Impacts of 9/11 on US Airline Performance

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US Airline Industry Before 9/11

- **Current industry "crisis" began before 9/11:**
  - Dot.com bubble burst, stock market slide, and softening economy
  - Industry losses forecast for 2001 even before 9/11 attacks
- **Other airline industry concerns at the time:**
  - Air transportation system capacity constraints led to record flight delays in 2000
  - Consumer perceptions of poor service and airline indifference, exacerbated by delays
  - Dominance of large network airlines, accusations of anti-competitive actions vs. new entrants

Impacts of 9/11 Attacks

- **Unprecedented use of aviation for terror:**
  - Hijacking by suicide terrorists
  - Aircraft as missiles flown into buildings
- **Most airlines reduced operations almost immediately after 9/11:**
  - 80,000 layoffs by US airlines alone, many more since then
  - US airline capacity (ASMs) cut by 25%, hundreds of aircraft retired/parked
  - US airline traffic (RPMs) initially dropped by 45% due to passenger fears, security hassles

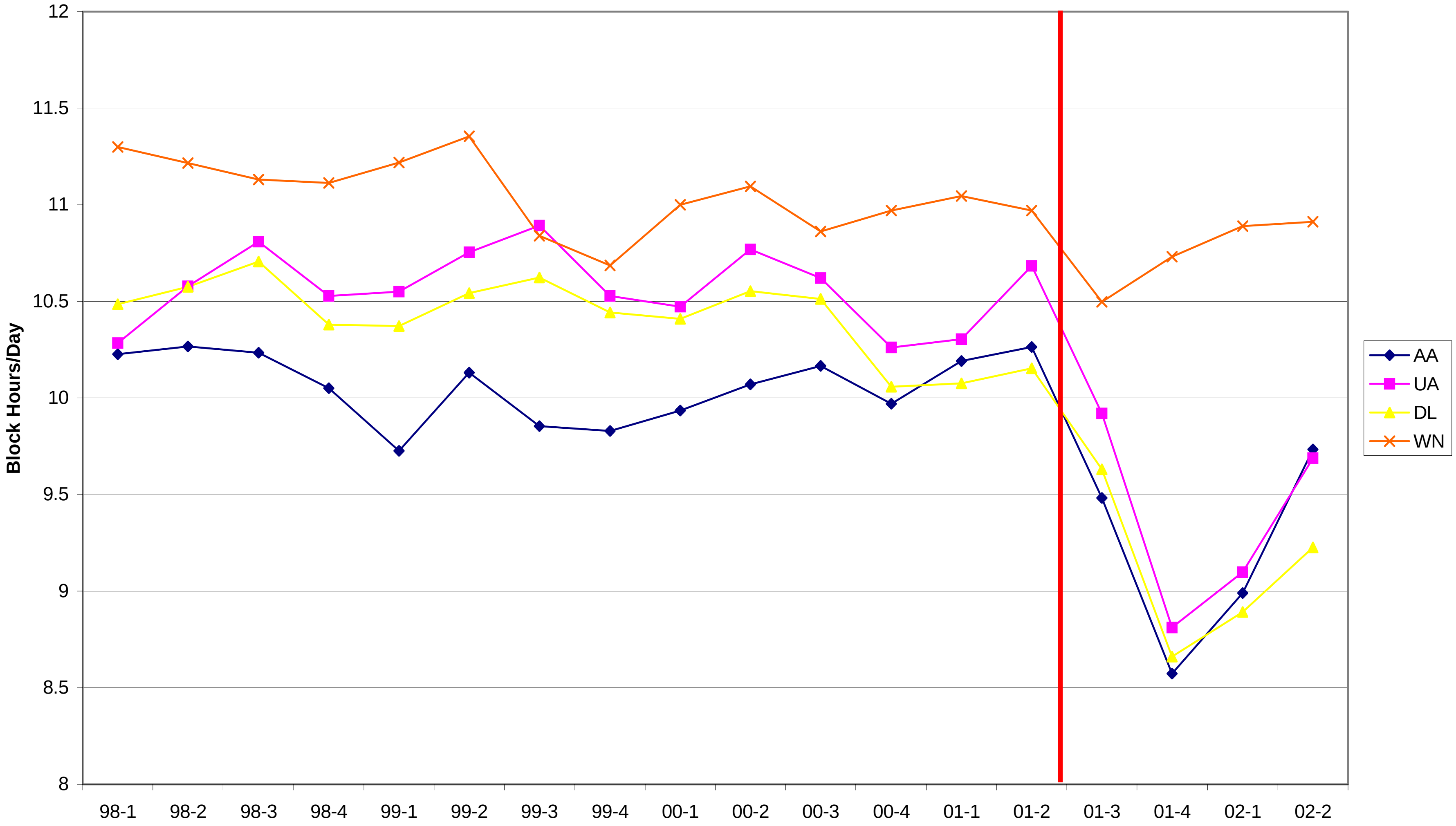
Post-9/11 Setbacks

- Invasion of Afghanistan (Oct 01)
- Iraq War (Mar 02)
- SARS epidemic (Spring 03)
- US Terror Alerts keep security concerns in passengers' minds
- Airline fuel prices soared to record levels (2004-05)

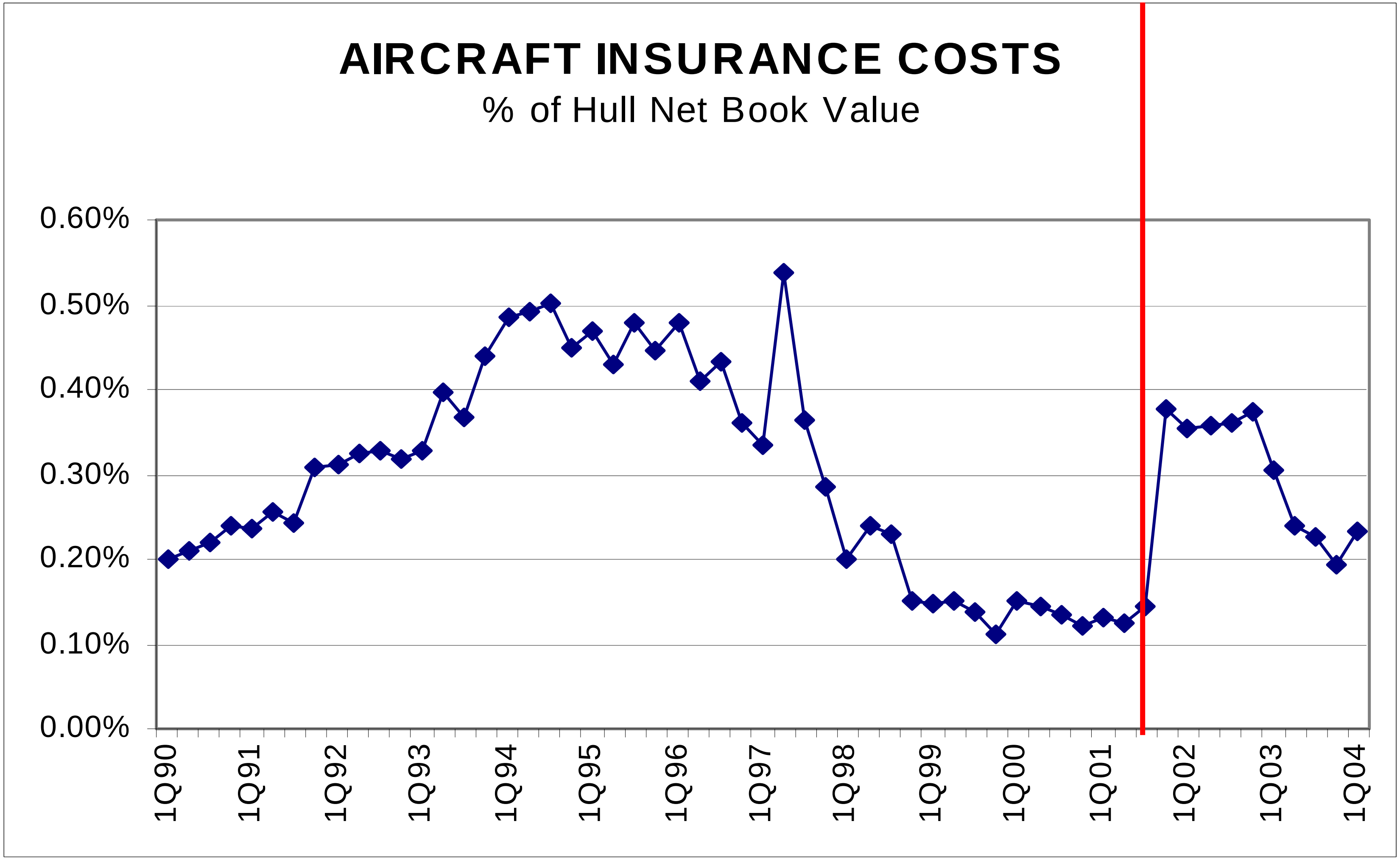
Cost Impacts of 9/11

- **Operating costs increased substantially:**
  - Lower aircraft utilization due to schedule cuts increased unit costs
  - Added security requirements and associated delays further affected productivity
  - Higher aircraft and liability insurance costs
- **New security fees also imposed:**
  - Passenger Security Fee added to passenger tickets
  - Airlines pay Aviation Security Infrastructure Fee to cover TSA screening costs ($315 million in FY04)

