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Cost Differences Suggesting a New Mid-Term Structure?

William S. Swelbar, Research Engineer, MIT

FAA Forecast Conference

April 2009

Backdrop for the Discussion

- In June of 2008, we published a piece in the ***Journal of Air Transport Management*** entitled: *Cost convergence in the US airline industry: An analysis of unit costs 1995–2006*
  - **Our initial analysis looked at the Network Carriers v. the Low Cost Carriers**
- We are long overdue in re-thinking the correct descriptors to describe the various sectors of the US airline industry
  - Network, Regional, LCC and Other (Alaska, Hawaiian, Allegiant etc)
  - Price of product or service often primary determinant to purchase
- If price the primary determinant of purchase, then **cost was the best descriptor**. But, there has been a **convergence in costs --** where controllable.

Backdrop for the Discussion

- Cost differences increasingly difficult to discern and are mixed
- **Increasing discussion that the hospitality industry provides a way to think about the US airline industry.**
  - With that said,
    - **Network Carriers:** AA, CO, DL, UA, US – neither upscale or luxury but **breadth of network** – global and domestic – establishes the brand/product
    - **Southwest:** only real established brand. The carrier from which all comparisons are made – rightly or wrongly. Network today a large US footprint.
      - Southwest skews results when grouped with other LCCs/Midscales
    - **Midscales:** jetBlue, AirTran, Frontier – quality service with amenities at a market price. Network largely centered on North America and Caribbean
      - Alaska excluded due to data issues
    - **Economy:** Spirit, Allegiant – budget traveler. Reasonable quality at a low price. Network focus on secondary and tertiary markets to largest leisure destinations.
      - Excluded from this analysis due to data issues

Backdrop for the Discussion

- **We should not have this conversation without a piece on revenue – I know, but…….**
  - Fare compression along all points of the domestic yield curve
  - Low fares available on all carriers regardless of sector
    - Distribution systems virtually ensure this
  - Operating costs historically the determinant of segmenting
  - Network carriers still drive a fare premium, only 2/3 of historic level
  - Southwest, AirTran, jetBlue and Frontier aggressively searching for new revenue sources
  - Assume that network carriers at least cover cost of "purchased feed"
- **So let's talk about unit costs……..**

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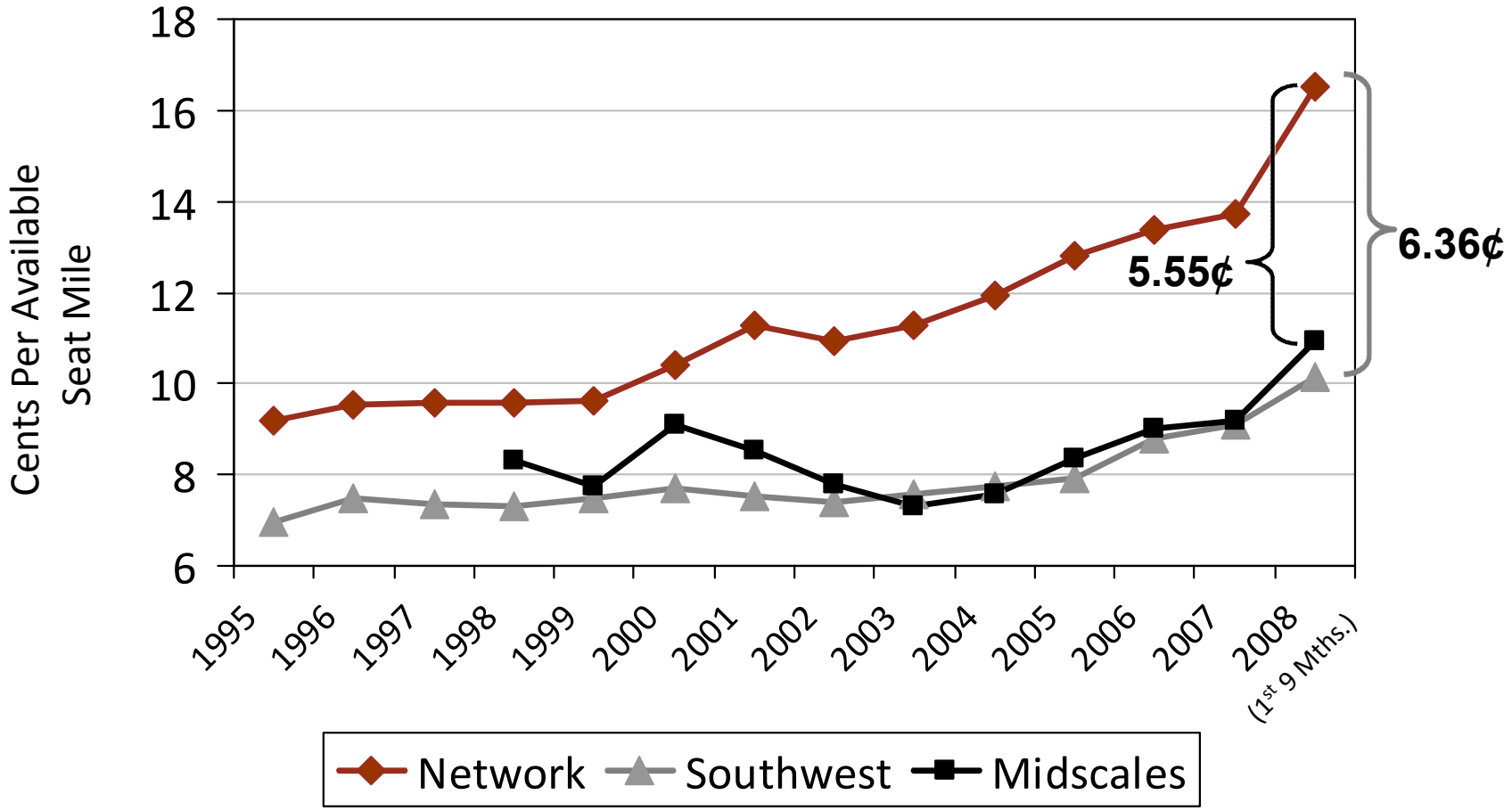
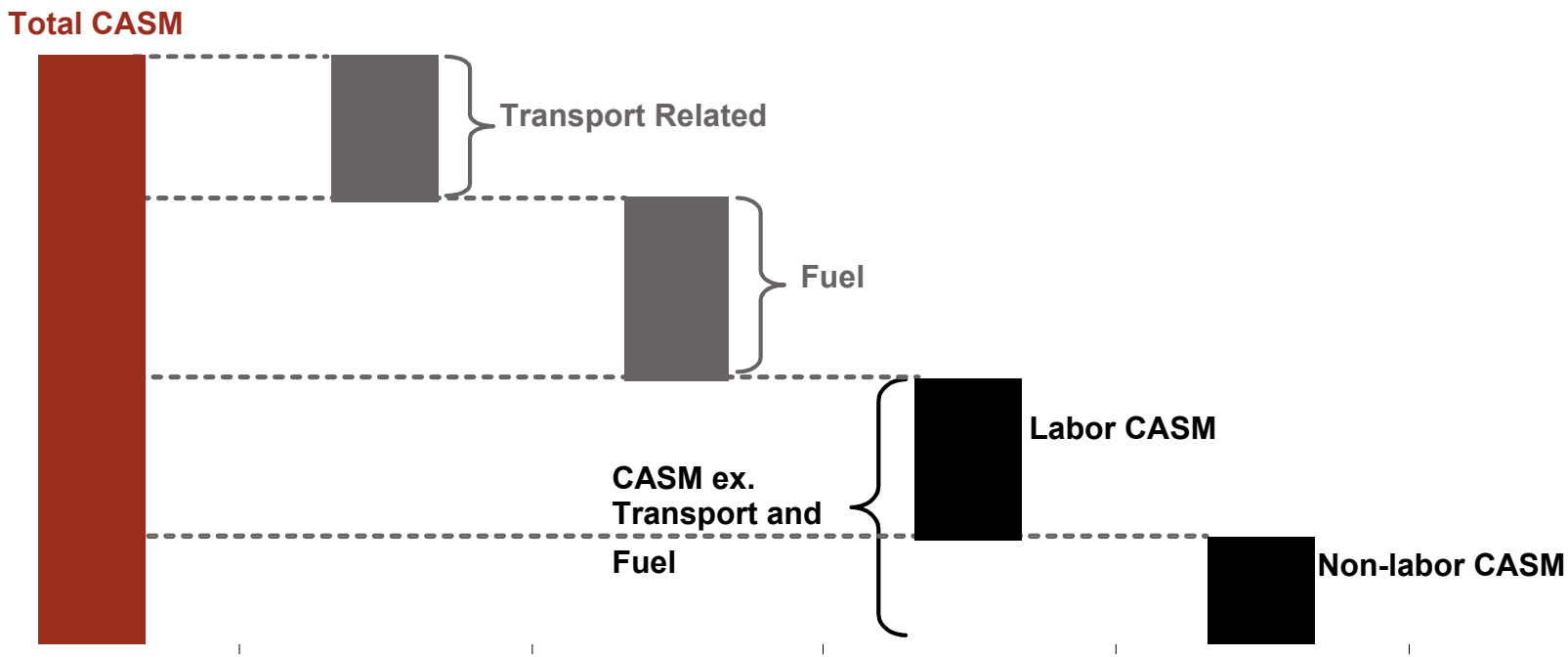
Total Cost per Available Seat Mile
Much More to the Story



