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Why the US Majors are in such trouble

Three facts define the circumstances of the US Majors (American, Delta, United, Northwest, Continental and US Airways):
• They have a cost problem, not a revenue problem - while their unit revenues compare favourably to those of their low cost competitors, their unit costs are far higher;
• Labour costs, driven by below average productivity, are the defining problem that must be fixed; and
• Past excesses have created a pension plan crisis - this, surprisingly, may be the big aviation issue in the US in 2004, as statutory cash contributions to their defined benefit pension funds could act as a catalyst for new bankruptcies.

As pension plans are now less than the funding threshold required by law - almost $50bn in obligations and $22bn in underfunding (see table 1, below) - US Majors will be required under special pension funding rules to pay hefty surcharges known as "deficit reduction contributions." These cash contributions are estimated at about $5bn in 2004, in contrast to the $400m incurred in 2001.

The Senate is scheduled to consider the pension issue in December after failing to agree on a proposal for easing pension-funding requirements for the airlines and other industries with underfunded pension plans. The House of Representatives recently approved a two-year moratorium that would allow the airlines to defer 80% of what they are currently required to contribute toward the underfunded plans.

The stock market bubble of the mid to late 1990s masked the true costs of the plans because plan asset returns were higher than assumed returns. Even though this year's stronger stock market will help the pension funds somewhat, it will not erase the deficits or the future costs of the plans. Recurring annual expenses are estimated to be approximately $2.4bn in 2004, reflecting the annual service and interest costs of the plans. This is double the amount spent in the late 1990s (and in addition to the $5bn of cash contributions).

Table 1 **FUNDED STATUS OVER/(UNDERFUNDED) IN $m**

Airline	1999	2000	2001	2002	2003F	2004F	2005F
AA	(346)	(703)	(1,940)	(3,434)	(3,777)	(3,758)	(3,112)
UA	1,320	(741)	(2,520)	(6,380)	(5,968)	(5,571)	(4,396)
DL*	148	1,135	(2,353)	(4,907)	(4,620)	(4,169)	(3,141)
NW	519	(486)	(2,275)	(3,950)	(3,795)	(3,450)	(2,658)
CO	(287)	(282)	(587)	(1,190)	(1,211)	(1,142)	(943)
US**	(722)	(301)	(2,344)	(2,445)	(2,573)	(2,403)	(1,920)
AS	68	9	(53)	(223)	(101)	(175)	(177)
Total	**700**	**(1,369)**	**(12,072)**	**(22,529)**	**(22,045)**	**(20,668)**	**(16,346)**

Notes: *= as of 12/12/02, 31/12/01, 31/12/00, 30/6/99; **= US Air is calculated as if the pilots' plan had not been taken over by the PBGC.
Source: Company reports and AirlineForecasts

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Underfunding creates even more competitive problems for the majors because their low-cost competitors offer a different variety of the retirement programs, known as 401(K) plans, and are not required to make large future cash requirements to fund defined pension obligations. Airlines like Southwest, JetBlue, America West, AirTran and Frontier have defined contribution plans, which are more transparent and pay employees in cash. (The majors also have these plans.)

Table 2 **PLAN ASSETS AS % OF PENSION LIABILITY**

	1998	1999	2000	2001	2002	2003F	2004F	2005F
American	89	94	89	74	61	61%	62%	65%
United	95	118	92	75	51	51%	57%	63%
Delta *	110	102	112	78	62	62%	63%	68%
Northwest	87	111	91	66	51	51%	55%	62%
Continental	63	78	81	62	45	45%	48%	55%
US Airways (1)	69	83	93	57	54	54%	56%	62%
Industry	**92%**	**102%**	**96%**	**72%**	**56%**	**54%**	**57%**	**63%**

Notes: *as of 12/12/02,31/12/01, 31/12/00, 30/6/99, 30/6/98, 30/6/97;
US Air is calculated as if the pilots' plan had not been taken over by the PBGC
Source: Company reports and AirlineForecasts

Companies must make deficit reduction contributions when the fair value of assets in their defined benefit plans drops below 80% of the current pension liability to current and future retirees (see table 2, above). Accelerated "catch-up" contributions then kick in to ensure that future obligations can ultimately be met. The airlines do not have to cover their entire pension shortfall all at once because US accounting rules allow the gains and losses to be spread out over three to five years. Pension "smoothing" calculations involve numerous lags, and therefore the pension funds are only beginning to show the full effects of the three year bear stock market and historically low interest or discount rates used to calculate the present value of the obligations. Low interest rates make future pension obligations look larger because they approximate the rate of investment return on the pension fund over time.