Daily Aircraft Utilization by Legacy Carriers Plunged After 9/11 (not for Southwest)

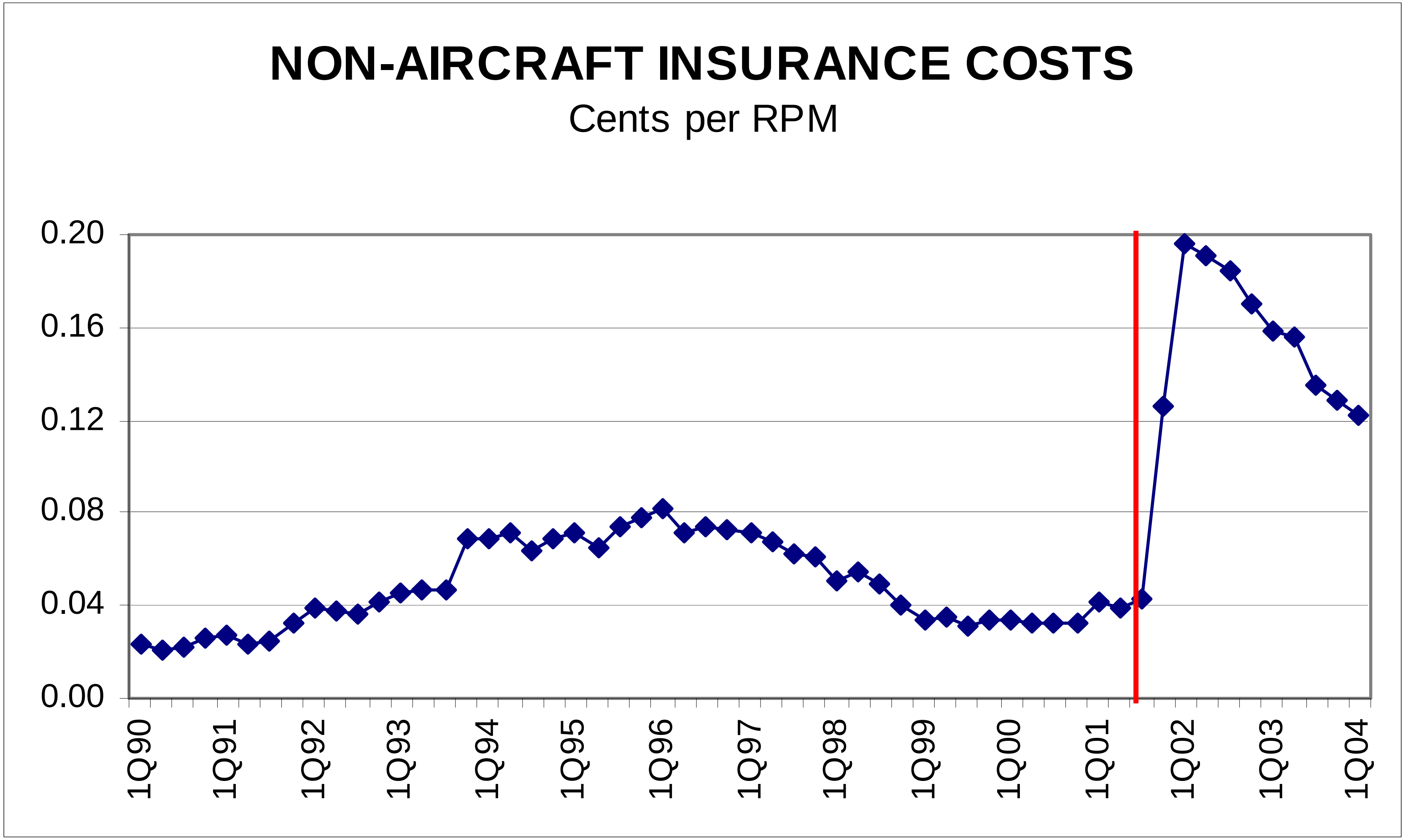


Aircraft Insurance Costs Doubled after 9/11



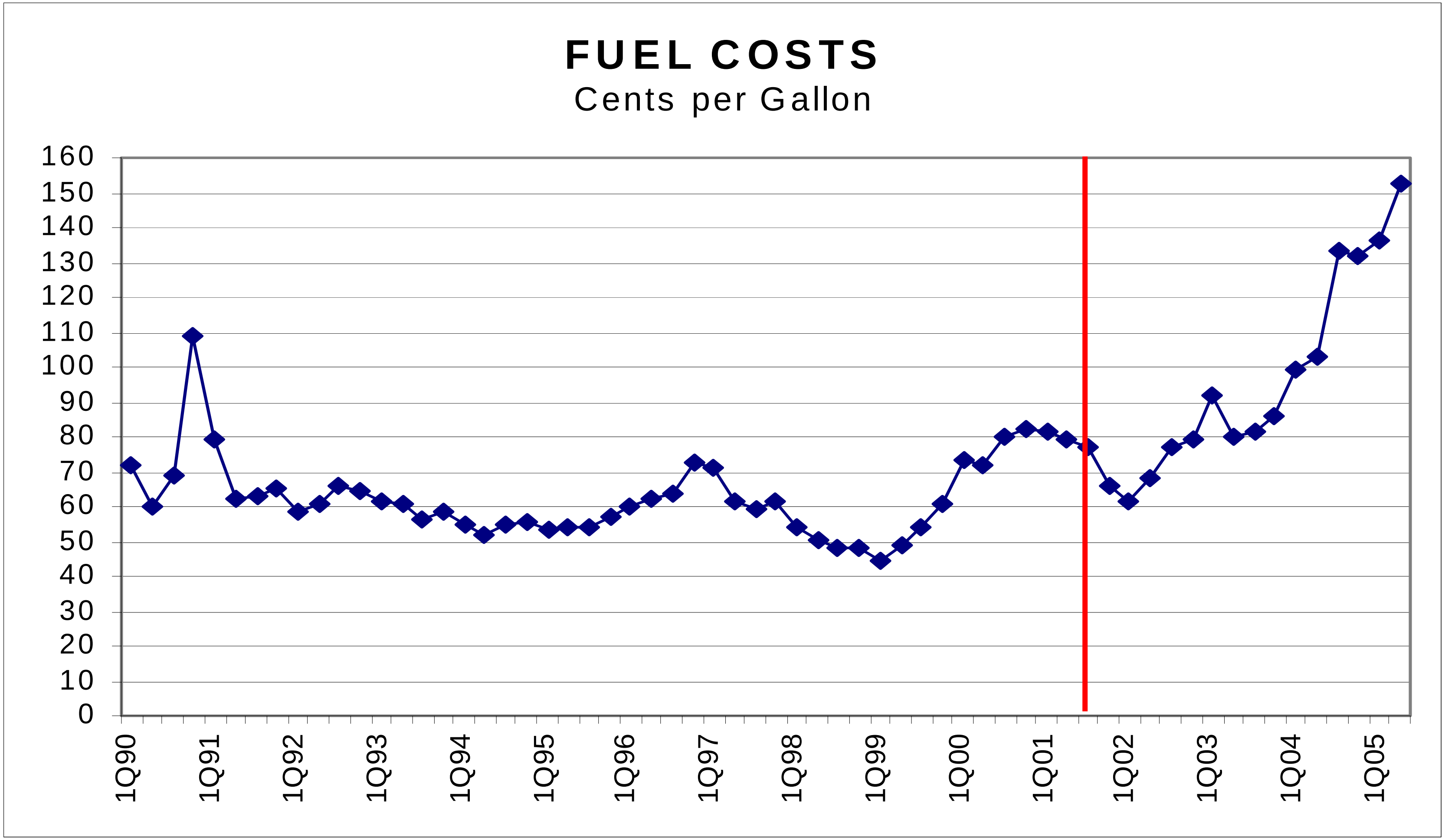
Source: ATA data

Other Insurance Costs Increased by 400%



Source: ATA data

Jet Fuel Prices Up 100% Since Q3 2001

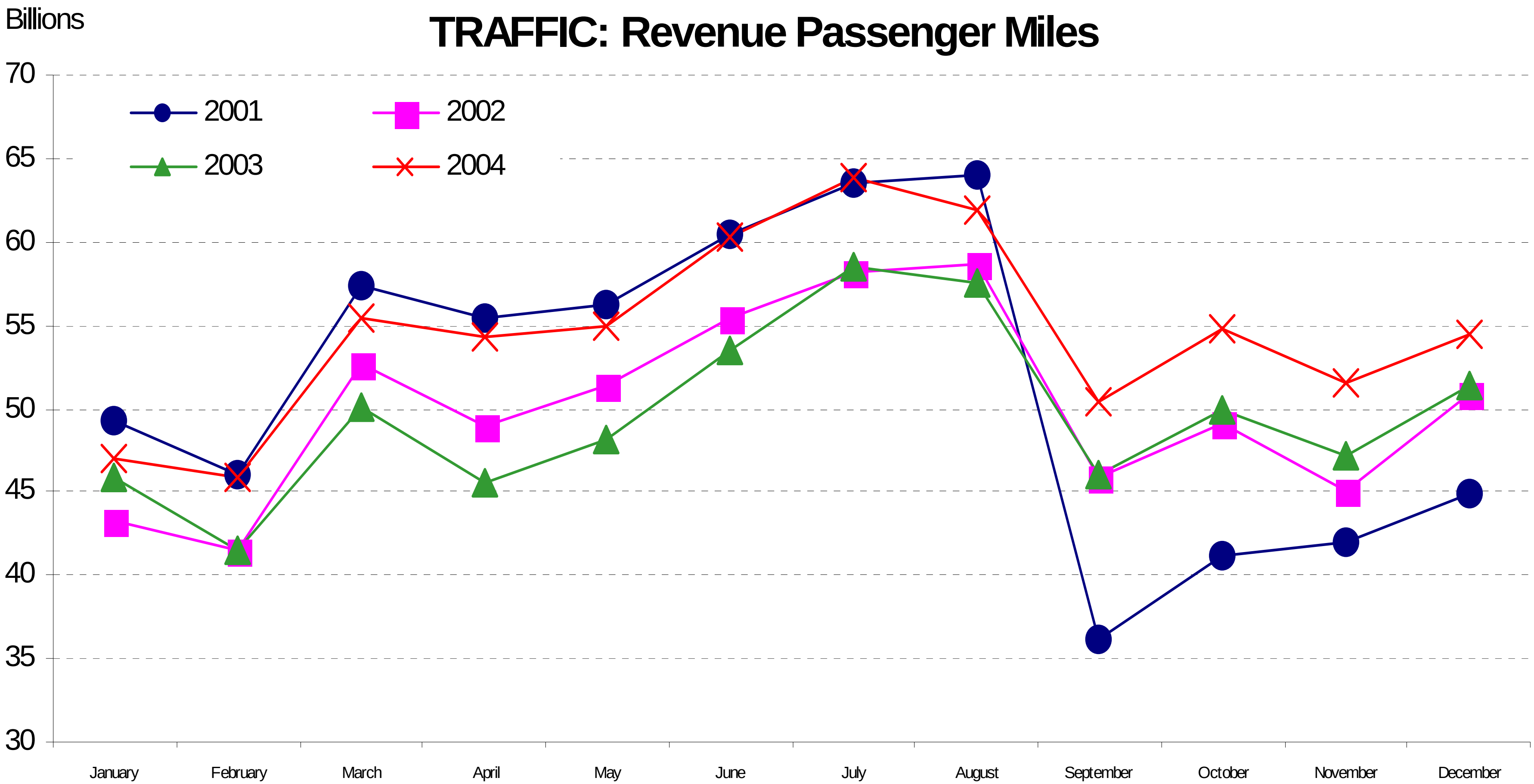


Source: ATA data

4 Years Later, Traffic Has Recovered

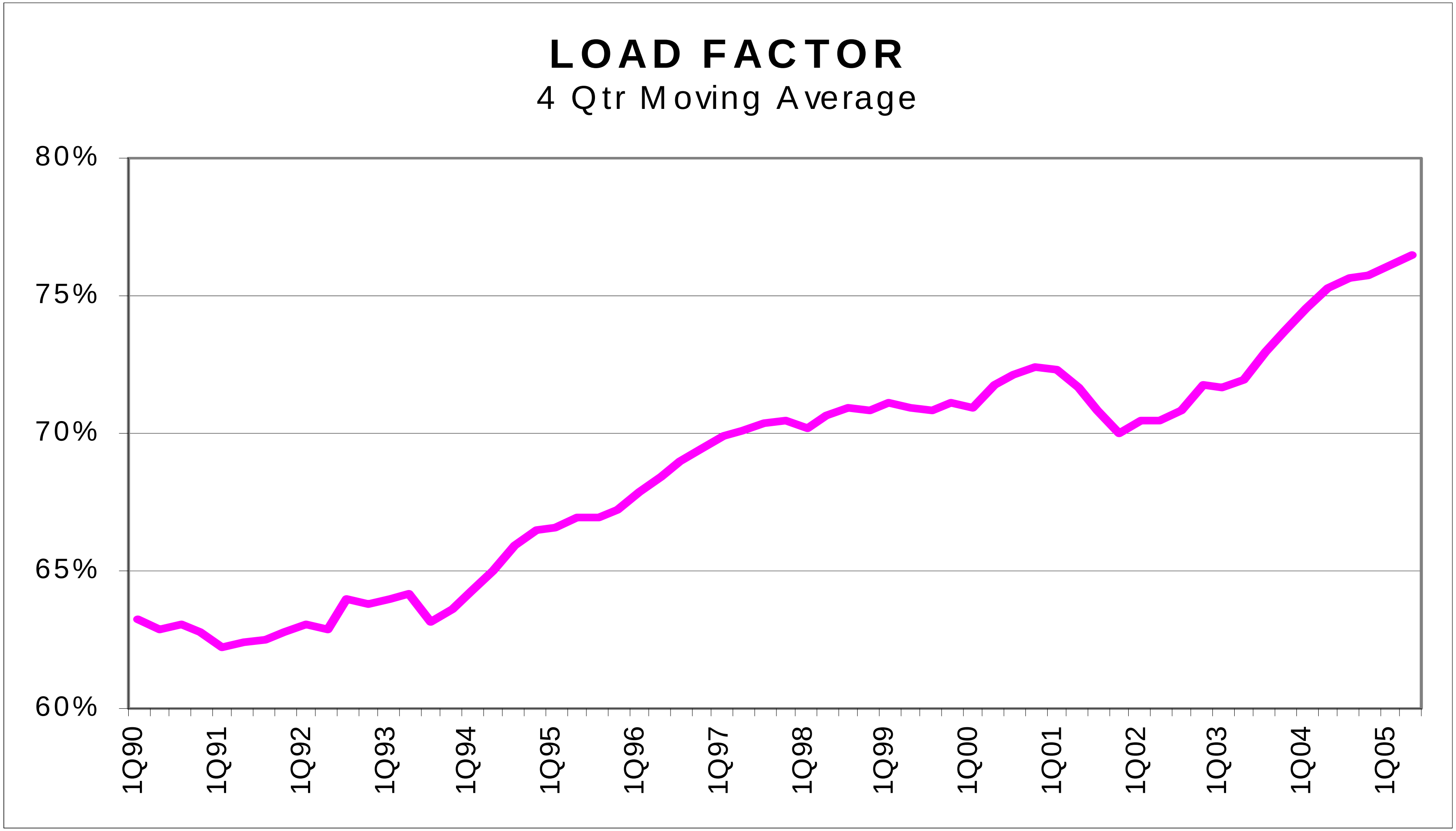
- **US airline RPMs returned to 2001 levels in mid-2004**
  - But August 2005 US airline capacity still 6% lower than August 2001
  - Average load factors are now above pre-9/11 levels – 85.1% ALF in July 2005 is highest month on record
- **No expectation of US industry profits in 2005:**
  - Revenue mix of traffic is weak, despite recovery of traffic and load factors
  - Average fare (yield) is still running about 15% lower than in 2000
  - Record fuel prices have wiped out hopes for profits