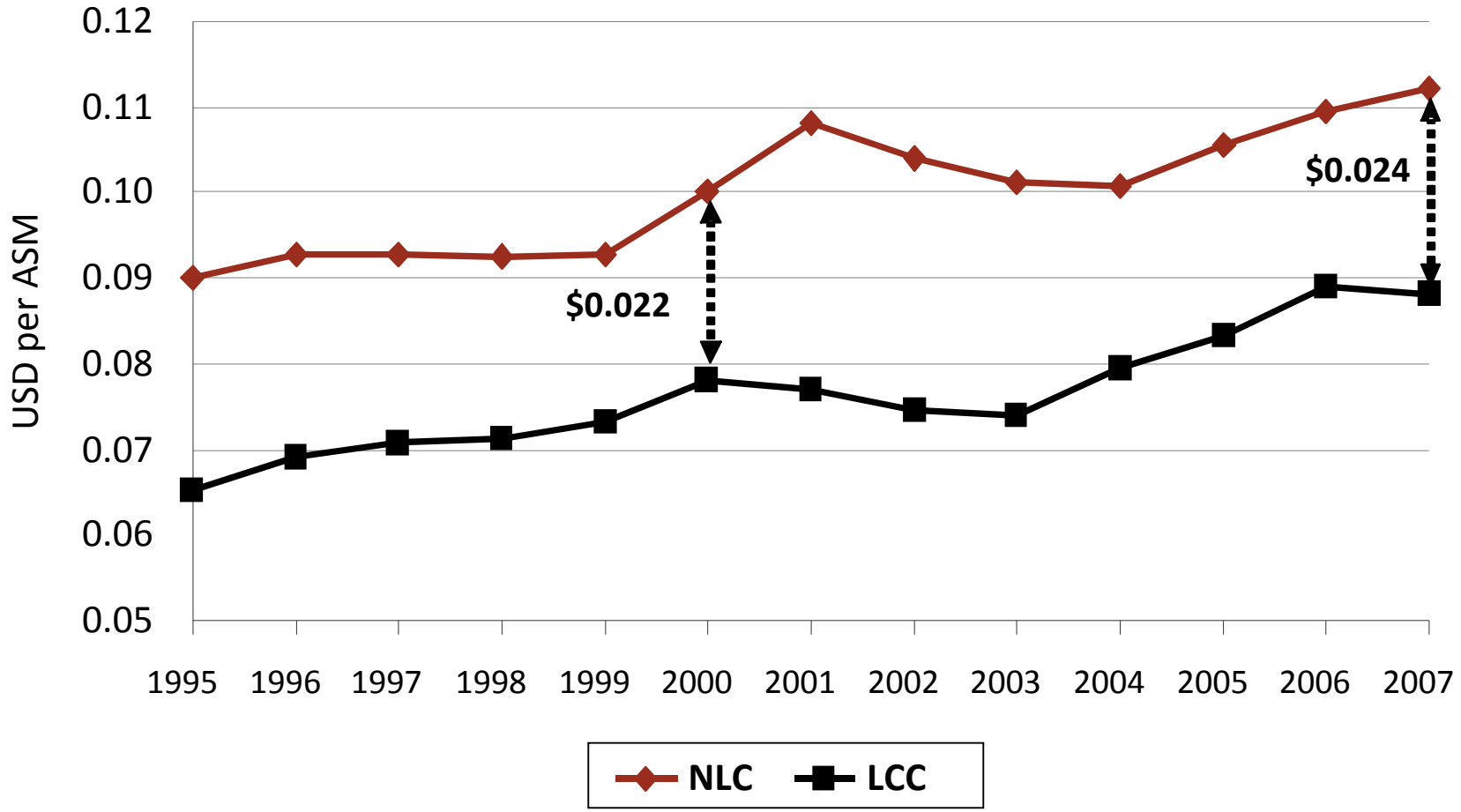
Source: MIT Airline Data Project

CASM Breakdown

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



Unit Costs (excl. "Transport Related")



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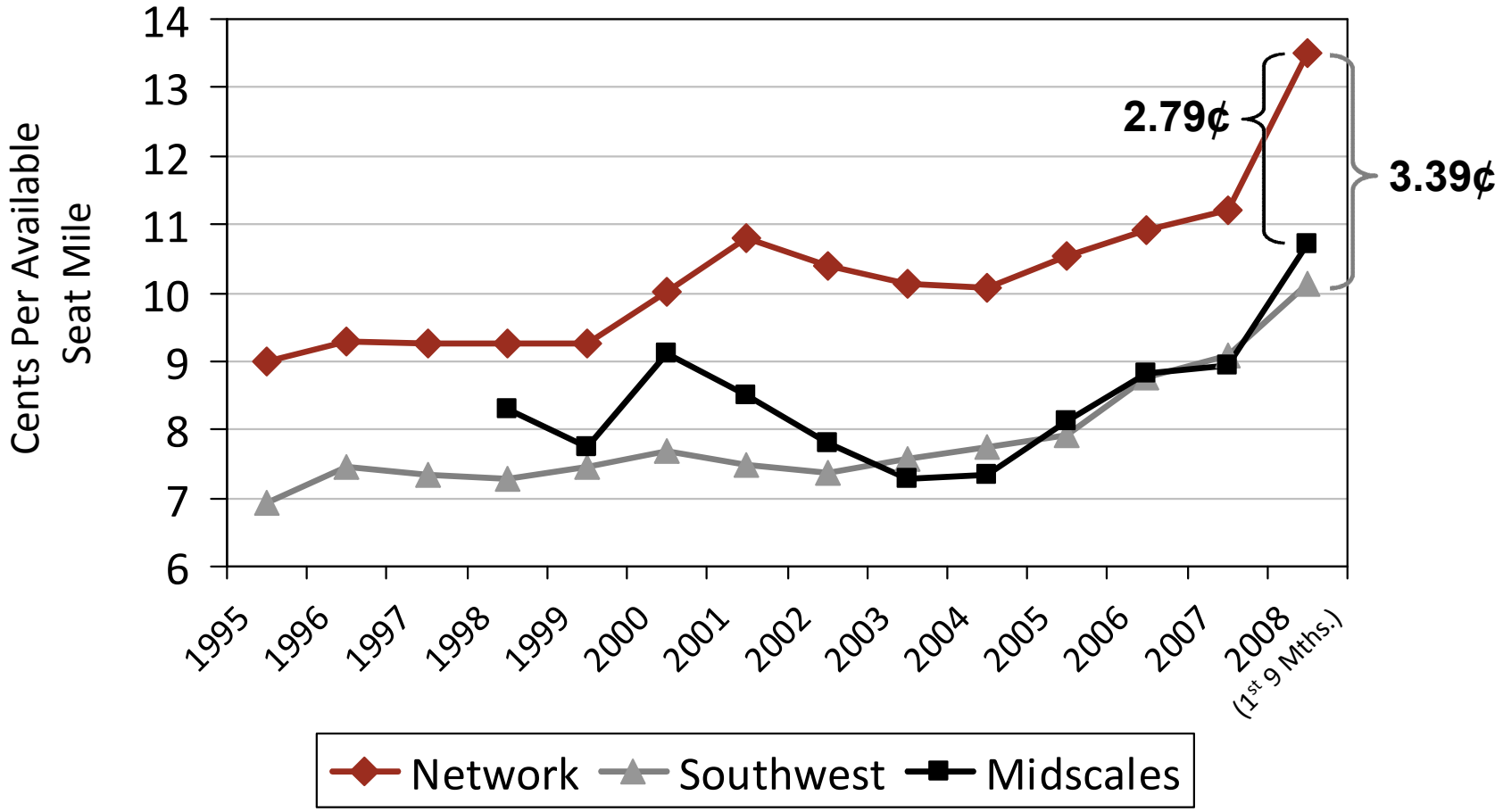
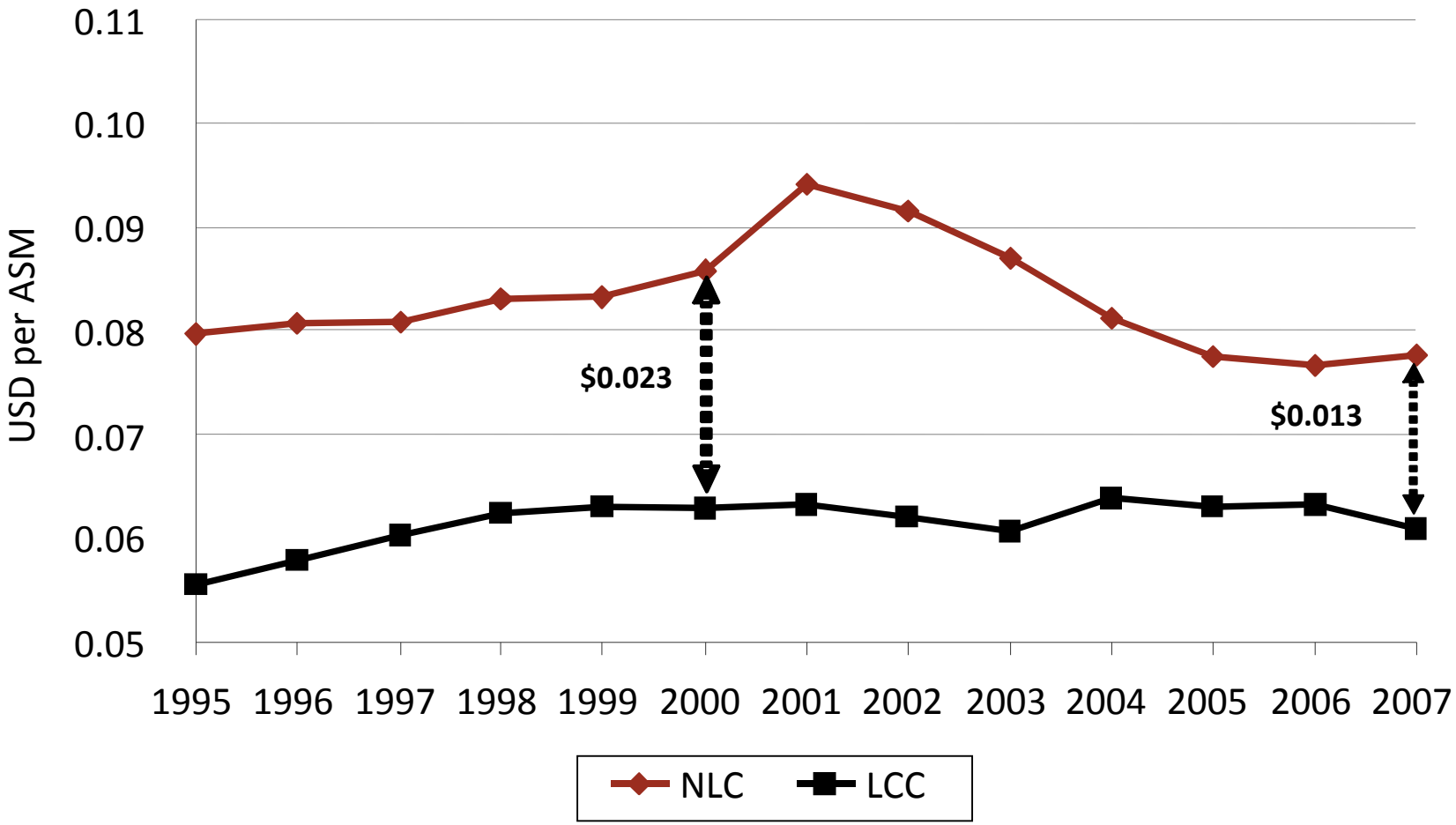
Cost per Available Seat Mile