After running plan surpluses of more than $700m at the peak of the stock market bubble in 1999, pension plan funding for the seven US airlines with the defined benefit plans will end 2003 with a $22bn deficit. Due to pension accounting convention, airlines, until now, have been able to avoid the unpleasant reality of lower plan asset returns and interest rates at historical lows. Smoothing mechanisms, originally designed to reduce reported earnings volatility, have led to misleading financial statements that mask the real costs and future cash requirements of the plans. The funding deficits have reached a point where they are affecting earnings, balance sheet values, and perhaps even the very survival of the high-cost "legacy" airlines. The magnitude of the problem becomes apparent when the deficits are measured against revenue or market values (see table 3, opposite). In the worst-case scenario, the airlines could be forced into bankruptcy or even liquidation.

The pension crisis will hit at a time when the legacy airlines are making a feeble financial recovery. But, even with a robust economic expansion underway, Big Six revenue levels are expected to be 18% less in 2003 than in 2000. And, based on current assumptions, the Big Six US airlines will lose $5.8bn in 2003, $500m in 2004 and eke out $1.5bn in net earnings in 2005 (see table 4, opposite - all these results are before the effect of pension cash contributions).

This is hardly good news when considering the $4bn in profits generated during the peak of the last business cycle. Cumulatively, the group will have negative earnings of almost $25bn for the years of 2001, 2002 and 2003. Moreover, United, US Air, Northwest, American and Delta will end the year with $16bn in negative equity on the balance sheets (see table 5, on page 4).

Even with across-the-board cost cutting and better unit revenue trends, these airlines face substantially higher claims on operating cash flow until 2008 as a result of large debt repayment needs and required pension plan

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Table 3

MARKET VALUE AND PLAN DEFICITS

Data as of 2/12/2003	Market Cap ($m)	Sales ($m)	Mkt Cap To Sales	Employees	Pension Deficits ($m)	Deficits per employee	Deficits as % of market
Composite	**27,965**	**80,986**	**0.35**	**394,849**			
JetBlue	3,515	923	3.81	3,823	0	0	0
Southwest	14,114	5,820	2.43	33,705	0	0	0
AirTran	1,219	879	1.39	4,700	0	0	0
SkyWest	1,026	859	1.19	5,079	0	0	0
Frontier	560	547	1.02	2,651	0	0	0
Atlantic Coast	505	857	0.59	4,311	0	0	0
Alaska	745	2,359	0.32	10,114	(101)	$ (9,970)	14%
Continental	1,201	8,662	0.14	42,944	(1,211)	$ (28,198)	101%
AMR Corp	1,985	17,153	0.12	92,800	(3,777)	$ (40,695)	190%
Northwest	1,086	9,442	0.12	38,722	(3,795)	$ (98,008)	349%
Delta	1,478	13,213	0.11	70,100	(4,620)	$ (65,909)	313%
US Airways	375	6,695	0.06	26,300	(2,573)	$ (97,830)	687%
UAL Corp	156	13,578	0.01	59,600	(5,968)	$(100,136)	3816%
	27,965	**80,986**		**394,849**	**(22,045)**	**$ (55,831)**	

Note: (1) US Airways' pension deficits are based on estimates prior to the PBGC takeover of the pilots' plan.
(2) United's pension deficits do not consider any new labour agreements as a result of the bankruptcy.

Source: Company reports and AirlineForecasts

funding. United's situation is the most dire.

Liquidation or plan termination

Documents filed in federal bankruptcy court revealed an ugly surprise for United's employees. The total deficits of United's four main domestic pension plans may be as high as $7.5bn - $1bn more than the $6.4bn deficit disclosed in the most recent annual report, and in total contrast to the $1.3bn funding surplus reported as recently as 1999. The $6.4bn figure represents the estimated shortfall if it terminated its major pension plans in April and tried to use the assets of each plan to cover the benefits already earned by its workers. United will most likely postpone some of its annual pension contributions and has disclosed that it may have to contribute $4.8bn to its four pension funds by the end of 2008. The company built up credit balances during the good times and avoided making large cash contributions over the last several years because of strong plan returns achieved during the stock market bubble.

In the absence of changes in the pension rules regarding required contributions or a termination by the PBGC, analysts at Fitch Ratings estimate that cash funding requirement of $1.5bn-$1.8bn will be required over the 2004/2005 period. United is proposing a new "Uniform Pension Plan" that would provide $1.87bn in savings over a six-year period, of which $789m of the savings would come from the pilots. Fitch believes that the cash flow effect of existing pension plan funding obligations is simply unmanageable for United in a post-bankruptcy emergence scenario, and will impede its ability to attract interest from outside equity investors in support of the reorganisation plan. Estimated annual cash funding requirements of $1bn or more by 2005 repre-

Table 4

NET EARNINGS ($m)