Traffic Returned to 2001 Levels in 2004



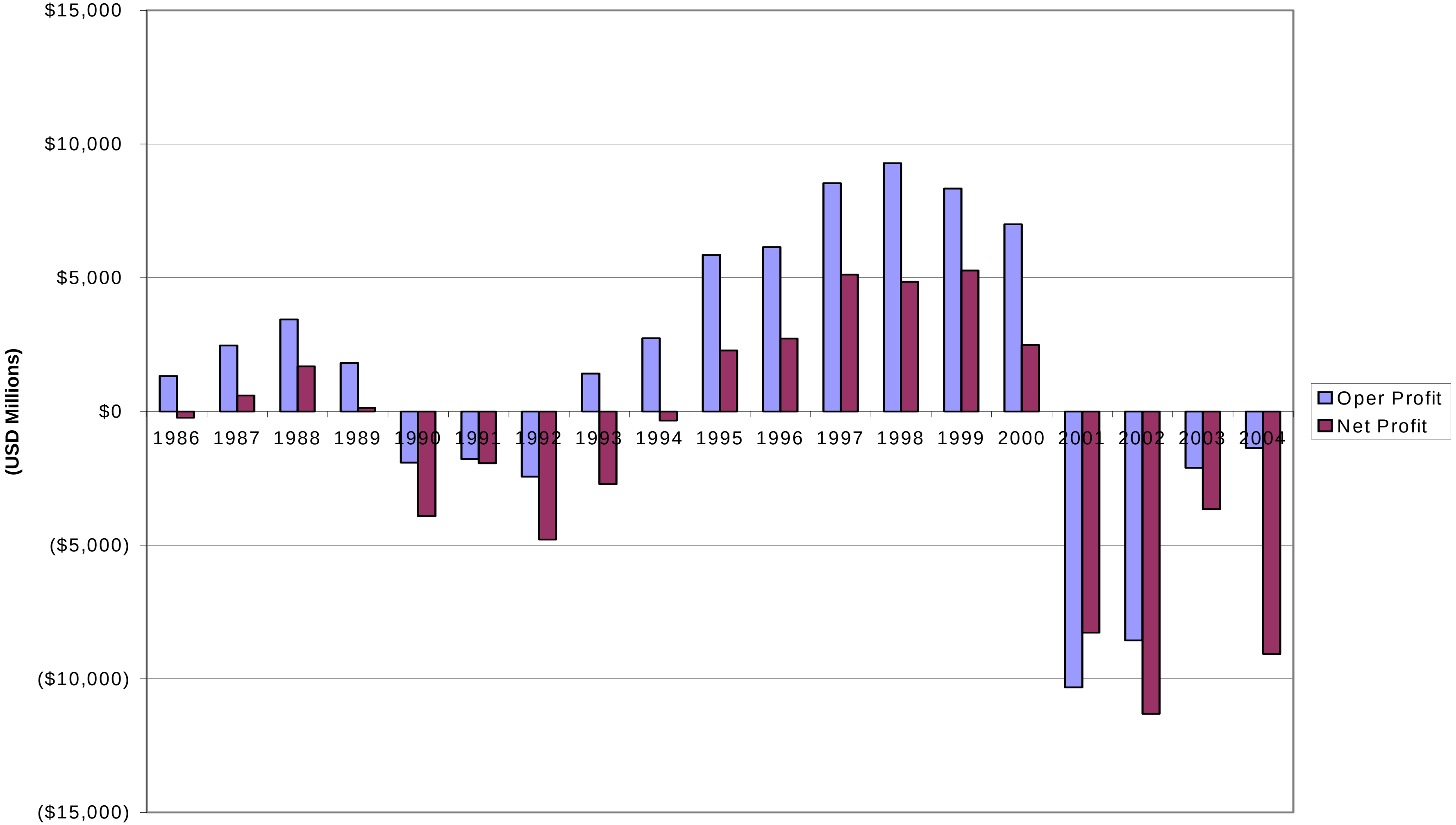
Source: ATA data

Load Factors are at Historical Record Levels



Source: ATA data

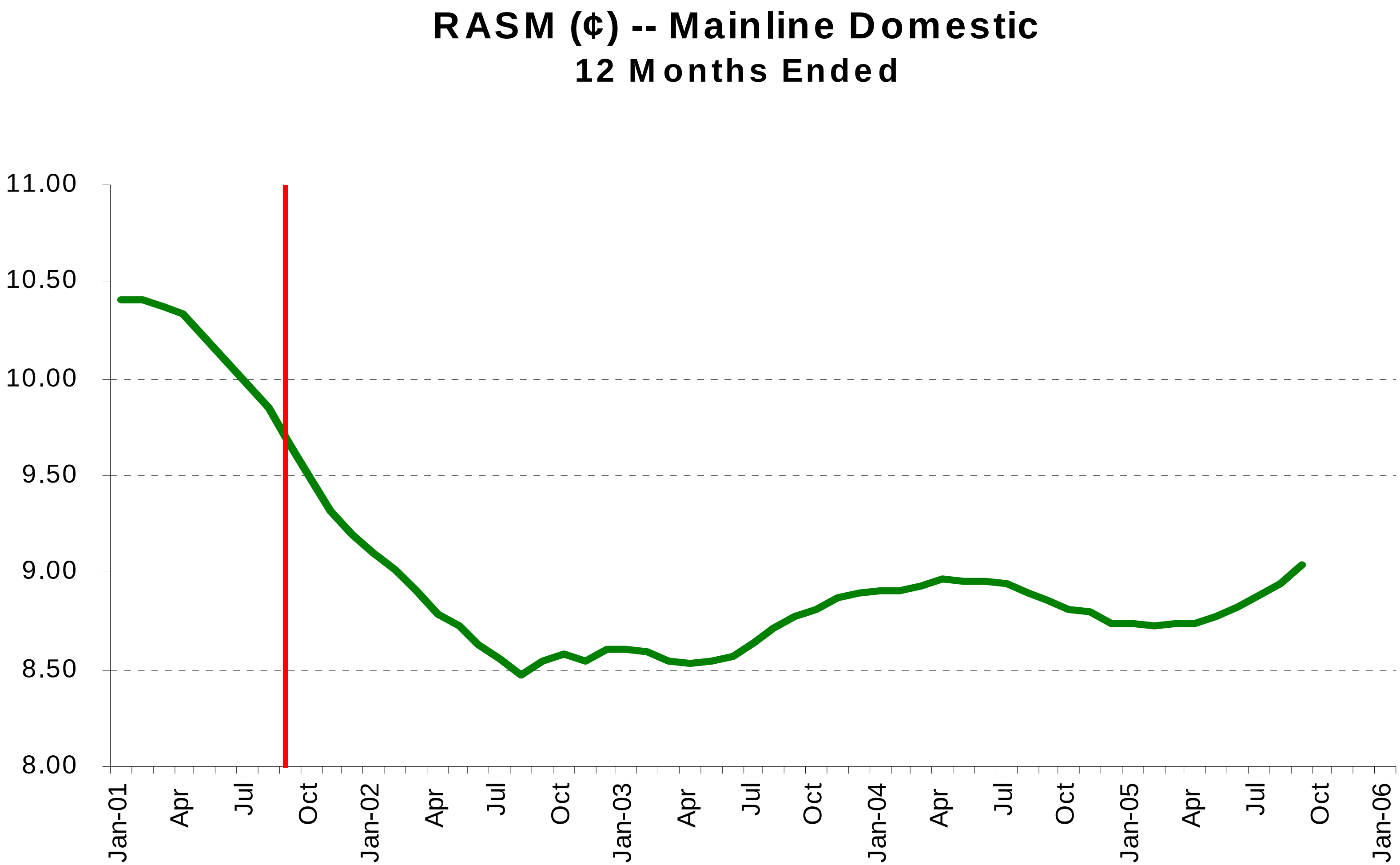
US Industry Losses Over $30 Billion Since 2001



Revenue Challenges: "The Perfect Storm"

- **Revenue power of legacy airlines has disintegrated, with little relation to 9/11:**
  - Business passengers no longer willing to pay 5 to 8 times the lowest available fare
  - Internet distribution channels give more passengers more information about air travel options
  - Cutbacks have reduced service quality differences between network and low-cost carriers
- **Low-fare airlines have taken advantage:**
  - LFA share of domestic passengers increased to 25% in 2004, from 16% in 2000 and only 5% in 1990