(ex Transport Related Expenses)



Source: MIT Airline Data Project

Unit Costs
(excluding "Transport" & Fuel Expense)



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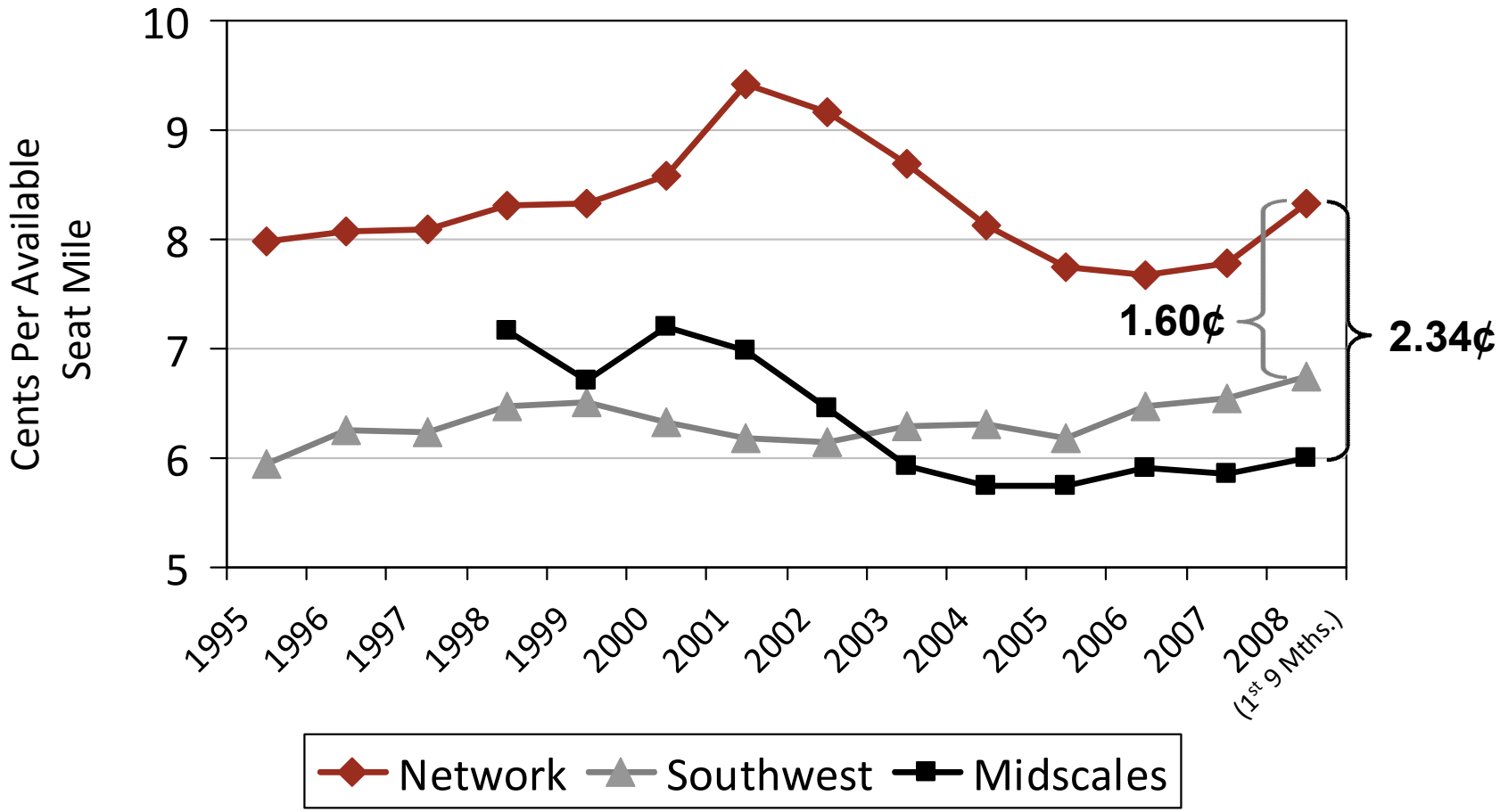
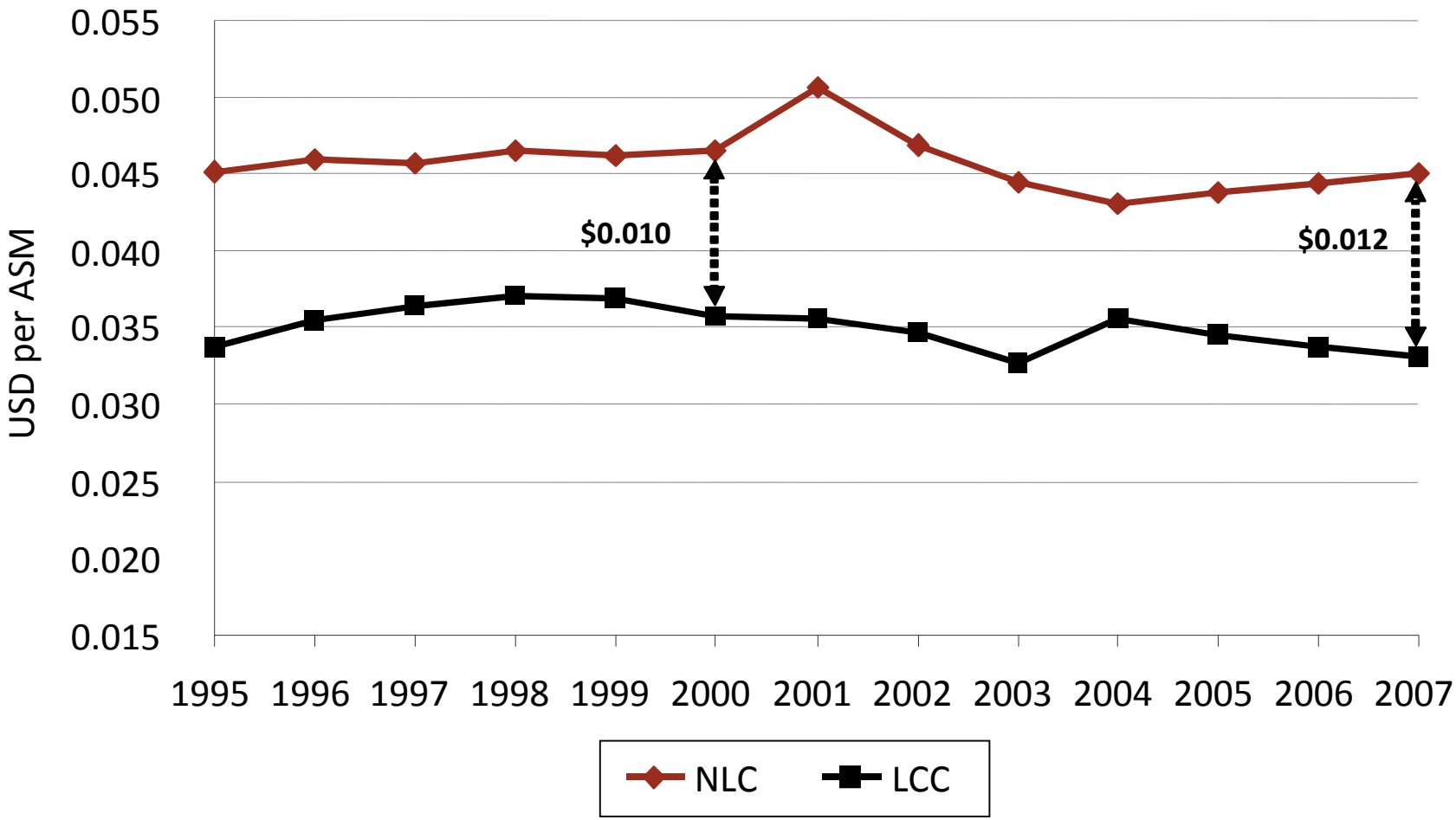
Cost per Available Seat Mile