	1998	1999	2000	2001	2002	2003F	2004F	2005F
American	1,314	985	813	(1,762)	(3,511)	(1,310)	(19)	395
Continental	464	337	343	(95)	(451)	(220)	47	199
Delta	1,078	1,096	987	(1,230)	(1,287)	(651)	(315)	254
Northwest	(285)	300	296	(423)	(798)	(275)	(115)	213
United	827	781	322	(2,145)	(3,212)	(2,643)	200	420
US Airways	538	28	(154)	(2,117)	(1,646)	(695)	(340)	(100)
Big Six	**3,937**	**3,526**	**2,606**	**(7,772)**	**(10,905)**	**(5,794)**	**(542)**	**1,382**
AirTran	(41)	(99)	47	(2)	11	56	70	81
Alaska	134	125	1	(43)	(119)	(36)	28	64
Amer West	109	120	(4)	(148)	(430)	(28)	32	52
ATA Holdings	41	47	(16)	(82)	(175)	(6)	12	18
Frontier	(18)	31	26	55	17	24	35	24
JetBlue		(14)	(21)	22	49	93	118	153
Southwest	433	474	625	511	241	307	488	611
Low Cost	**658**	**683**	**659**	**313**	**(407)**	**410**	**783**	**1,002**

Source: Company reports, consensus earnings estimates and AirlineForecasts

Table 5 **BOOK EQUITY AND LEVERAGE (IN $m)**

	1999	2000	2001	2002	3Q 03	*Year End* Book Equity 2003E	*Sept Qtr* Assets 3Q 03	Equity as % of Assets
Southwest	2,836	3,451	4,014	4,422	4,868	4,947	9,699	**51.0%**
Jetblue	115	109	324	415	640	663	2,010	**33.0%**
Alaska	931	862	819	656	683	662	3,239	**20.4%**
Amer West	714	667	522	128	127	124	1,663	**7.4%**
Continental	1,593	1,610	1,161	848	764	712	10,878	**6.5%**
Delta	4,908	5,343	3,769	893	(600)	(805)	25,761	**-3.1%**
American	6,858	7,176	5,373	957	(521)	(714)	29,943	**-2.4%**
NWAC	(52)	231	(431)	(2,262)	(2,573)	(2,726)	13,749	**-19.8%**
United	4,846	4,885	3,033	(2,579)	(5,871)	(6,182)	21,626	**-28.6%**
US Air (1)	(117)	(358)	(2,630)	(4,956)	(5,818)	(5,923)	8,488	**-69.8%**
Industry	**22,632**	**23,977**	**15,954**	**(1,478)**	**(8,301)**	**(9,243)**	**127,056**	**-7.3%**
Big 5	*16,443*	*17,277*	*9,114*	*(7,947)*	*(15,383)*	*(16,350)*	*99,567*	*-16.4%*

Notes: (1)a This is what the US Air's equity would look like without (post-bankruptcy) fresh start accounting
(1)b US Air reported a book equity value of $356m for the quarter ending June 30, 2003
Source: Company reports and AirlineForecasts

sent an enormous claim on United's operating cash flow even after a restructuring of its debt and lease obligations has taken place in Chapter 11. Therefore, United probably will be forced to terminate one or more of its employee-defined plans, with the PBGC assuming the terminated obligation.

Fresh start accounting - a function of emerging from Chapter 11 bankruptcy - has allowed US Airways to eliminate $5.9bn in negative equity cumulated through the third quarter of 2003, and has also allowed it to alleviate its pension underfunding problem. The pension plan for US Airways' pilots was underfunded by $2.5bn, with $1.2bn in assets to cover $3.7bn in benefit liabilities. Of the $2.5bn in underfunding, the PBGC estimates that it will be liable for approximately $600m, making the US Airways' pilots plan the sixth-largest claim in the agency's 28-year history.

Fragile balance sheets

Shareholder equity is hugely negative for the big five US airlines and it is becoming increasingly clear that if they are to recover, they must find a way - perhaps with the assistance of appropriate legislation - to defer payment of past pension obligations across a time span of many years. In the meantime, they must become profitable; failing that, no amount of pension deficit deferral will be helpful. The present problem can be attributed to both management foolishness and excessive union power. Managements bear responsibility for succumbing to the siren song of Wall Street and using billions of dollars to buy back stock during the prosperous 1990s. Any experienced airline manager knows that the business is deeply cyclical and will never be able to offer its investors the high returns offered by less competitive and less cyclical industries. Thus, buying back stock in the name of "enhancing shareholder value", acquiring competitors who would have been better left to expire naturally and buying too many types of aircraft are management errors.

On the other hand, the excessive labour costs of the major carriers primarily arose as a consequence of strong unions, which have historically been willing to enforce their demands with threats of and actual strikes. Since no airline can logically accept a work stoppage - the cost of a strike is always many times the present value of the incremental labour cost demanded - managements resisted as long as they could and then, typically, caved. The result has been inflated labour costs.

The shrunken big six airlines must now find a way to make a profit in an industry which will never generate the revenue levels of years past (see table 6, opposite) while simultaneously earning enough to eventually meet past pension obligations. Revenue for the group is estimated to be $69bn in 2003, which is $16bn less (19%) than it was in 2000. The old-line airlines have a major problem because retirees receiving health care benefits and pensions outnumber the current workers on the payrolls.