Domestic Unit Revenues Are Down 15%

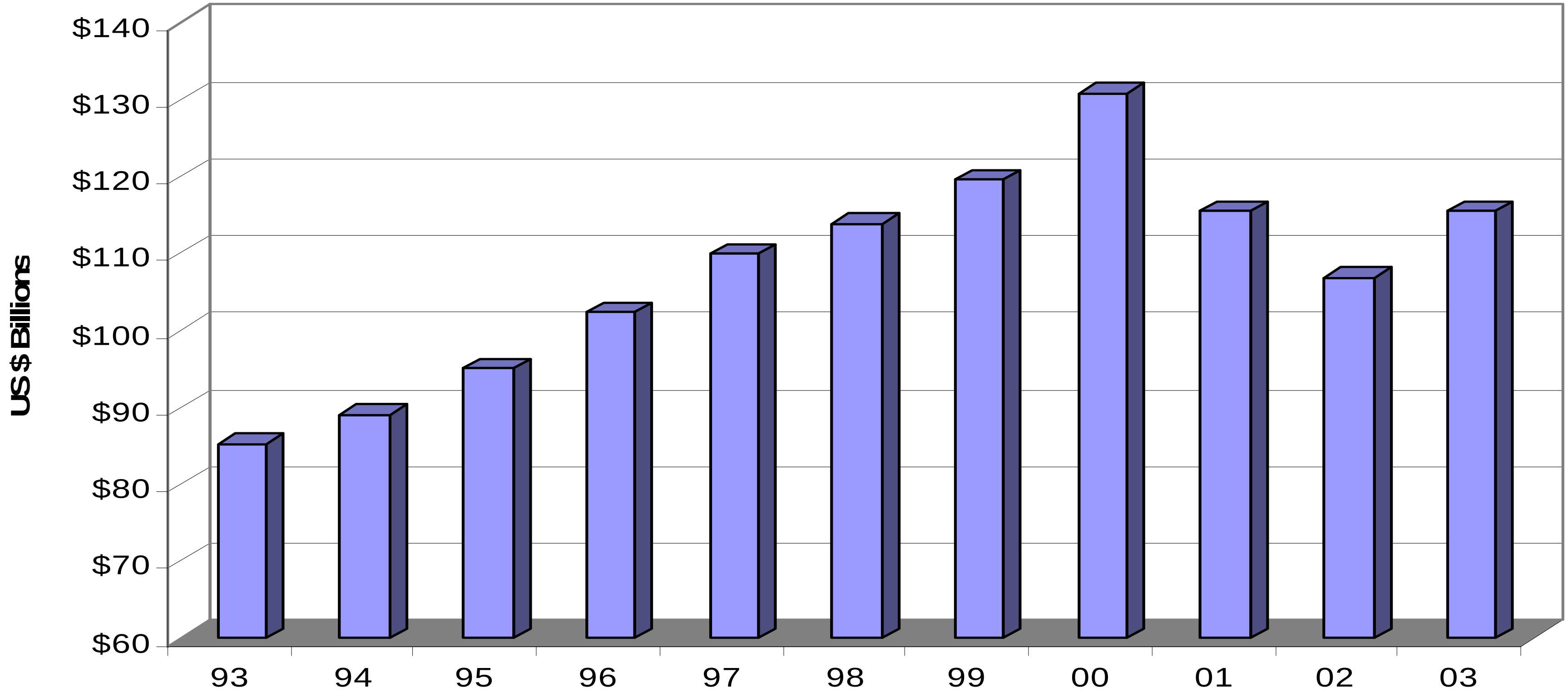


Source: ATA data

Growth of Low Fare Carriers in US

- **Recent conditions favorable for low-fare airlines:**
  - Less business travel overall, reduced willingness to pay for premium services
  - More stable demand for price-sensitive leisure travel
  - Leisure travel demand less affected by post 9/11 "hassle factor"
- **Low-fare carriers threaten the viability of legacy network carriers:**
  - Desperate search for new "business models" to respond and compete with low-fare airlines

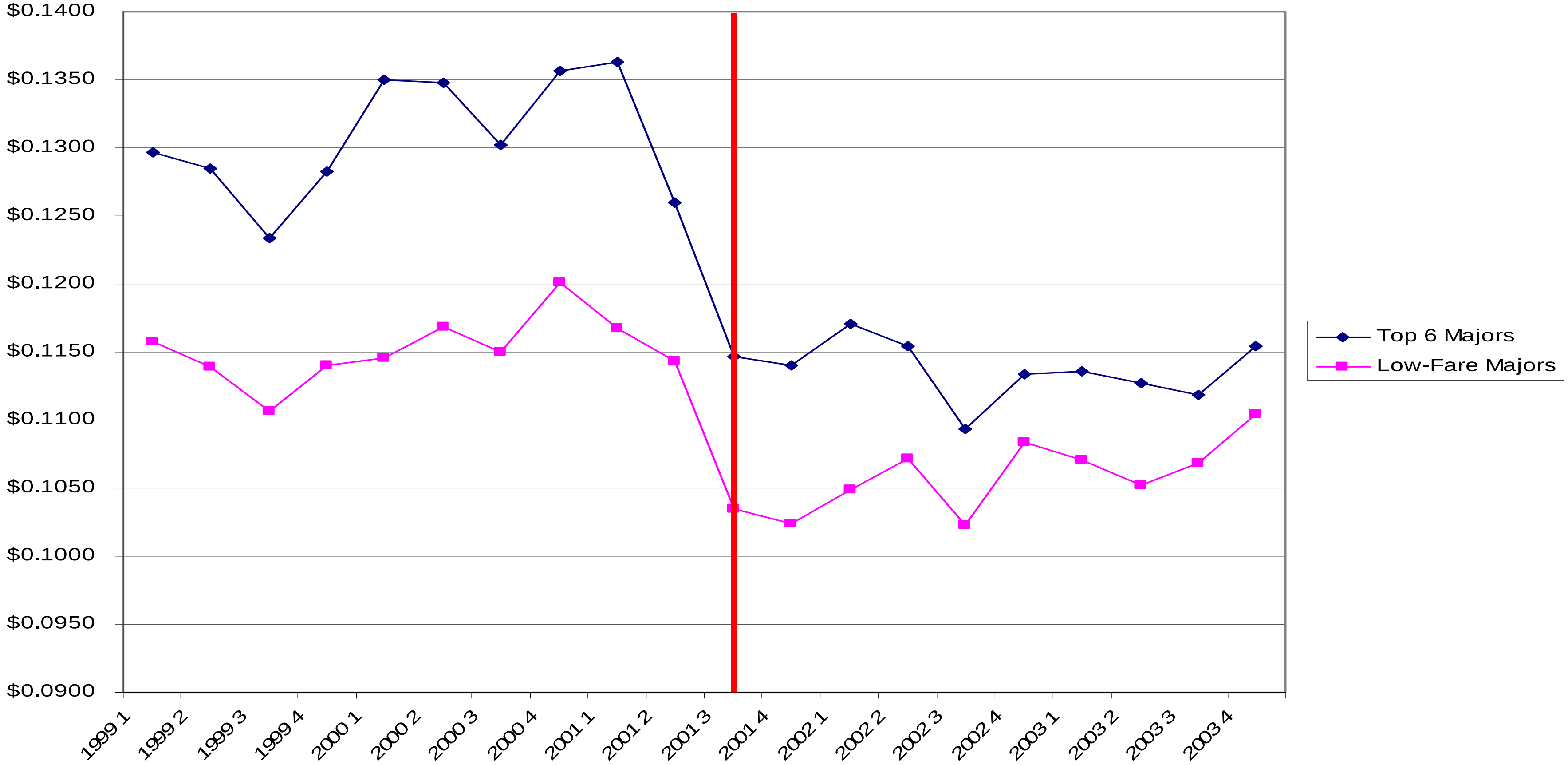
US Airline Industry Revenues



Source: Air Transport Association

Total industry revenues dropped by almost 20% and are still 12% lower than in 2000

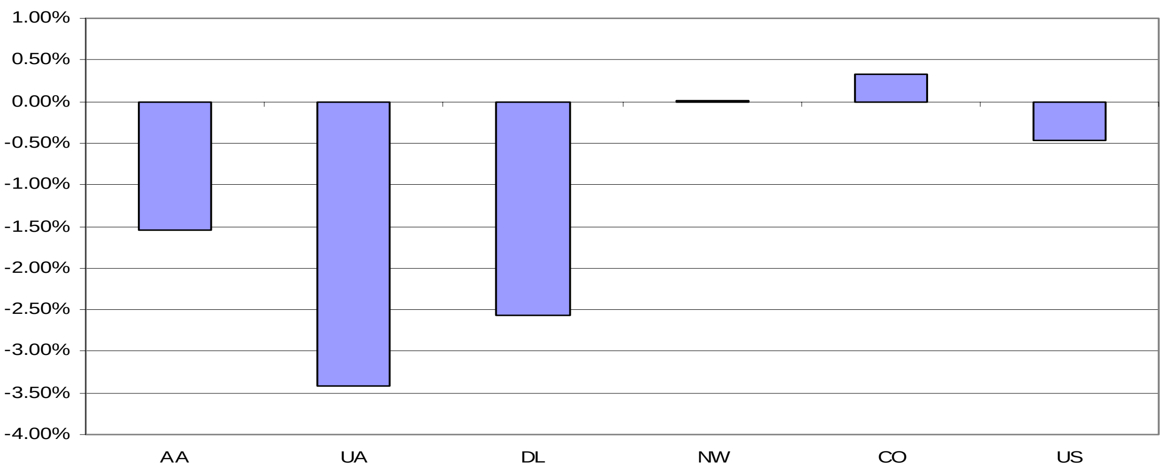
US Airline Yields (Revenue/RPM)



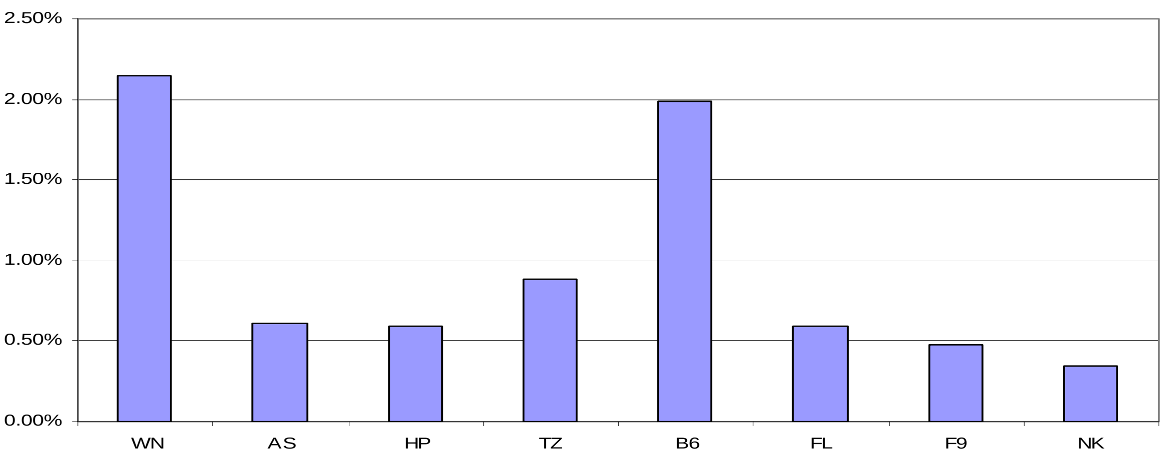
Yields began decreasing prior to 9/11 and have shown little sign of recovery