(ex Transport Related and Fuel Expenses)



Source: MIT Airline Data Project

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



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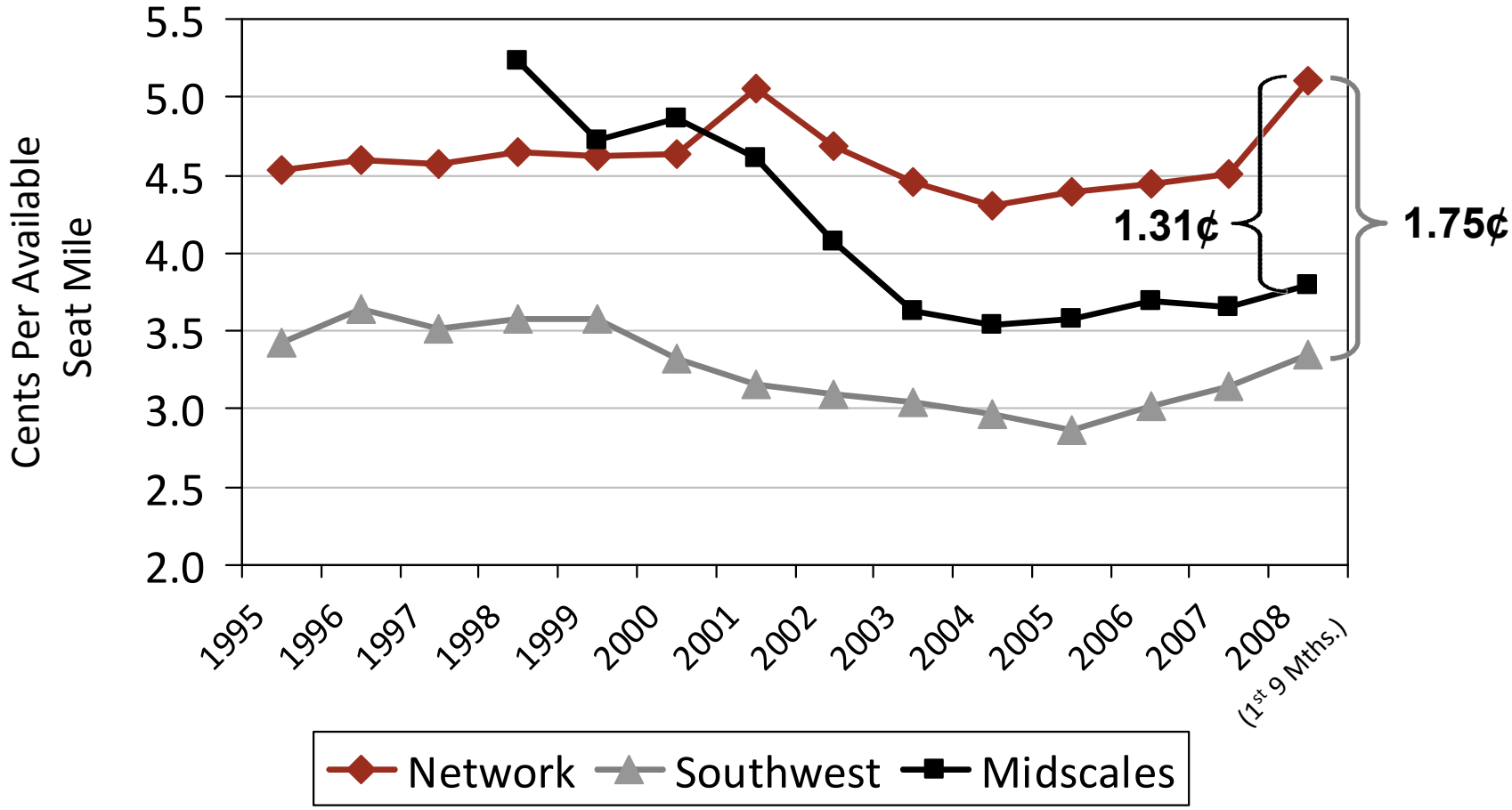
Non-Labor Cost per Available Seat Mile

(ex Labor, Fuel and Transport Related)