The future has caught up with these underperforming businesses and the real economics are much worse than investors and employees appreciate. For example, US Airways used aggressive accounting assumptions to minimise cash contributions required for the defined benefit plans. Pilots believed that pension plans were 93% funded based on accounting rules (using US Airways' pension assumptions) during the bankruptcy proceedings. However, using more conservative assumptions, including a lower discount rate, the PBGC found the plans to be only 35% funded.

The labour cost issue

With as much as 80 % of all US domestic markets now having low-cost competition, the major airlines are forced to retreat or restructure costs. The key competitive difference between the low-cost and high-cost airlines is labour costs - in all of its forms. As the low-cost segment gains greater market share, the industry averages for wages and labour productivity move lower and the majors' labour cost disadvantage becomes even more apparent. As an example, the average per employee cost for Delta, United, US Airways, American and Northwest in 2002 was $90,500 per year and they collectively lost $9.5bn in operating profits. Southwest's labour costs were 35% lower at $59,000 per employee. (see table 7, below)

If Southwest had the labour costs of the biggest five carriers, the company's costs would have been $1bn greater in 2002 and they would have reported operating losses of almost $600m versus $417m in operating profits. Conversely, if the big five airlines had Southwest's labour costs, operating expenses would have been $9.8bn less in 2002. In other words, the legacy airlines would have produced $300 m in operating profits during one of the worst years in aviation history. (Operating profits are calculated before interest, taxes, and nonrecurring restructuring charges; the number of employees used in the calculation was based on average employee levels in 2002.) These data illustrate clearly that the majors have cost, and not a revenue problem.

The old-line airlines have legacy costs that make them uncompetitive relative to the new generation airlines, where labour claims a far smaller share of revenue. As an example, if US Airways had paid market-level rates of pay over the last 18 years, the company would have accrued $7.5bn in additional earnings. Instead, they had the highest labour costs in the industry, and ended its legal life in bankruptcy with $5.8bn in negative equity. In contrast, Southwest had one of the lowest labour costs in the industry; will end the year with over $5bn in equity on the books, and produce almost $500m in net earnings. Unfortunately, US Airways' costs are still too high post-bank-

Table 6

REVENUE ($m)

	2000	2001	2002	2003F	2004F	2005F
American	19,703	18,963	17,299	17,399	18,062	18,705
Continental	9,899	8,969	8,402	8,829	9,196	9,665
Delta	16,742	13,879	13,305	13,207	13,766	14,247
Northwest	11,108	9,905	9,489	9,400	9,729	10,070
United	19,352	16,138	14,248	13,480	13,952	14,510
US Airways	8,388	8,288	6,977	6,776	6,945	7,119
Big Six	**85,192**	**76,142**	**69,720**	**69,091**	**71,650**	**74,315**
AirTran	624	665	733	926	1,200	1,474
Alaska	1,749	2,141	2,218	2,031	2,600	2,800
Amer West	2,288	2,066	2,047	2,255	2,500	2,700
ATA Holdings	1,292	1,275	1,277	1,500	1,600	1,700
Frontier	330	473	445	637	797	957
JetBlue	105	320	635	981	1,400	1,800
Southwest	5,650	5,555	5,522	5,893	6,600	7,300
Low Cost	**12,038**	**12,496**	**12,877**	**14,222**	**16,697**	**18,731**

Source: Company reports, consensus estimates and AirlineForecasts

Table 7

EMPLOYEE COSTS

	Year 2002	3Q 2003	*Annualised*	2003E		
	Per employee Annual costs	Number Employees	Total Labour costs	Per employee Annual costs	03 vs 02 change	03 vs 02 % change
			(in $ '000s)			
America West	**$45,800**	11,175	626,492	**$56,062**	$10,262	18%
Delta	$82,100	70,100	6,256,000	**$89,244**	$7,144	8%
Southwest	$59,100	32,563	2,216,000	**$68,053**	$8,953	13%
Continental	$61,600	42,944	3,112,000	**$72,466**	$10,866	15%
AMR	$89,800	92,800	6,772,000	**$72,974**	-$16,826	-23%
Alaska	$69,600	10,114	794,800	**$78,584**	$8,984	11%
UAL	$90,200	59,829	4,840,000	**$80,897**	-$9,303	-11%
US Airways	**$103,700**	26,300	2,348,000	**$89,278**	-$14,422	-16%
Northwest	$86,700	38,722	3,925,333	**$101,372**	$14,672	14%
Sum		**384,547**	**30,890,625**		**-$2,259**	
Average	**$76,511**			**$78,770**		3.3%

Source: Company reports and AirlineForecasts ruptcy and many believe the company is headed toward a second trip to bankruptcy court.

The fat is in the overstaffing

The real fat in the legacy airlines has been in overstaffing, resulting from a huge array of workrules designed to increase the number of personnel and reduce hours actually worked for active employees. Flight crew working rules are the most egregious problem, but these are compounded by union agreements that require as much as seven weeks of vacation for some employees, restrictions of many kinds of cross utilisation of ground personnel, requirements for double and triple compensation for those who work on holidays, contractual restrictions which prevent effective monitoring of sick time usage, and a host of other limitations on management's right to realise effective utilisation of available personnel.