Change in Market Share by Carrier

Change in % Market Share from 1st Qtr 99 to 3rd Qtr 03

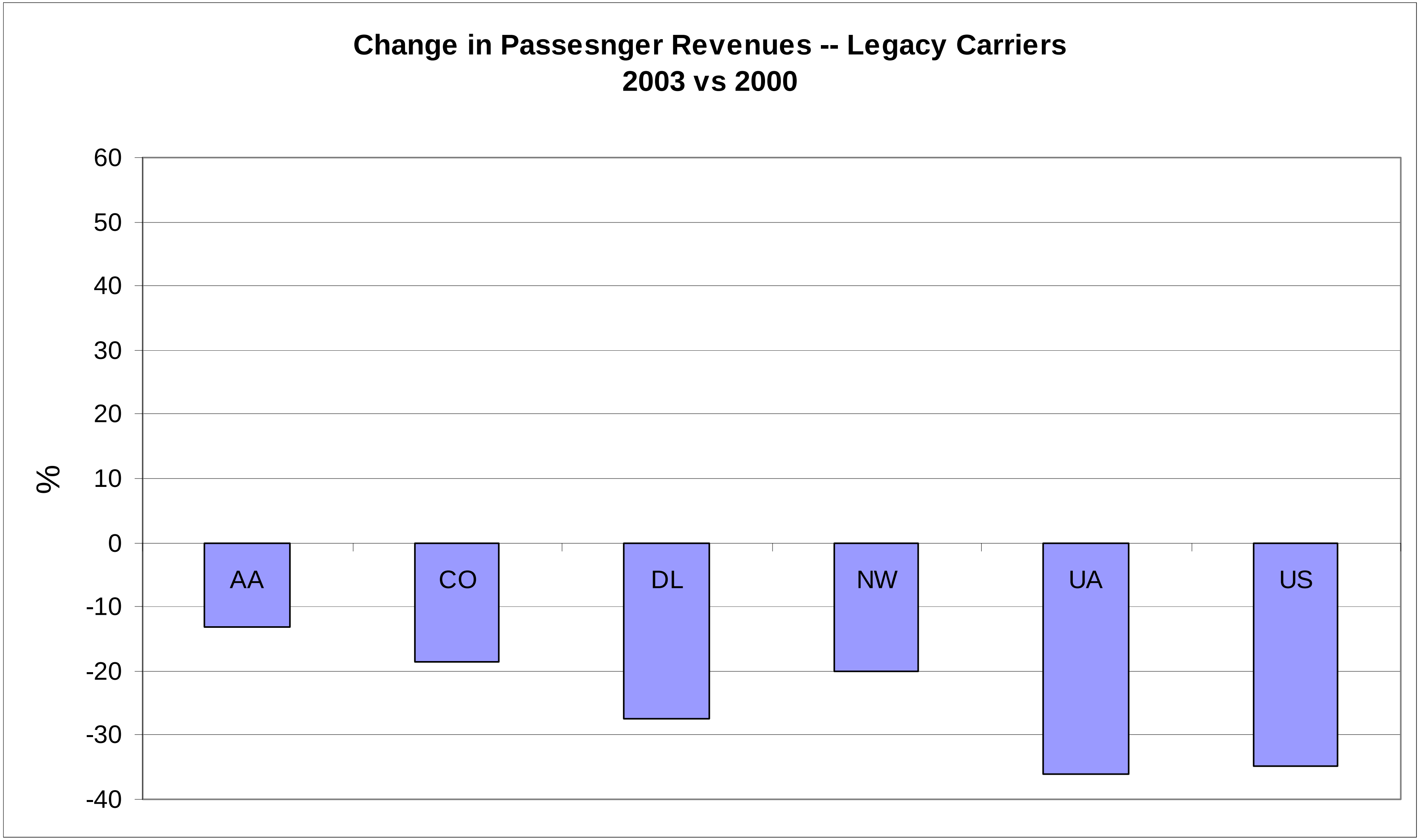


Change in % Market Share from 1st Qtr 99 to 3rd Qtr 03

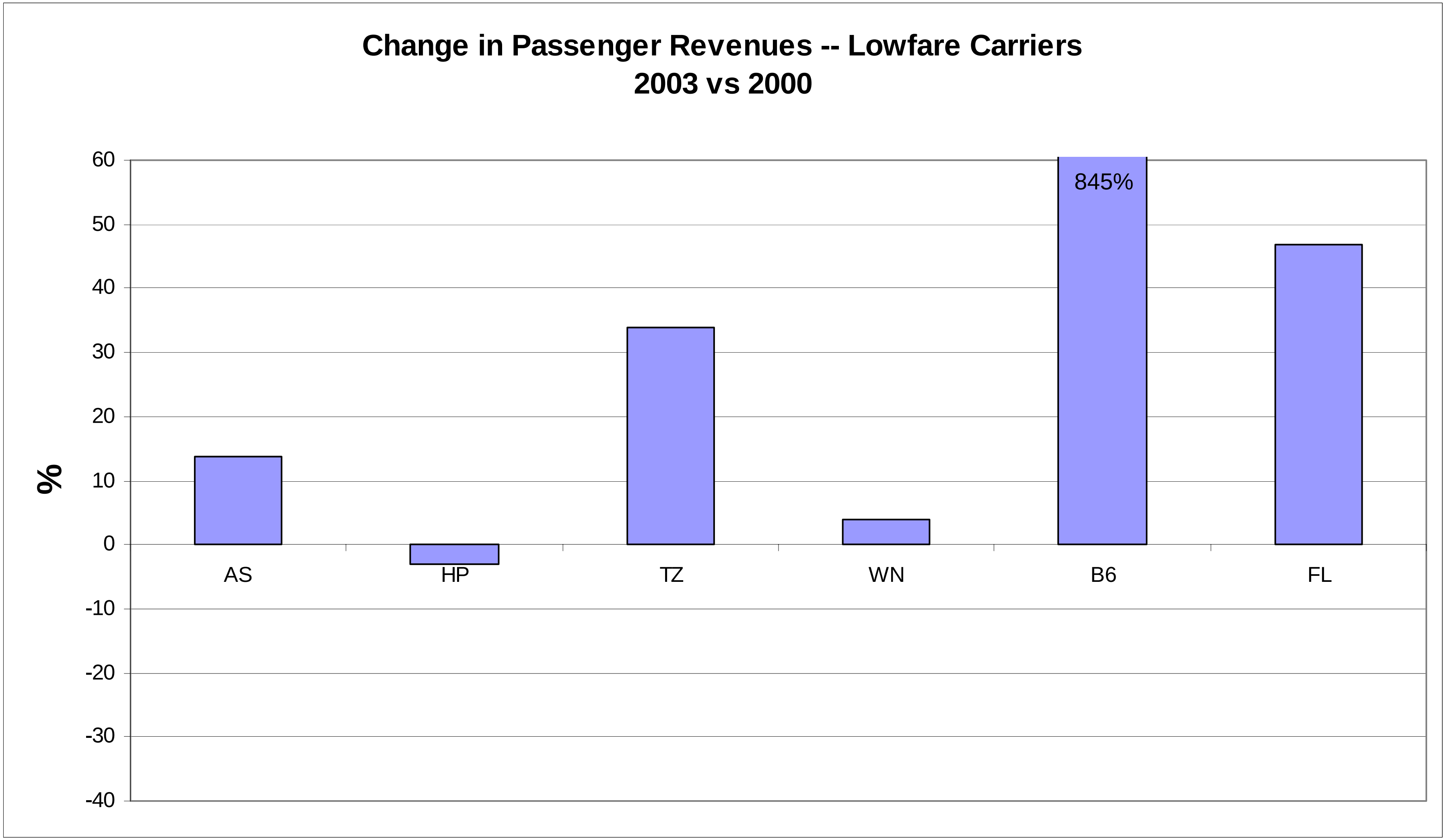


While 4 out of 6 network carriers have lost market share since 1999, all low-fare airlines gained market share during this period, led by Southwest and JetBlue