Source: MIT Airline Data Project

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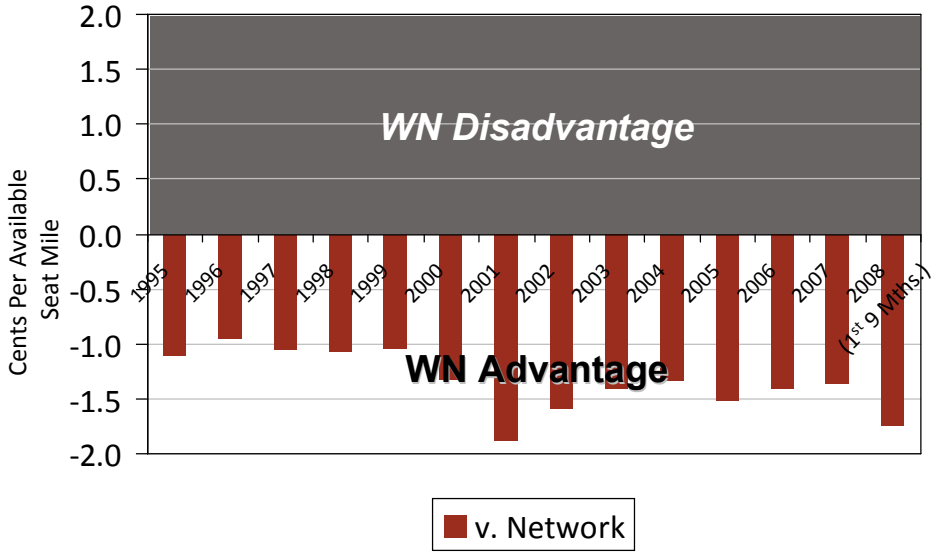
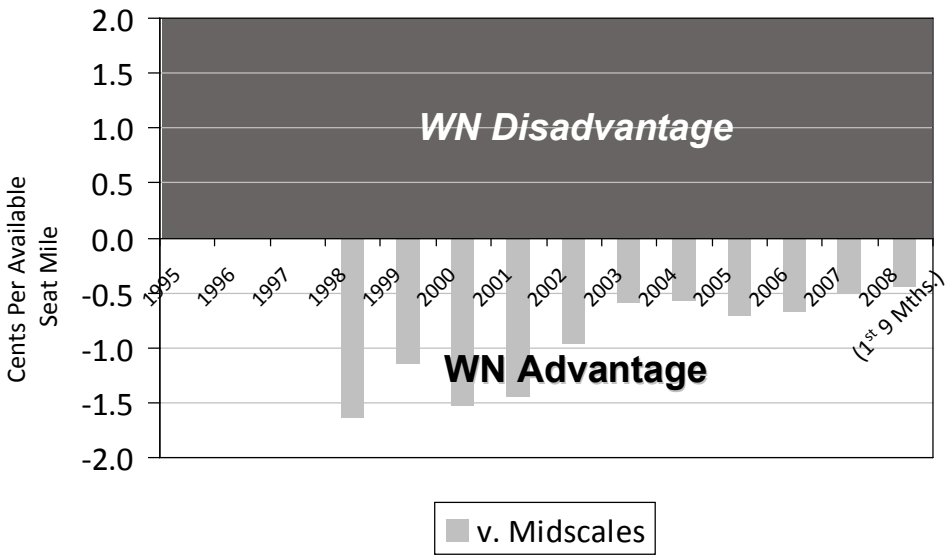
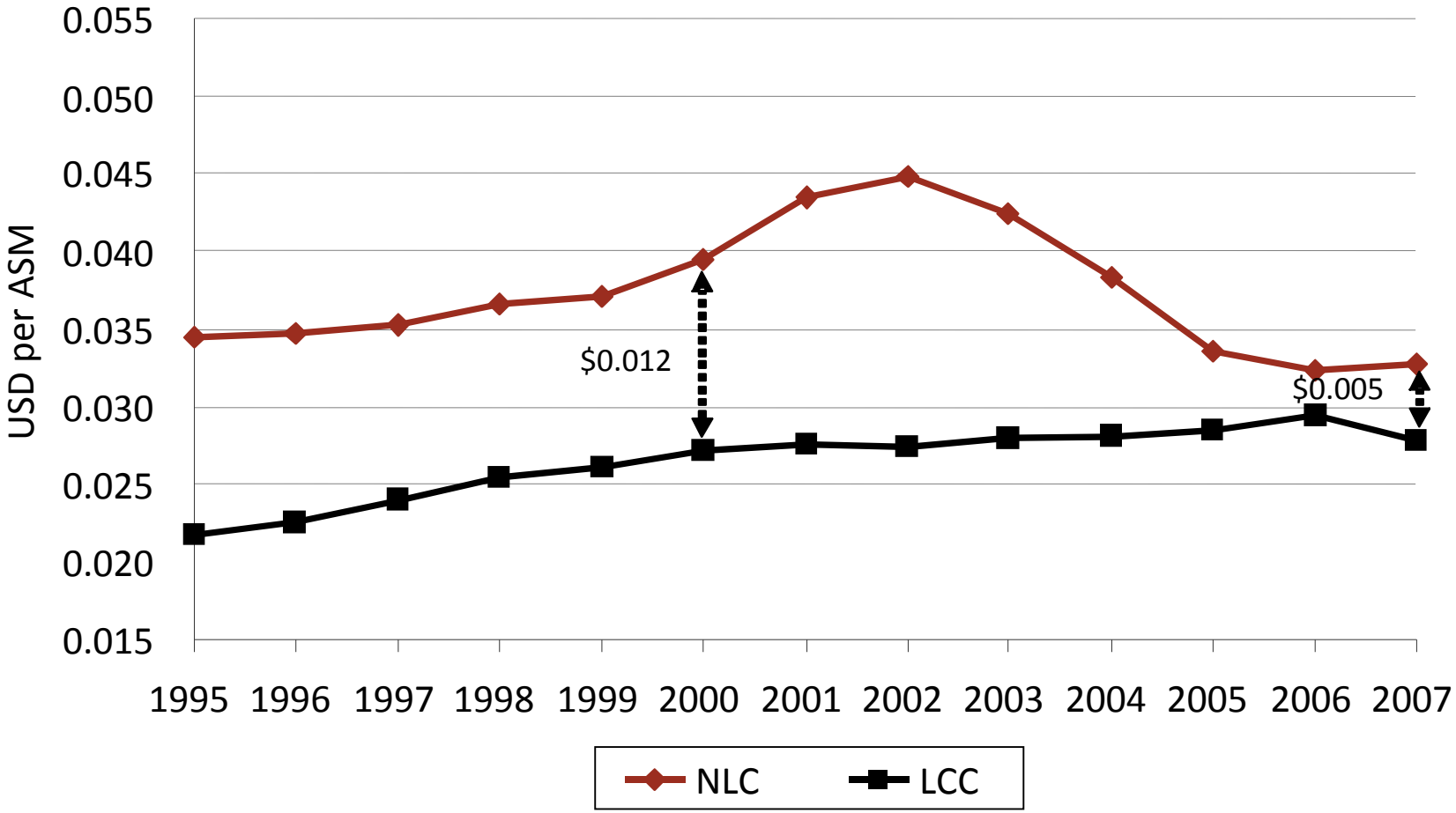
Southwest Cost Advantage/Disadvantage in Non-Labor Cost per Available Seat Mile