Based on the head count and wage/benefit reduction that has taken place over the last three years, it could be argued that as much as 10% of the big six legacy airlines' total cost structure represented excessive staffing. In terms of total labour costs, unnecessary staffing represented about 18% to 20% of the annual costs. In other words, bloated payrolls have inflated labour costs by about $6.5bn per year. The magnitude of the cost savings is quite spectacular when one considers the $7.3bn in total labour savings achieved this year over year 2000 by the big six. Only $840m (or 11.5%) of that was from wage and benefit reductions. In terms of total cost reductions for the group, third quarter year-over-year results show that 57% of the savings were from labour.

The hidden costs of anachronistic work rules (i.e., featherbedding and payroll padding) can be quantified by examining the annual savings derived from reducing the number of employees per aircraft for the big five US network airlines.

The big five "legacy" US airlines averaged 139 employees per aircraft two years ago but have improved labour productivity 21% by reducing head count to 110 this year (see table 8, below). Roughly speaking, each head count reduction saves the group $225m in annual labour costs. In other words, the big five saved $6.3bn a year by simply rationalising head count toward industry averages. This represents 88% of the $7.1bn total in labour savings from 2000, which includes wage and benefit reductions. In other words, the real savings are based on reducing unnecessary employees on the payroll. The bulk of these productivity savings is a function of changing collective bargaining agreements.

American and United account for 63% of the group's cost improvement and collectively have lowered labour costs by $4.5bn annually. Both of these companies had head count and wage/benefit levels that defied logic when compared to industry averages. ALPA (Air Line Pilots Association) and the IAM (International Association of Machinists) legally killed the golden goose at United Airlines by padding payrolls for too many years. Almost 60% of the mechanics have lost their jobs since the company filed bankruptcy and the ramp employees no longer make three times the market rate of pay, in fact, those jobs have now been contracted out to third party service providers. The payroll bloat at

Table 8 HEAD COUNT REDUCTION AND SAVINGS

	3Q 2003 Aircraft	Headcount per Aircraft yr 2000	Headcount per Aircraft yr 2003E	00 vs 03 Change	Savings per head count reduction	Total annual Labour savings ($'000s)	% Change
UAL	539	165	111	54	$43,604	$2,354,595	-33%
AMR	799	150	116	34	$58,306	$1,973,950	-23%
Northwest	427	129	101	38	$43,286	$1,644,865	-22%
Delta	829	145	127	18	$49,260	$886,677	-12%
US Airways	279	106	94	12	$24,908	$292,295	-11%
Continental	352	131	122	9	$25,508	$229,574	-7%
America West	140	94	79	15	$7,849	$117,730	-16%
Alaska	109	104	93	11	$8,566	$96,030	-11%
Southwest	385	86	85	1	$26,200	$37,225	-2%
	3859	**129**	**94**	**35**		**$7,632,940**	

Source: Company reports and AirlineForecasts

United showed up in the head count numbers that exceeded industry averages by 28% during the union-controlled, employee-owned ESOP (Employee Stock Ownership Plan). American was almost as bad at 16%.

Saving $7bn a year in labour costs is a major accomplishment for these five big airlines. It took a September 11, a war in Iraq, SARS, an economic recession, two bankruptcies, and a threat of liquidation to change the collective bargaining agreements.

Collective bargaining agreements (CBAs) became far too restrictive in terms of what an airline can do competitively. Every aspect of an airline's operation is impacted by these labour contracts: marketing, sales, pricing, market values, scheduling, aircraft orders, and growth. The full savings reflected in the head count rationalisation programmes under way at United and American have yet to be realised or recognised. Northwest and Delta have yet to achieve adequate labour savings and they most likely will not be as successful as those that have had the leverage (or threat) of bankruptcy.

Special treatment

Unions and airline management have now joined forces to push aggressively for legislation that would allow the airlines to defer these cash contributions. The measure favoured by the airlines - "The Airline Pension Act" - is supported by politicians representing nine states with Major airline operations. The proposed legislation would exempt all the major airlines from the rules governing pension funding and would allow an airline whose asset values fall below 80% of the fully funded level to defer making cash contribution payments for five years. During the five-year period, only interest payments will be required. The contribution debt would then be amortised over 15 years with annual instalments.

It would also allow all companies to assume a more generous rate of return on their pension funds for two years, thereby reducing their pension liabilities. This is not the plan the unions and airlines were hoping as reflected in the "Airline Pension Act" but it does dramatically lower the amount of cash required in 2004 and 2005. If the Senate goes along, and the President signs the bill into law, the airlines could reduce the $5bn in required cash contributions in 2004 by approximately $4bn.