All Legacy carriers have lost revenues; UA and US revenues down by over 30%



Low fare group has maintained or increased revenues – led by JetBlue, AirTran



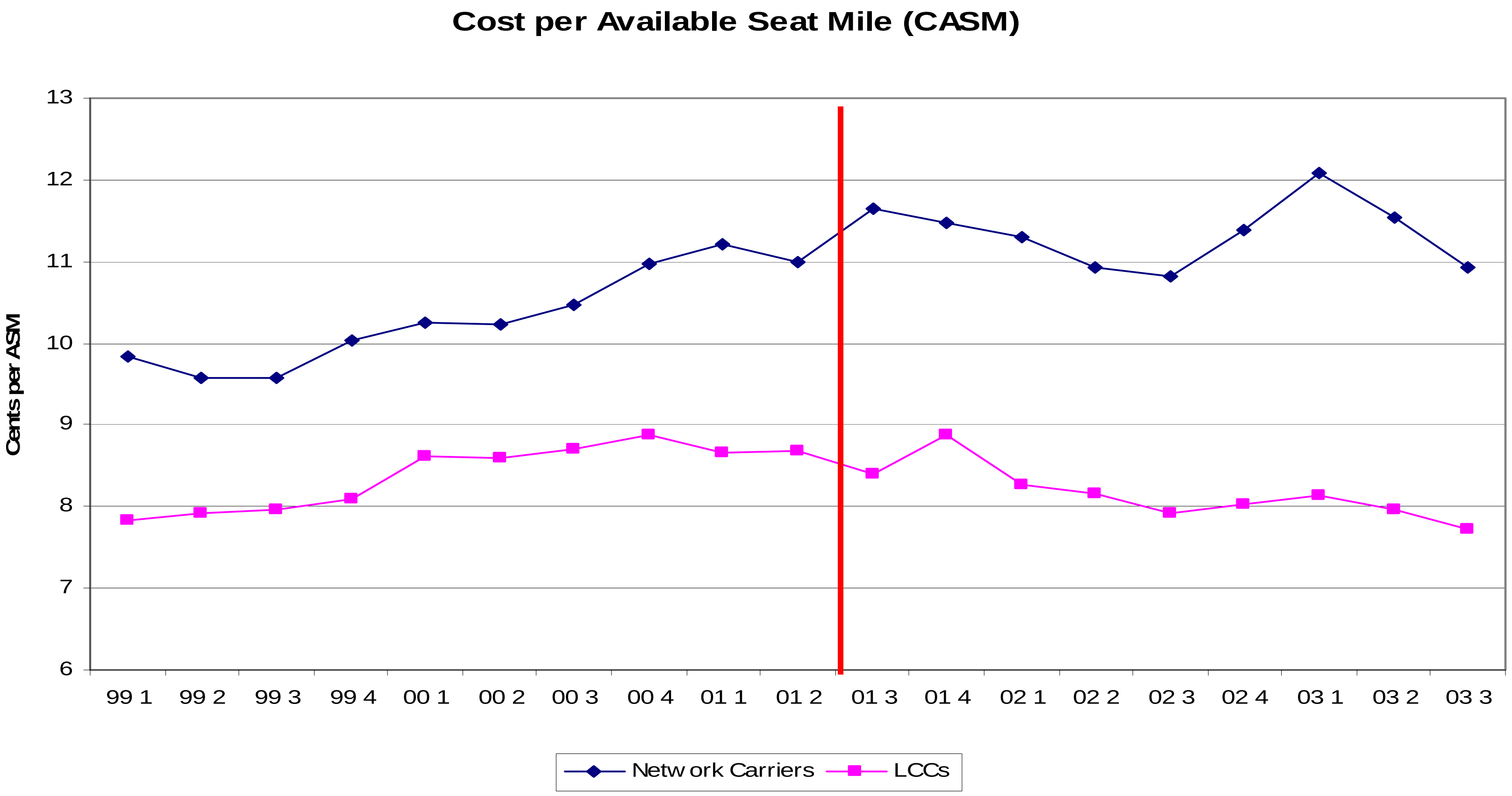
Summary: Revenue Challenges

- **Pricing actions increased unit revenues, but not to previous levels:**
  - Price cuts to stimulate leisure demand have led to record load factors but did not improve revenue quality
  - Efforts to “simplify” fares by removing restrictions have likely re-attracted some business passengers
  - But, fare simplification still leaves unit revenues 10-15% below levels of 2000
- **Conclusion: Pricing actions alone cannot return the network airlines to profitability**

Cost and Productivity Challenges

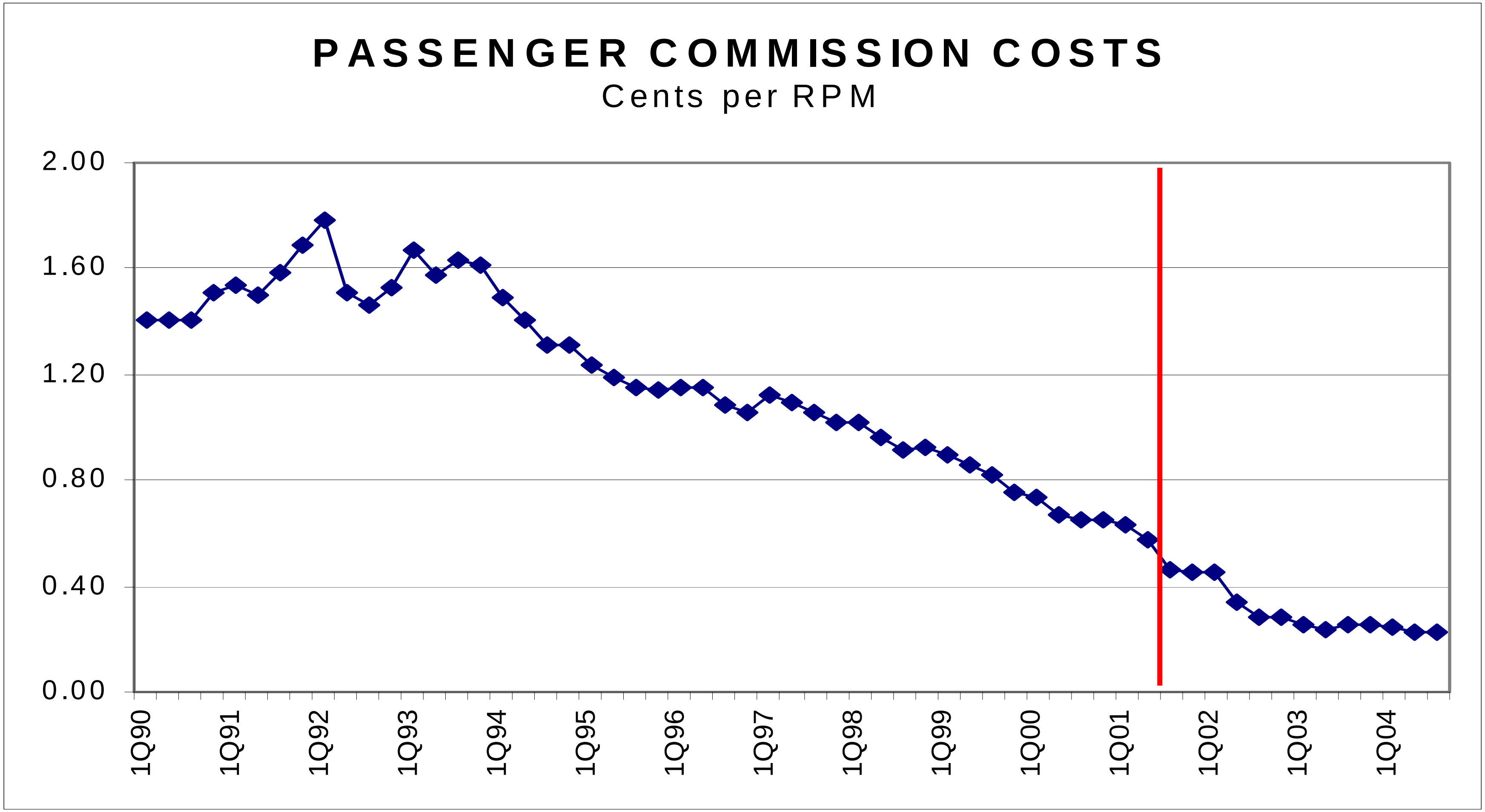
- **Given revenue shortfall, legacy airlines must cut costs and increase productivity:**
  - Low-cost carriers often used as “benchmark” for unit costs
  - Changing work rules, reducing workforce and cutting wage rates are all options for reducing labor unit costs
  - Unit cost differences also due to aircraft productivity:
    - ➔ Point-to-point vs. hub-spoke networks
    - ➔ Seating density
    - ➔ Scheduling and aircraft ground turn-around times

US Airline Unit Costs (per ASM)