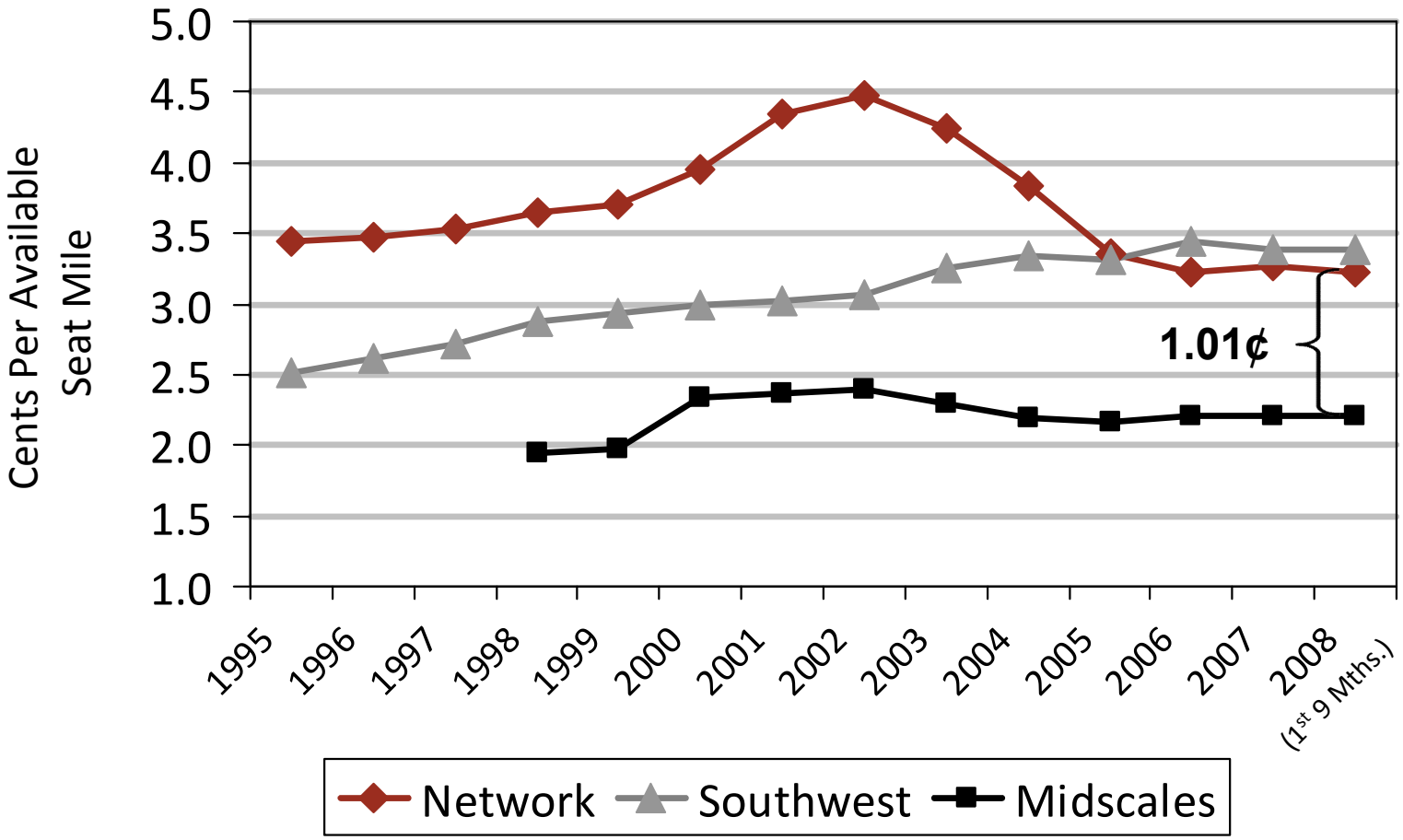


Source: MIT Airline Data Project

Labor Unit Costs



Labor & Related Cost per Available Seat Mile



Source: MIT Airline Data Project

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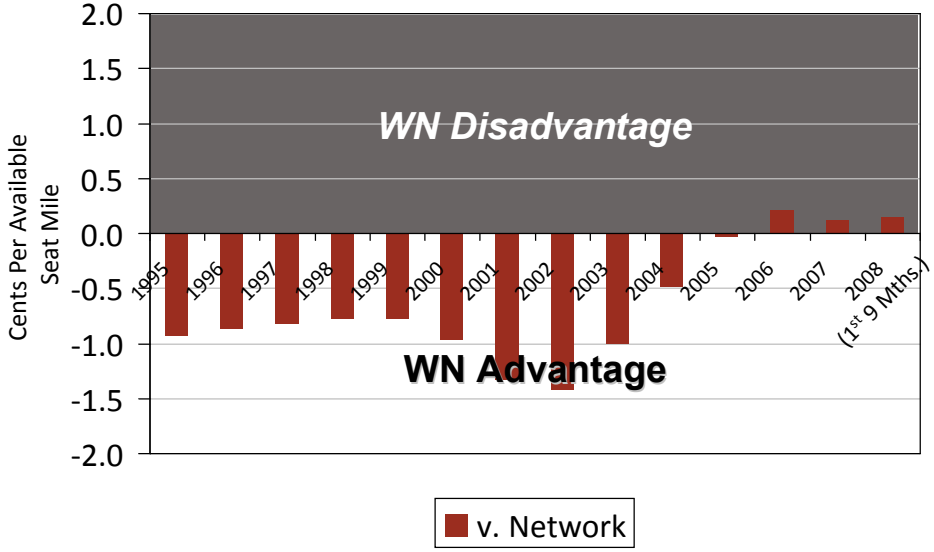
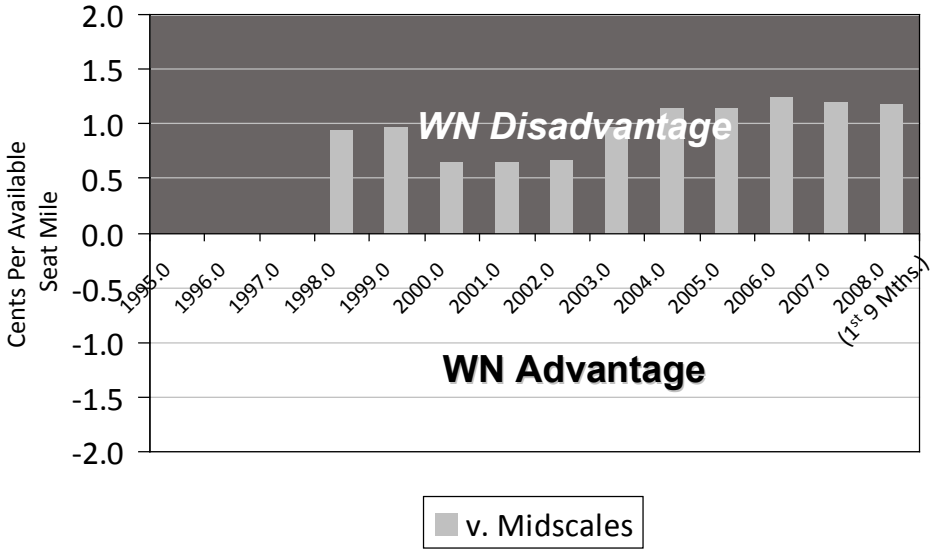
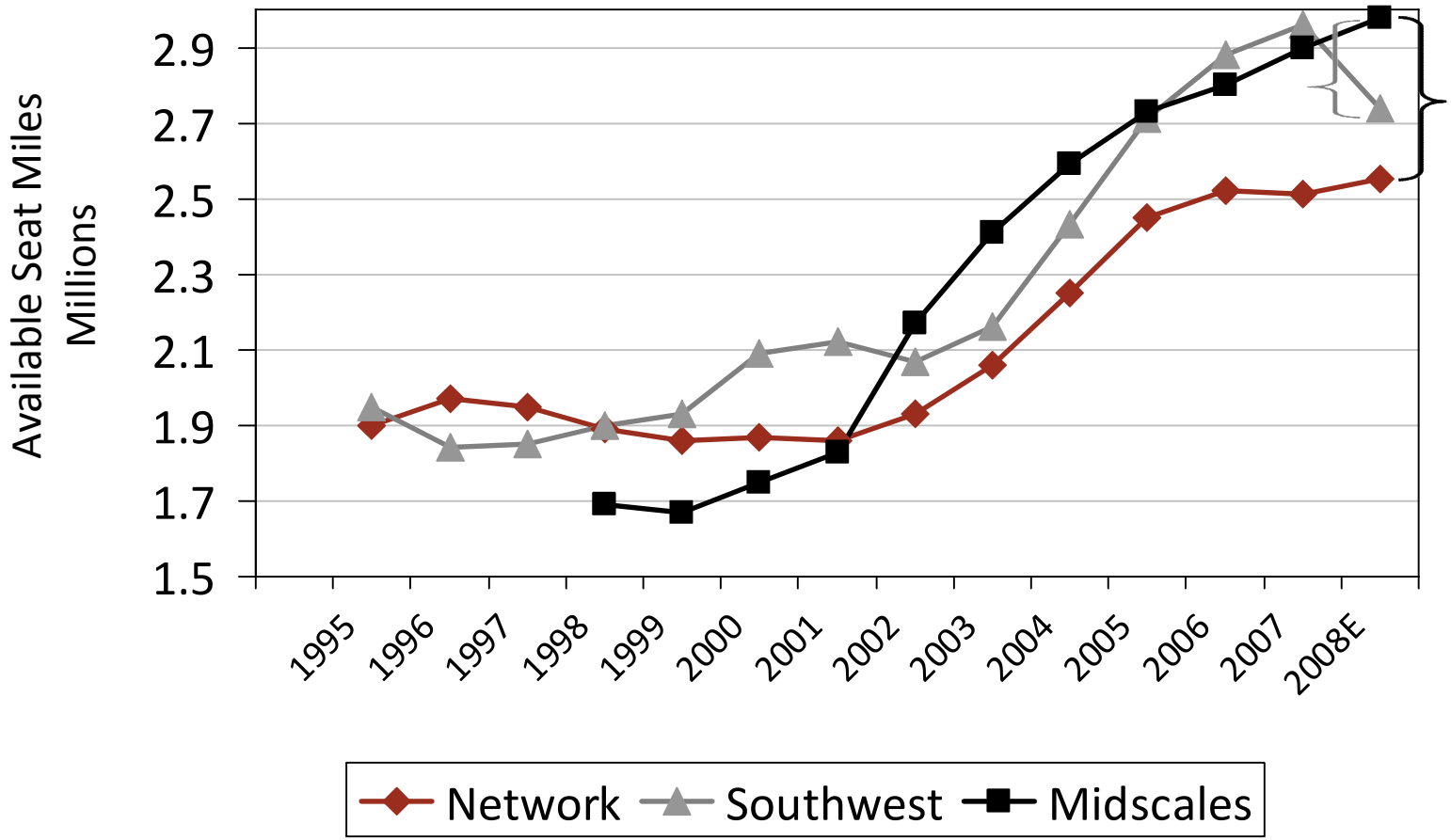
Southwest Cost Advantage/Disadvantage in Labor Cost per Available Seat Mile