Duane Woerth, president of the Air Line Pilots Association, the union spearheading the drive for the legislation, said the industry suffered unique damage as a result of September 11: "everyone knows the airlines can't afford to make the cash contributions and fund operations". Treasury officials, the Bush Administration and the PBGC, the agency that insures pensions (see box, page 11), oppose the legislation on the grounds that it would prompt other troubled industries to demand relief as well, leading to further pension deficits and eventually a bankrupt PBGC.

Administration officials don't like the legislation because when weak companies reduce the amount of cash contributions, the plans typically get weaker over the contribution holiday. The fear is that some of the weakest pension plans could fail if the rule were rolled back for two years, because the sponsoring companies might still be unable to come up with the needed cash when the two-year reprieve expired. If this were to occur, the PBGC would end up with a bigger burden than if it simply took over the plans now. The Director of the PBGC was quoted as saying "giving a special break to weak companies with the worst-funded plans is a dangerous gamble. The risk is that these plans will terminate down the road even more underfunded than they are today". His agency has a large deficit, and would be about $350bn short if it had to assume all of the plans that it believes are in danger of going bust.

Pension-relief legislation will not solve funding problem

Pension relief is likely to happen by the first quarter of next year. $5bn in required cash contributions - needed to close the $22bn pension-funding gap - will be reduced and delayed in 2004. This will help the cash flows of the big six airlines but will have the negative effect of making the pension obligations larger once the temporary relief is lifted. The obligations will grow larger as benefits accrue and the workforce ages and required contributions are lowered. Strong stock market returns will boost plan assets but the funding gap will not decrease because higher obligations will offset higher plan returns. Other things held constant, the obligations will be about 5% to 8% higher next year because the discount rate used in the calculations will be lower by about 50 basis points.

The balance sheets and the underfunded pensions remain big problems for the legacy airlines. Excluding US Air, which no longer has a major funding problem, about $8bn of the funding shortfall is not reflected on the balance sheets of the big five. For example, NWAC has a negative $2.7bn book value. This would be worse by $1.4bn if the part of the pension liabilities not reflected in the financials were considered. For the industry as a whole, $26bn in equity has disappeared over the last three years. It will take a very long time to accrue this level of equity and it means that the majors will not be growing capacity as fast as they did during the last economic recovery. The airlines that grow too fast will be the ones filing for bankruptcy during the next shock or downturn.

Solving the pension problem is something both the government and airlines need to worry about because of the impact of airline plan failures on the PBGC, which may ultimately come back to the taxpayers.

The airlines with the big funding liabilities are trading for pennies on the (sales) dollar in the marketplace. The market-to-sales multiple (see table 3, page 3) compares the relative valuation of each airline and it is easy to see who is creating the greatest value. Clearly, the big airlines promised (or the unions demanded) more than the airlines could afford. As these airlines shrink to stop the losses, the deficits and cash contributions per employee increase. In other words, relative unit-labour costs move further away from market averages and the airlines become even less competitive with those that can afford to grow. The defined benefit plan deficits are significantly larger than the market values of the DB airlines. This means that there may not be anything left for the owners of the assets or enough money to properly reinvest in the competitive resources of the business.

A window of opportunity

There is a window of opportunity to fix the legacy airlines and it will only be open during the expansion phase of the current economic recovery underway. Earnings estimates over the next few years suggest that the airlines will make slim profits during the good times but will not be able to cover true capital costs or fix the balance sheet over the full business cycle. If management and labour do not get the economic house in order during the upside, a bankruptcy judge will help them sort it out during the downside. Reducing labour costs and improving customer service is the key to reinventing the legacy airlines.

Hub airlines and point-to-point airlines can coexist and an expanding economy will lift all boats, albeit at different levels of profitability. Legacy airlines will continue to lose market share until they repair the balance sheets and narrow the fare differentials with the low cost airlines. Reducing debt is a top priority and there will be little cash remaining to "reinvent" or reinvest in the airlines until a certain amount of debt is paid down. This will take five to ten years and even then the reduction may not be enough for the next downturn.

United and Delta are experimenting with lower-cost "branded" operations, but, unless labour's cost differentials are narrowed with the low-cost airlines, no amount of branding will fix the high fares required to compensate for the higher costs. Branding an airline with out-of-line costs is like putting perfume on a pig. Regardless of the new (branding) smell, it's still a pig of a competitor and passengers' perceptions and expectations will not change as long as fares are too high.

There are hidden savings in the collective bargaining agreements with the various labour groups. United and American are on the right path with their new labour agreements and Northwest and Delta will have to follow their lead. Bankruptcies will be postponed as pension relief legislation delays and reduces the contributions required to close the $22bn funding gap, and, as the economic expansion lifts all boats. Several of the legacy airlines are raising equity capital and this will help shore up the balance sheet. Capacity contraction will not be necessary during the recovery phase because passenger traffic will increase as average fares continue to fall and economic growth stabilises around its long run potential.