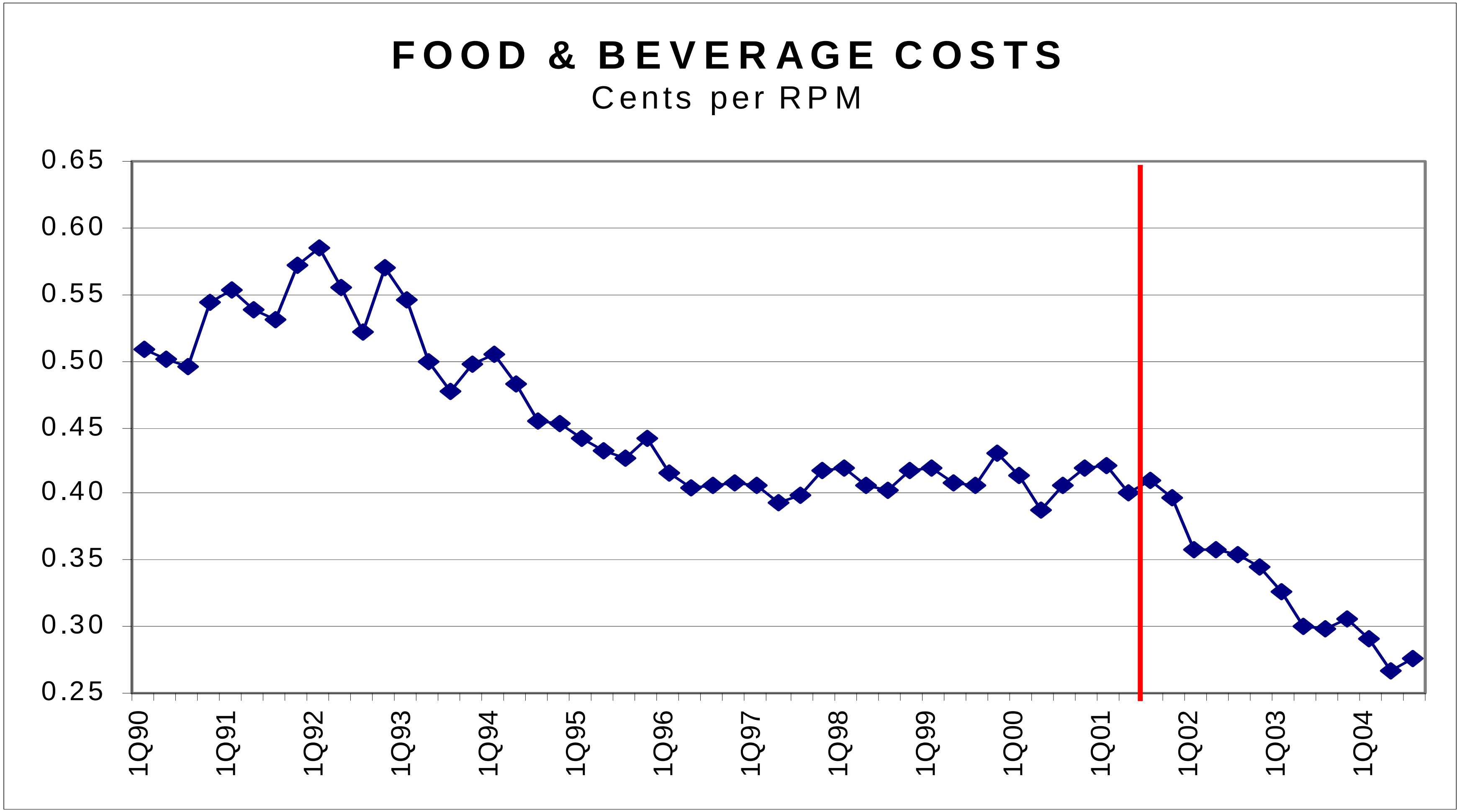
Unit Costs differences between network carriers and LCCs remain despite cost-cutting efforts

Travel Agency Commissions All But Eliminated – Down 85% Since 1994



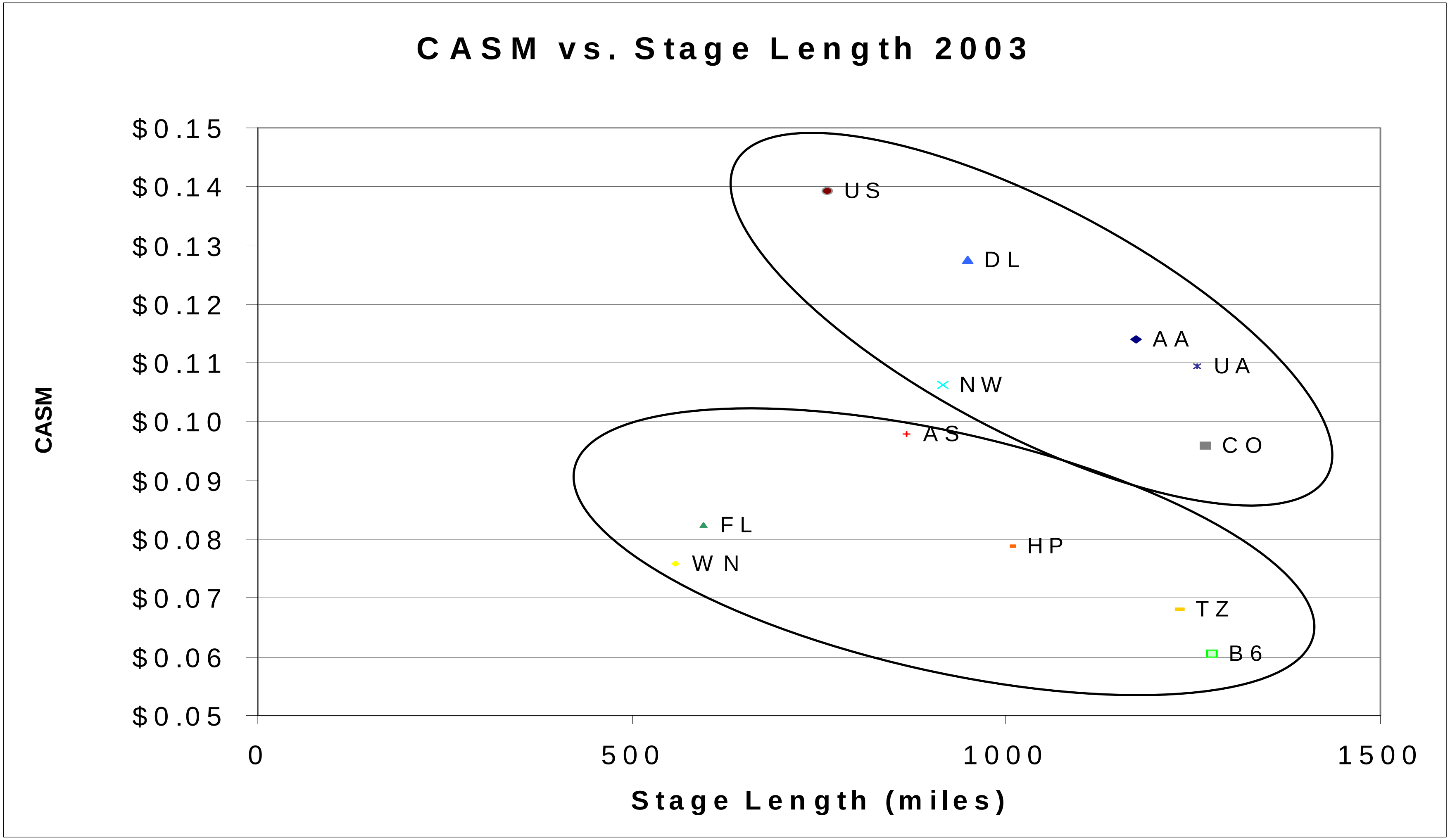
Source: ATA data

Food and Beverage Costs Cut in Half



Source: ATA data

Lowfare carriers have lowest CASM across all average stage lengths



US Airline Performance Since 9/11

- **US airline industry is in the midst of its greatest transition in history**
  - Fundamental shifts in airline business models
  - More efficient new entrants with much lower costs
  - Changes envisioned by architects of deregulation more than 25 years ago
- **9/11 was not the primary cause of this "crisis"**
  - It did lead to increased operating costs
  - Subsequent unfortunate events have not helped
  - But new competition is transforming the industry

Key Questions for the Future

- **What industry structure will emerge?**
  - Will (most) network carriers be able to adapt and survive?
- **What are the new revenue/operating paradigms for network carriers?**
  - Are LCC pricing and operating models broadly applicable?
- **What will be the impact on small markets?**
  - Most domestic O-D pairs can only be served with a hub network
- **Should the government intervene?**
  - Disruption of “re-structuring” process spurred by market forces

Questions for This Forum

- **Are we ready for another 9/11?**
  - Even if we are, unlikely that the next major terror attack will mirror the events of September 2001
- **Can airlines survive another terror attack?**
  - Return of traffic worldwide after 9/11 and subsequent setbacks illustrates the tremendous resiliency of air transportation
  - But, not all airlines (both US and elsewhere) will survive the current industry restructuring, and this has little to do with 9/11