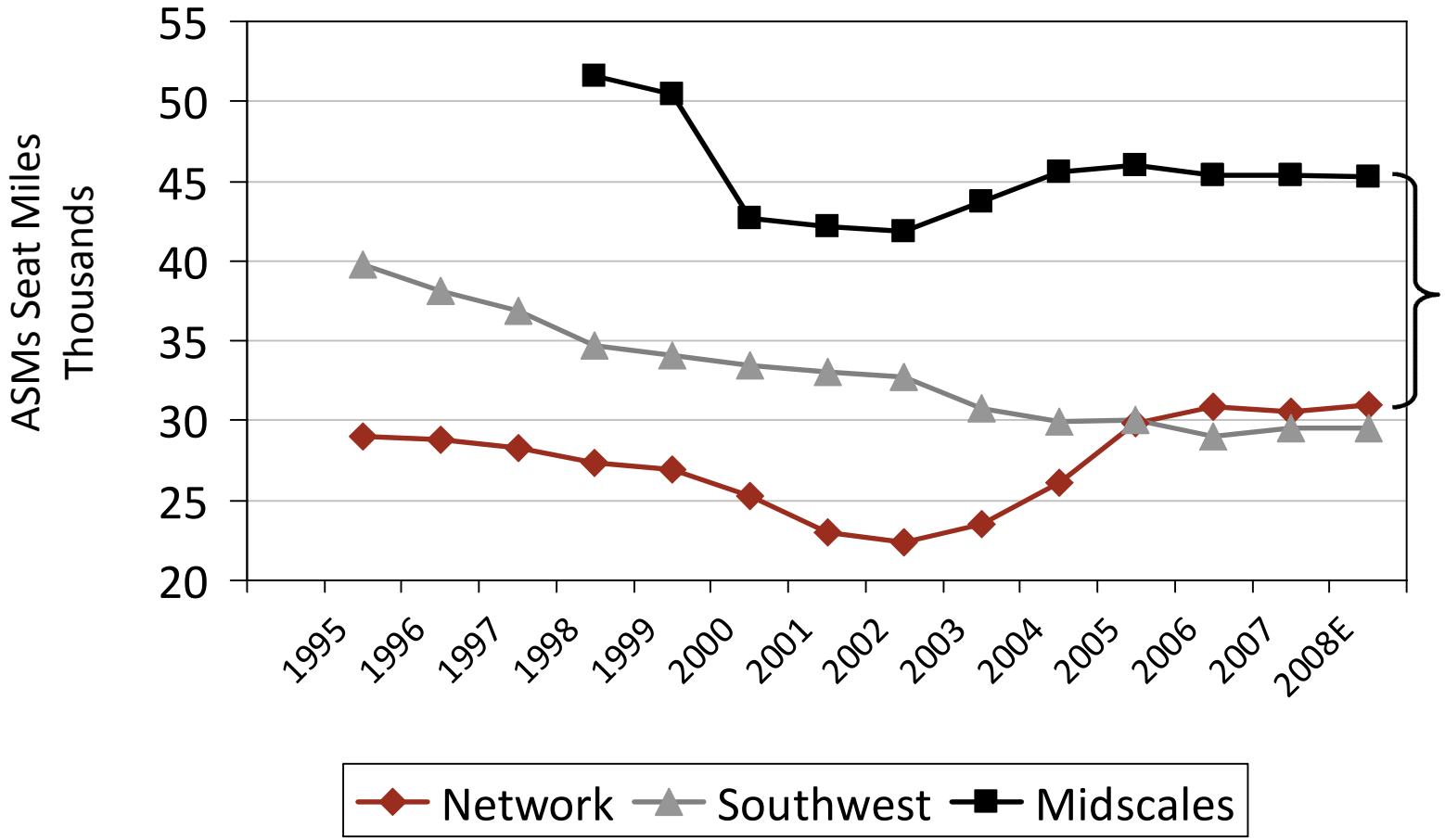
Source: MIT Airline Data Project

ASMs per Employee Equivalent



Source: MIT Airline Data Project

ASMs per Dollar of Compensation



Source: MIT Airline Data Project

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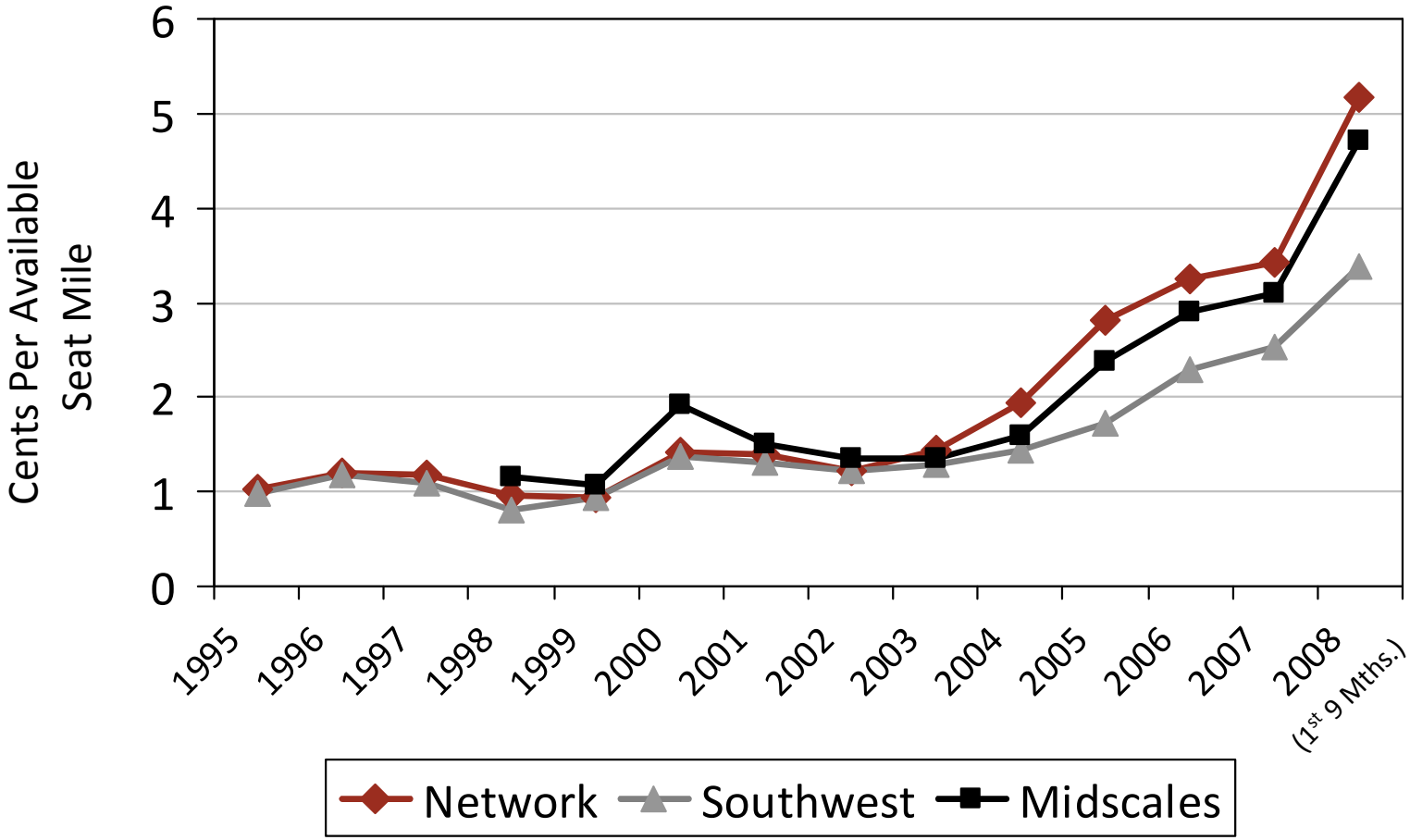
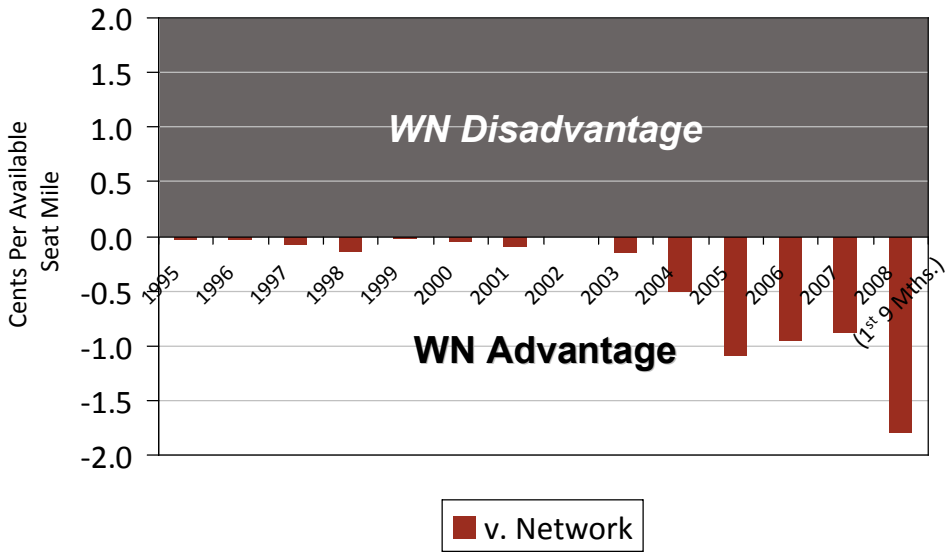
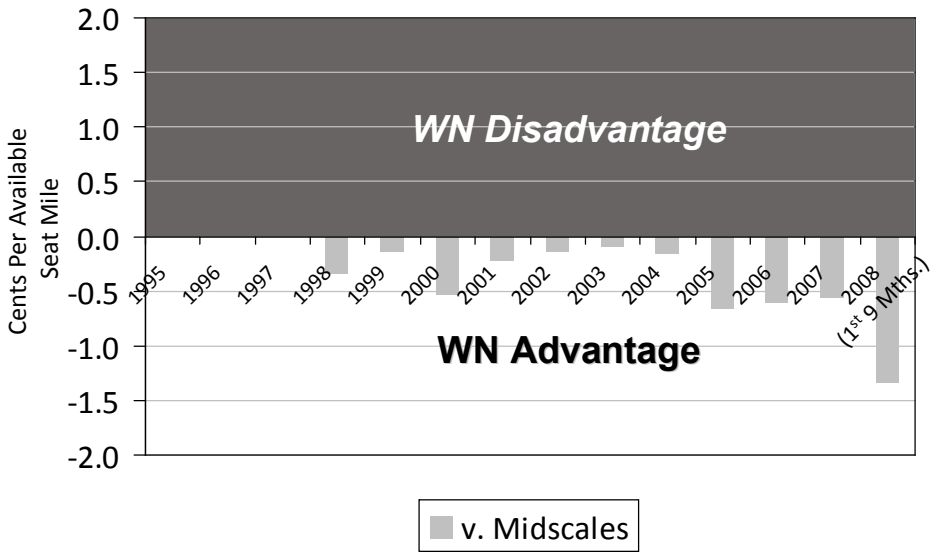
Fuel Cost per Available Seat Mile