The legacy airlines as a group will not be able to match the operating profits of a Southwest or JetBlue, however, there is reason to believe that they can achieve a 5% to 10% operating profit during the economic expansion. Northwest, Continental, Alaska, and America West did quite well during the September quarter and will be producing positive earnings next year. United's unit costs will most likely fall below nine cents next year and this implies a 5% operating margin. This would also imply that unit costs will be 20% higher than Southwest's, however, unit revenue does not need to be 20% higher for United to achieve adequate profitability. Maintaining a 12% unit revenue premium could do the trick, and is lower than the historic 18% premium that resulted in lost market share, which was a function of higher average fares.

Delta will most likely achieve concessions from their pilots and will also regain profitability by 2005. During the first nine months of 2003, Delta has had the highest labour costs in the industry - 48% of every dollar or revenue went to labour versus the industry's 36%. The magnitude of this difference becomes apparent when considering the $1.6bn in additional "above market" annual labour costs that Delta must endure. In other words, with market-level labour costs, Delta would make $900m in profit this year. The company can continue to pay a labour premium but they will have to cut at least $500m more out of labour to be viable. Delta will end the year with negative $800m of book equity and incur $700m in net losses. They have $4.6bn in unfunded pension liabilities, of which about $1.2bn is not reflected on the balance sheet. Bottom line: Delta will end 2003 with a negative net worth of around $2bn.

As a group, the US Majors will post positive operating margins next year and be profitable in 2005, albeit at perhaps half the level of the peak of the last business cycle. US Airways is in deep trouble and will have to go back to labour for more relief. It is losing market share with a 23% unit revenue premium above Southwest's and can't make money because they have a 50% unit cost disadvantage.

What it takes to make the Majors viable

The legacy airlines are viable when they can cover their true capital costs over a full business cycle. This would include a "normal" rate of return charge for equity capital and this is the difference between GAAP-based accounting earnings. Normal return is risk-adjusted and based on the opportunity cost concept. The airlines are viable if they did not have the cash contributions required to close the funding gap over the next 5 years and if their labour costs - in all of its forms - was closer to that of the industry average. Under these conditions, the legacy airlines can make money and thrive. Retirees and current employees must understand this simple concept and accept appropriate concessions before it's too late.

Government policy makers should take advantage of the leverage they have with pension legislation. This means: no temporary relief unless:

(1) Unions and management fully understand and agree that there is a crisis and that they are on the path toward bankruptcy or liquidation;

(2) The future costs of the plans are reduced significantly; and

(3) Labour and management agree on labour contracts that bring unit costs within, say, 5% of Southwest and labour agrees that all future contracts will be subject to some type of binding arbitration. This means that all new employees will not be in the defined benefit plans and the airlines switch to cash contribution plans or modify/freeze the current plans.

Unfortunately, even this may not be enough - several airlines will end up meeting the "distressed termination" criteria in a bankruptcy court by the end of the current business cycle.

Labour leaders persist in telling members that labour costs are not the problem and that it is a revenue problem. Apparently many believe that a rebounding economy and higher future revenues will solve the non-competitive cost and pension problems of the legacy airlines. Higher revenues and expanding traffic will help but it will not solve these two problems. Everyone one should clearly understand

Table 9

PENSION EXPENSE AND CONTRIBUTIONS PER EMPLOYEE ($)

	2001	2002	2003	2004	2005
Alaska	8,517	7,900	23,965	4,449	5,537
American	4,066	9,029	13,422	16,078	15,949
Delta	(327)	3,266	21,049	21,517	20,600
Continental	4,103	8,644	11,805	13,463	13,129
Northwest	6,122	11,869	30,740	34,415	31,309
United	7,190	10,234	31,695	34,663	30,923
US Airways	5,688	13,185	20,529	28,801	26,736
Composite	**4,445**	**8,727**	**21,127**	**23,441**	**21,938**

Source: Company reports and AirlineForecasts

that the legacy airlines have a cost problem and not a revenue problem. They have a pension funding and expense problem, a "deficit reducing" cash contribution problem (see table 9, above), and a wage/benefit/productivity problem. And, they have an earnings and balance sheet problem. Simply stated, they have a labour cost problem.

Based on reasonable revenue estimates for the industry, the big six will produce approximately $74.5bn in 2005. This is $11bn less than that produced during the market-bubble years in the late 90s and 2000. The Majors have become price-takers because 80% of their markets now have low-cost, low-fare competition. The big six's revenue-share of the industry (17 airlines) will be down to 75% in 2005 from almost 90% in 1998. Estimated profit-share will be down to 54% from 85% over the same time period. Southwest as a contrast will capture 25% of the profits in 2005, but only 7.4% of the revenue.

The $1.5bn in estimated net earnings for the big 6 in 2005 do not reflect the billions in "deficit" reducing cash contributions required to close the DB funding gap. They are no longer viable businesses because operating cash flows will not support operations and the cash contributions at the same time. Negative book equity, combined with large off-balance sheet pension liabilities and large losses make raising money difficult if not impossible. The legacy airlines have loaded up with debt and the revenue will not support the costs of the total assets. Basically, revenue levels in 2003 will be the same as those produced in 1994 and 95. Corporate assets, on the other hand, are larger by 73% - and this does not include a large portion of the off-balance sheet pension liabilities. Estimated total assets for the big 5 in 2003, $99.5bn; book equity, -$16.4bn; pension liabilities in 2004, $57.7bn; pension assets, $37bn; net pension assets: -$20.7bn; net pension assets as a percentage of corporate assets, 23%.

