

## RISKS TO THE FORECAST

The FAA is once again “cautiously optimistic” that its current outlook for aviation demand and activity can be achieved. As has been the case for the past several years, terrorism remains the greatest risk to achieving the forecasts. Tighter security measures have restored the public’s confidence in the integrity of U.S. and world aviation security systems. However, because of aviation’s high visibility and global reach, concerns remain about international terrorism. Any terrorist incident aimed at aviation would have an immediate and significant impact on the demand for aviation services. In addition, there has been much discussion about a worldwide pandemic with the Asian flu. Should such an event occur, it is likely that severe limits on aviation would be enacted and would have a significant impact on the demand for aviation services.

Terrorist and pandemic concerns notwithstanding, this year’s forecast is driven, at least in the short-term, by the weakened financial health of the commercial aviation industry, which, in turn, is inextricably tied to what appears to be a permanent shift to higher jet fuel prices.

Oil prices peaked at \$70/barrel in late August 2005 and then fell below \$57/barrel by mid-November. However, prices then gradually rose to over \$61/barrel by mid-December. Most economic projections now assume that oil prices will remain in the \$45-\$55/barrel range over the next several years, with \$40/barrel being touted as the new floor for future oil prices.

Higher fuel prices cost U.S. commercial air carriers \$9.6 billion in fiscal year 2005, essentially wiping out the significant improvements made by the legacy carriers in reducing their operating costs. The legacy carriers, which currently account for 62 percent of the industry’s domestic capacity and carry 52 percent of the industry’s domestic passengers, are most at risk from higher fuel prices. If oil prices (and jet kerosene prices) had stayed at 2004 levels in 2005, most carriers, including several legacy carriers, would have been profitable. This year’s forecast assumes \$54/barrel oil in 2006, falling gradually to under \$51/barrel by 2010. With oil prices in the \$50-\$55 range, it is unlikely the industry will return to profitability in 2006. In a high oil price scenario, the potential exists for major supply disruptions/dislocations and/or increased passenger inconveniences, either of which could significantly lessen capacity and passenger demand and reduce competition in many markets. In a \$70/barrel plus scenario, supply disruptions would most likely occur through liquidation and/or further contraction of mainline carrier route structures. Under this scenario, several large U.S. airports could lose their major service provider. In a \$60-\$65/barrel scenario, supply disruptions could occur through industry consolidation and/or contraction of legacy carrier route networks. However, it is unlikely that any airport would lose its major airline tenant.

Low-cost carriers are forecast to continue to increase their share of domestic traffic over the forecast period. However, except for Southwest, the 2005 financial performance of these carriers was, at best, mixed. Although most of the current low-cost carriers appear to have greater financial stability and access to funding than previous start-ups, continued high fuel prices, a prolonged slump in travel demand, and/or a prolonged fare war could cause these carriers to scale back planned growth and/or cease operations. In addition, low cost carriers have a significantly smaller percentage of their future

fuel needs hedged. With the apparent permanent shift to higher jet fuel prices, the cost gap between low-cost carriers and the legacy carriers should narrow, reducing the competitive advantage that many of the low-cost carriers currently enjoy. Any loss of competition could lead to higher fares and a loss of passenger demand.

Also, the forecast assumes continued high traffic and capacity growth among regional carriers, including the addition of sizable numbers of regional jets into their fleets. However, these carriers' future is closely tied to those of the larger legacy carriers. Should one or more of these large carriers cease to exist (three are operating under Chapter 11 bankruptcy protection), several regional carriers could find themselves either saddled with excess capacity or lack of sufficient capacity to accommodate future growth. The nature of this risk depends on whether the regional carrier or the legacy carrier owns or leases the aircraft. Already in both the Delta and Northwest bankruptcies, regional partners are seeing legacy carrier needs for regional flying substantially reduced.

