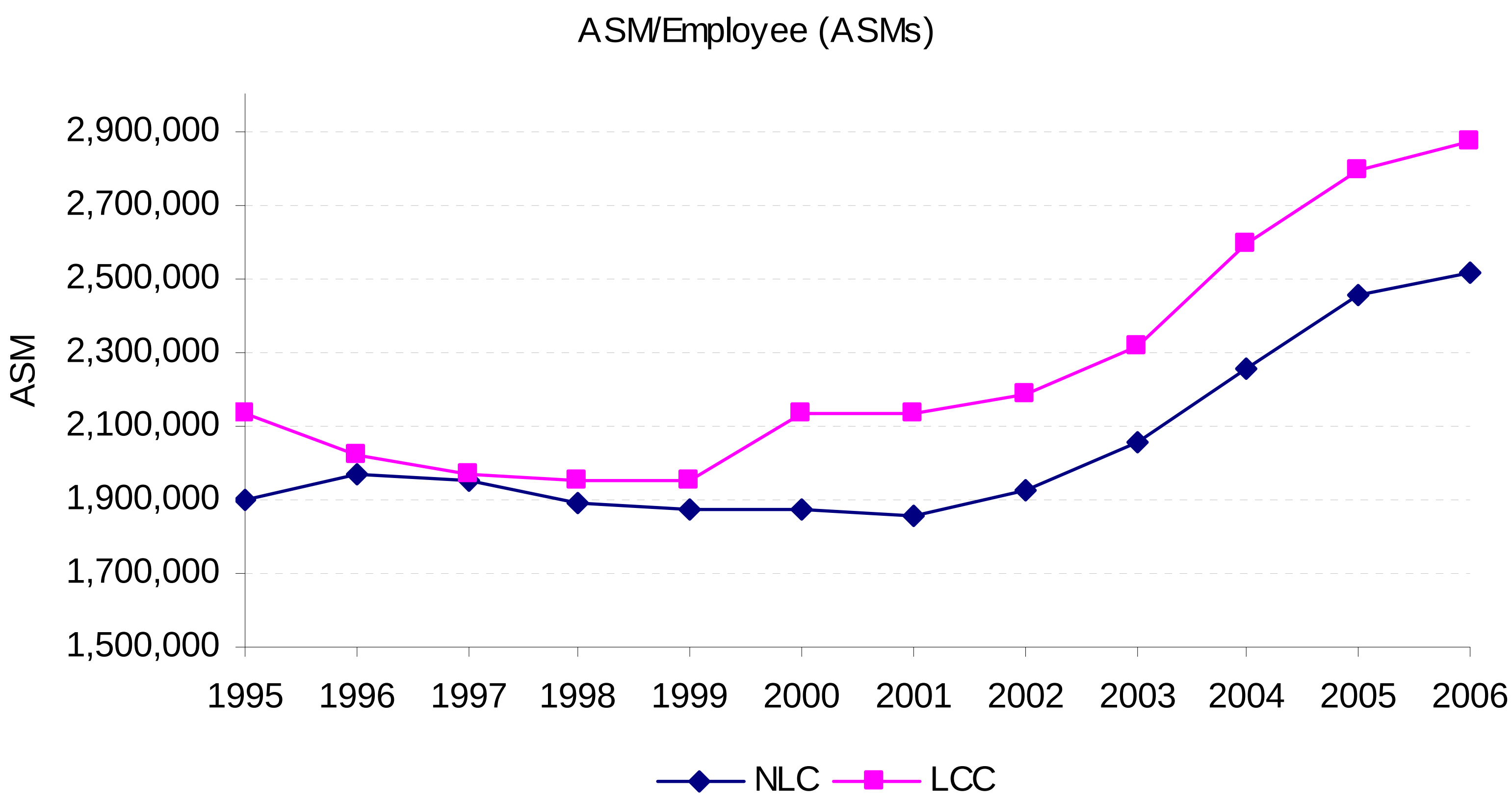
Employee Productivity Has Also Increased