Source: MIT Airline Data Project

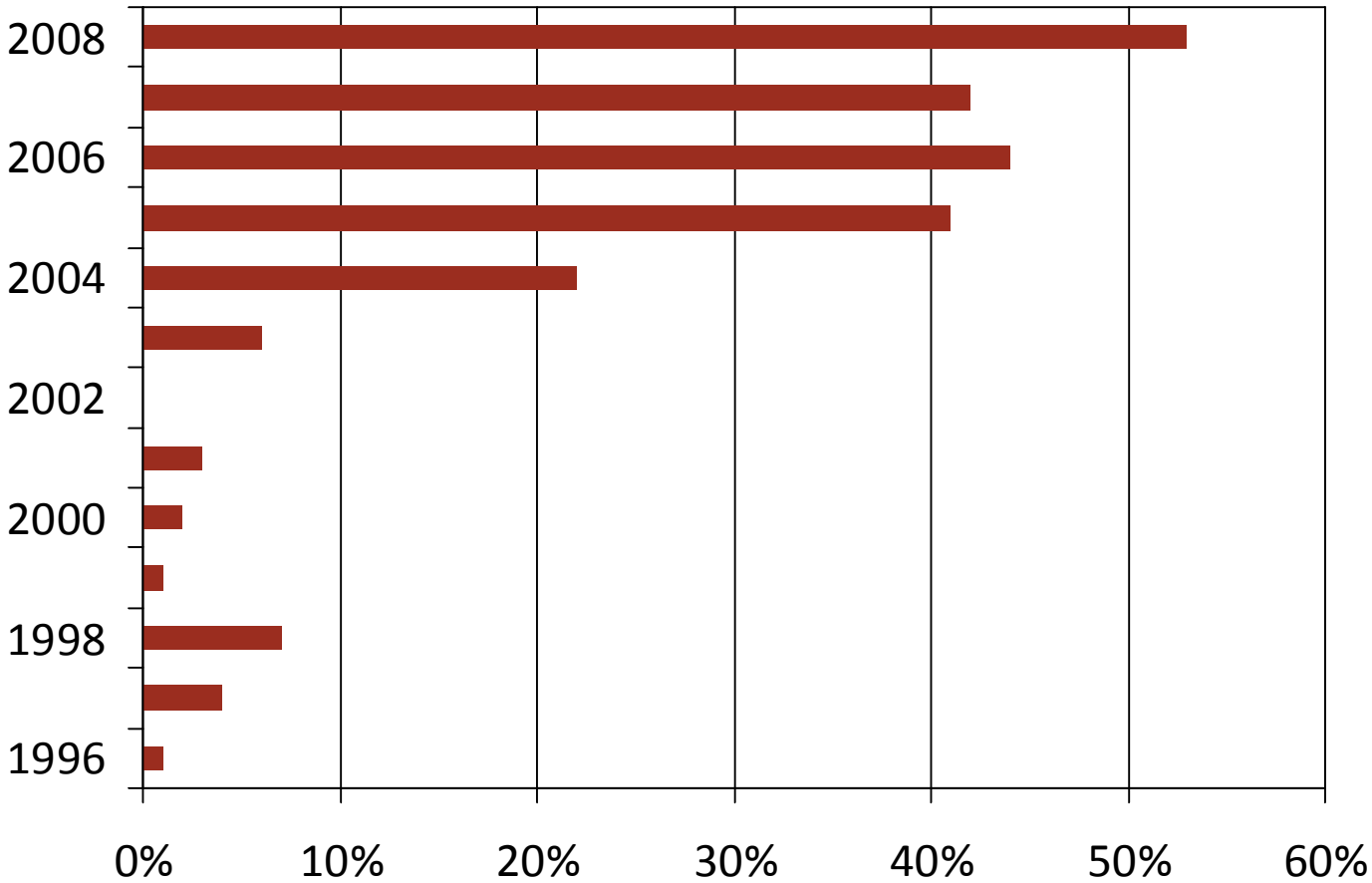
Southwest Cost Advantage/Disadvantage in Fuel Cost per Available Seat Mile





Source: MIT Airline Data Project

Percent of Southwest Unit Cost Advantage v. Network Carriers Attributed to Fuel (Hedges)



Source: MIT Airline Data Project

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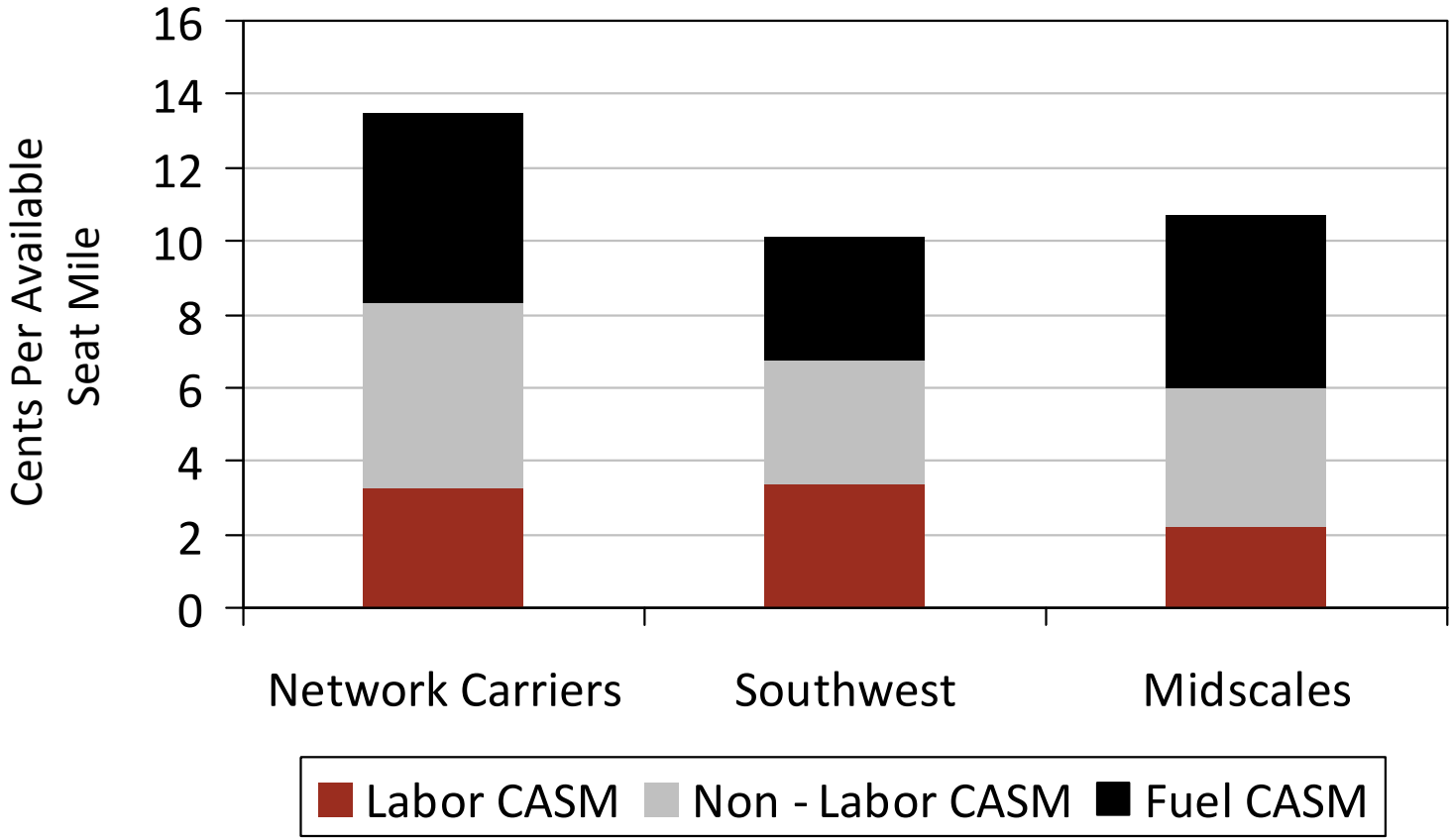
Cost per Available Seat Mile

(ex Transport Related Expenses)

2008



Source: MIT Airline Data Project

Some Concluding Thoughts

- The emerging cost metric for 2009 and 2010 is **CASM ex Fuel**
- **Why?**
  - **A labor cost push is underway**
  - **Shrinking Capacity**
  - **As economy improves, we will start talking about fuel again**
  - **Simply, there are few remaining areas of cost cutting remaining**
- **The revenue line is troubling as demand falloff still unknown**
- **Tomorrow's lower cost carriers emerging**
  - **Labor is the differential**
- **With credit tight, revenue soft, continued search for new revenue sources paramount for all sectors**
- **Sustainable model continues to appear elusive**

Final Thought

- **How important will the Spirit's and the Allegiant's – and others - be on shaping the industry structure**
  - **Cost advantage is significant**
    - **High oil prices may facilitate their growth**
      - **As others exit marginal markets**
    - **Low oil prices may keep others in markets that are either modestly profitable or make a meaningful network contribution**

About the MIT Global Airline Industry Program

About Us

- The MIT **Global Airline Industry Program** represents a large-scale effort that provides the means for MIT and the academic community to make contributions in studying the airline industry and in educating its future leaders. This effort is funded under the umbrella of the **Sloan Foundation's Industry Studies Program**.

- The MIT **Airline Industry Research Consortium** is an outgrowth of the MIT Global Airline Industry Program, sponsored by the Alfred P. Sloan Foundation. Its goal is to engage industry stakeholders in the next phase of the Program's research and to provide a forum for addressing key issues facing the airline industry during this critical period of transformation.

- Another goal of MIT's **Global Airline Industry Program** is to develop a body of knowledge for understanding development, growth and competitive advantage in this industry, which is one of the most diverse, dynamic and perplexing of the world. To further this goal, and to support the goals of the **Sloan Foundation Industry Studies Program** and the goals set forth in establishing the **MIT Airline Industry Research Consortium**, the **MIT Global Airline Industry Program** recently introduced the establishment of the **Airline Data Project**.

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- Air Transport Association of America
- Amadeus s.a.s.
- American Airlines
- American Express
- Federal Aviation Administration (FAA)
- Jeppesen Systems
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How to Find Us

http://airlinedataproject@mit.edu

swelbar@mit.edu

belobaba@mit.edu