Pension reporting (SFAS 87) is deeply flawed. It allows companies to treat assumed rates of return as actual rates of return for accounting purposes, and it permits them to bring "excess" and entirely fictional earnings onto the income statement. It's truly Alice in Wonderland stuff. Pension accounting is in need of serious reform and so are the legacy airlines. United is the test case for the PBGC. If United terminates one or more of their plans in order to emerge from bankruptcy, the other legacy airlines will have no choice but to follow United's lead, and if they don't, they will surely die on the vine of lower-cost competition. This is the base-case scenario in my opinion and the economics that support this scenario are quite compelling.

Labour's power to negotiate collective bargaining agreements (CBAs) that these legacy airlines cannot afford gets to the heart of the problem and must be addressed by policy makers who must deal with the funding crisis. If the taxpayers don't bailout the airlines' underfunded pension plans, the taxpayers will eventually be asked to bail out the PBGC. Either way, the employees - specifically the pilots - will only receive a fraction of the pension benefits promised in the current CBAs. The government has a rare opportunity to leverage its ability to help legislatively by requiring airline and union action as a condition of any legislative pension relief. But election year expediency and politics may prevent the industry from swallowing the bitter pill of reality. If President Bush signs off on temporary pension-relief legislation, legacy airlines will use the extra cash to expand capacity. They believe this the best strategy to reclaim lost market share. Union leaders will push for growth to bring back unemployed workers onto the payrolls. The downside to the extra growth is that it pushes down average yields. This type of industry capacity decision-making some call "destructive competition" and others call dumb management. Regardless, it's irrational at the

THE ROLE OF THE PBGC

The Pension Benefit Guarantee Corporation (PBGC) is the government agency that insures pension plans and protects benefits. It was designed to serve as a "safety net" (or type of insurance) for employees and retirees in the event that a severely financially distressed plan is in danger of failing. When the PBGC has made a determination that a company cannot continue to administer a pension plan, it may agree to allow the company to terminate the plan. In a "distress termination," an employer ends a plan that does not have enough money to pay all benefits that are owed. In order to end the plan, however, the employer must prove to the PBGC that it is unable to support the plan - something PBGC does not just accept at face value. Union consent must be obtained if a plan is maintained pursuant to a collective bargaining agreement. If union consent is not obtained, the collective bargaining agreement must be abrogated under Section 1113 of the US Bankruptcy code. The PBGC must find that the distress termination criteria have been satisfied. In a Chapter 11 proceeding, the termination of a pension plan may not violate a collective bargaining agreement. Thus, in absence of an agreement with its union, the airline must obtain the approval of the Bankruptcy court to terminate its collectedly bargained pension plan.

In a distress scenario, PBGC takes over the plan and uses its own assets and any remaining assets in the plan to make sure that current and future retirees receive their vested pension benefits, up to maximum dollar amounts set by law and subject to other legal limits. In addition to employer-initiated terminations, pension plans may also be terminated by the PBGC. An underfunded pension plan can be terminated by the unilateral action of the PBGC on a discretionary basis if:

1) The PBGC finds that an employer has not been satisfying the minimum funding standards under the Internal Revenue Code; or
2) It is determined that there is a possible long-run loss to the PBGC if the plan is continued in operation.

Pension Accounting rules are governed primarily by the Employee Retirement Income Security Act (ERISA) and the internal revenue code (IRS), while the Statement of Financial Accounting Standard (SFAS) No. 87 relates to how the information must be presented in the company reports. The accounting in SFAS No. 87, "Employers' Accounting for Pensions," is convoluted, misleading, and arguably the most technically complicated financial reporting pronouncement ever issued. It is important to understand that aggressive assumptions such as a high discount rate, a low rate of compensation increase, and a high expected rate of return can help improve operating results as well as improve the funding status of a plan. In addition, frequent changes to these assumptions can be a way for a company to effectively manage their earnings.

With the termination of the US Airways' pension plan for pilots, four of the ten largest claims in PBGC's history are now from airline companies. Overall, the airline industry accounts for 17% of total PBGC claims but fewer than 2% of insured participants. Losses suffered by the pension insurance programme must be covered by premiums paid by other companies that sponsor defined benefit pension plans. The PBGC receives no general tax revenue and is not backed by the full faith and credit of the US government.

industry level as it destroys the pricing environment and everyone suffers.

Temporary pension relief legislation sets the airline industry up for a bigger fall once the relief goes away. Funding deficits and cash contributions will be larger in later years because contributions will be smaller during the relief years. Stated differently, the industry will appear to be sound for a few years, but will in fact be getting much sicker.