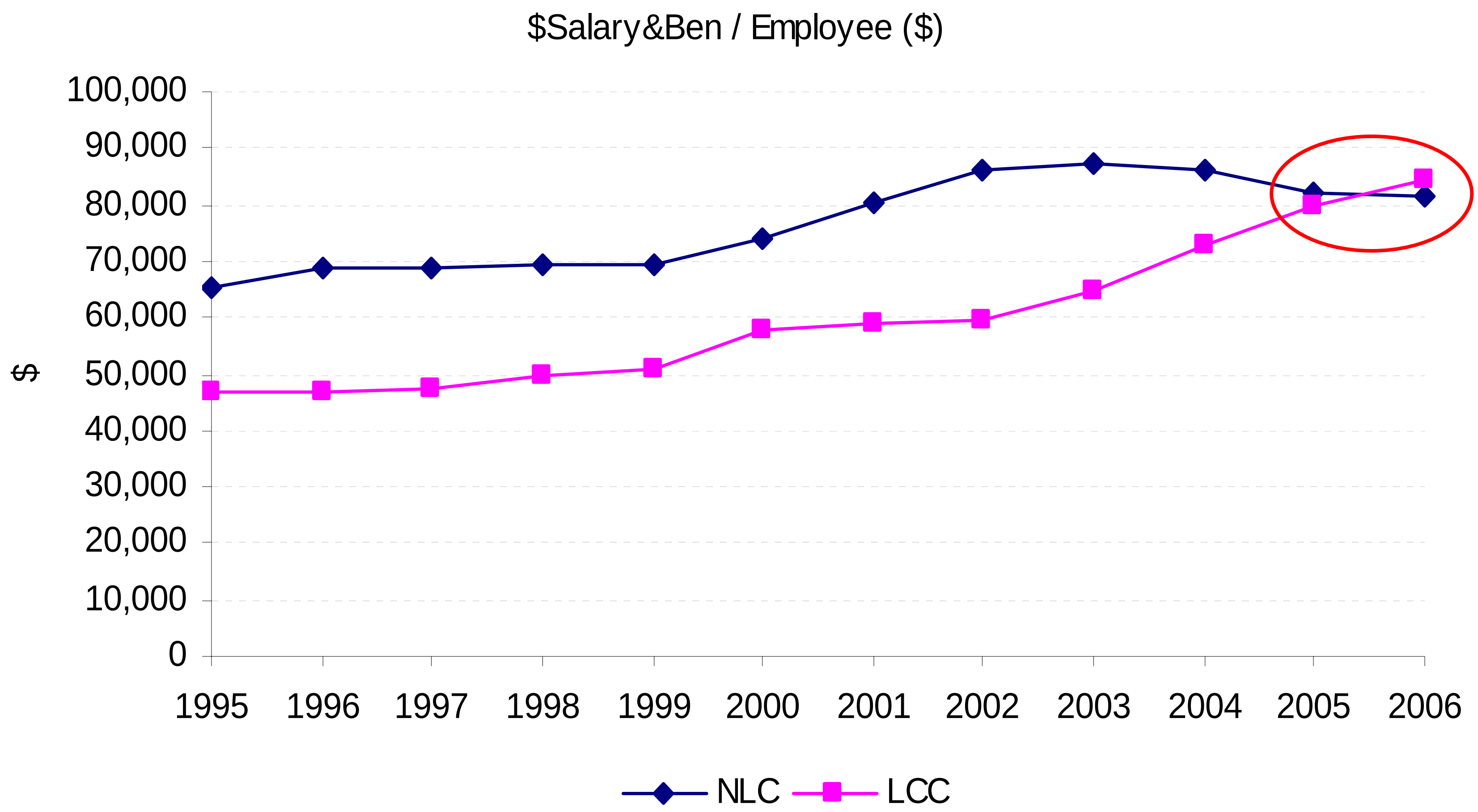
- Measured in ASMs per employee per period
  - Increases in this measure can be driven by both fewer employees and larger aircraft, longer stage lengths
  - In addition to less restrictive work rules, etc.
- Legacy carrier employee productivity is up almost 35% since 2000, but still lags LFAs
  - 25% reduction in legacy workforce
  - Salary & benefit gap with LFAs has narrowed dramatically
  - ASMs produced per dollar of salary + benefits is converging also

ASM per Employee

Both sectors have made huge gains in employee productivity – ASMs/employee up by 35% since 2000, but LCCs still 16% higher.



Gap in Salaries/Benefits per Employee Disappeared in 2006



Recent Trends: Legacy vs. Low Cost

- Significant turn-around by US Legacy carriers
  - Chapter 11 bankruptcy actions by US, UA, DL and NW
  - Similar shifts at AA and CO without Chapter 11
- Focus on cost cutting and improved productivity
  - 35% increase in employee productivity in both NLC and LCC sectors
  - Huge cost savings in distribution, passenger service
- Heading towards cost convergence with LCCs?
  - NLC unit costs decreasing, while LCC costs will face upward pressure – aging fleets and employees
  - Tremendous NLC success in cutting labor costs could pose problems in upcoming labor negotiations, and raises questions of sustainability