Although FAA uses economic projections from OMB to derive the forecasts of aviation demand, an important part of the FAA forecast process is to compare the OMB forecasts with other economic forecasts. FAA typically compares OMB economic forecasts to those of Global Insight, Inc., a leading economic consulting firm. Global Insight's U.S. GDP forecast is similar to OMB's. Growth in U.S. GDP is projected to average 3.1 percent a year between 2005 and 2010 compared to the OMB forecast of 3.3 percent a year. In addition, Global Insight regularly provides alternative forecasts and assigns a likelihood of their occurrence; along with the likelihood of the baseline forecast occurring. In January 2006, Global Insight was assigning a 55 percent likelihood of their baseline forecast. An optimistic scenario—higher economic growth in the rest of the world, lower oil prices, and a continuation of the information-driven technology boom—that results in higher U.S. economic growth was assigned a 20 percent likelihood by Global Insight. Higher economic growth would lead to increased demand for aviation services and speed the industry's return to profitability.

However, Global Insight's pessimistic scenario—a weaker dollar, rising oil prices, higher inflation, and rising unemployment—that results in slower U.S. economic growth was assigned a 25 percent likelihood. Slower economic growth would not only slow the recovery in the demand for aviation services but would also hamper and slow the industry's return to profitability.

The global economy recovered from 5 years of weak and uneven growth in 2004, posting strong gains throughout the world. Although the current forecast calls for a return to higher historical growth rates throughout the forecast period, there are many downside risks inherent in these forecasts. The fate of the global economy will continue to depend on the sustainability and strength of U.S. economic growth, with most world regions counting on strong export growth to the United States as a major contributor to their future economic growth. If, as predicted, the U.S. dollar continues to fall, strong U.S. economic growth may not translate into strong U.S. import growth. If this occurs, global economic growth could remain sluggish for some time into the future.

In addition, there are potential geopolitical risks that could slow global economic growth, i.e., the uncertain political situations in several major oil exporting countries. Doubts also remain over the strength of domestic demand in both Japan and the Eurozone as these countries continue to be constrained by structural economic problems, political gridlock, institutional constraints, and the authorities' reluctance to take decisive action. The current forecasts assume strong passenger growth for travel between the United States and other world regions. Any slowing of global economic activity could seriously inhibit the growth in world passenger demand.

Historically, international markets have been subject to a series of bilateral agreements that have, for the most part, severely restricted competition. However, if current negotiations between the U.S. and the European Union are successful, more U.S. carriers could gain access to new markets and introduce new competition in the North Atlantic market. Greater competition could lead to lower fares and higher growth in these markets.

The demand for general aviation products and services, including business jets, appears to be recovering. How quickly the industry recovers depends, in large part, on the strength of the market for business jets and microjets. How quickly this flying segment responds to forecast economic growth will go a long way in determining whether general aviation achieves the predicted increases in the demand for its products and services.

The current forecast assumes the introduction of low priced micro jets starting in 2006, with the market growing to 4,950 by 2017. This is a relatively conservative assumption compared to some industry estimates. If the higher industry estimates are correct, the general aviation active jet fleet and hours flown could be higher than forecast.

The mix of aircraft operating at most large hubs is also expected to become increasingly complex over the forecast period. The expected large increases in the numbers of smaller regional jets and new microjets will increase the complexities of the national airspace system and make the FAA's job more challenging. The increased complexity of the mix of aircraft serves to compound the increases in workload strictly due to the increasing demand for aviation services projected over the forecast period.

Delays occurred at many U.S. airports in 2005 and could become a critical limit to growth over the forecast period. Based on the 2005 FAA Terminal Area Forecasts, 23 of the 35 Operational Evolution Plan (OEP) airports currently exceed pre-9/11 activity levels. In addition, another two airports are expected to reach or exceed pre-9/11 levels over the next 2 years.<sup>11</sup> FAA's forecasts of both demand and workload are unconstrained in that they assume that there will be sufficient infrastructure to handle the projected levels of activity. Should the infrastructure be insufficient and result in more delays, it is likely that the forecasts of both demand and workload would not be achieved.

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<sup>11</sup> *Tampa in 2006; New York Newark in 2007.*