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The Impact on the Airlines of the Current Military Operations in Iraq

Executive Summary

This paper explains the current problems facing the airline industry and outlines policies Congress could consider to address the industry's problems without subverting the market process or rewarding some carriers at the expense of others. Since passage of the Aviation and Transportation Security Act in November of 2001, Congress has expected the airlines to perform a variety of national security functions and absorb the taxes necessary to pay for many of them at perhaps the most difficult time in the industry's history.

In these early stages of the current military operations, advance bookings for some carriers are down between 20 percent and 30 percent, figures that have eclipsed airline estimates. With industry losses in 2003 potentially exceeding $10 billion (admittedly due in part to self-inflicted labor costs), airlines argue that there is an urgent need for some type of relief from the costs of their security obligations.

The airline industry faces profitability issues unrelated to government, and Congress must not undermine the necessary industry restructuring and capital reallocation underway. However, there is little doubt that government decisions have affected the industry in substantive ways. In the context of the current geopolitical environment, Congress could appropriately consider temporarily relieving carriers of some of the taxes and security mandates imposed on them since the September 11th terrorist attacks.

Financial Condition of the Airline Industry

Market Capitalization

The financial condition of the U.S. airline industry has rarely, if ever, been as dismal as it is today. Cumulative losses in 2001 and 2002 exceeded $18 billion, and losses for 2003 are estimated to be in the range of $6 billion to $10 billion.[1] Currently, two of the seven largest carriers are operating in bankruptcy and several others may have to seek Chapter 11 protection from creditors in the days ahead.

The collapse in the airlines' financial performance has devastated their stock prices. Since September 11th, the airline sector, as measured by the Dow Jones U.S. Airline index, has lost over 60 percent of its value.[2] The worst performing stocks during this period have been the "major" hub-and-spoke carriers whose market niche is smaller rural communities at one end of the traffic spectrum and business and international travel at the other.

In the two years between March 1, 2001 and March 1, 2003, USAirways shed 99.6 percent of its stock market value, while losses at AMR, parent of American Airlines, were 93.4 percent, UAL, parent of United Airlines, lost 97.5 percent, and Continental Airlines' stock fell 89.2 percent.[3] Even the best performing airline stocks have not been immune from declines: Southwest (24.2 percent), Airtran (33.3 percent), and Alaska Airlines (35.3 percent) have all lost substantial value.[4]

Taken together, the combined stock market value of the entire U.S. airline industry stands at just under $13 billion – with the value of the six major airlines, which account for 78 percent of the nation's traffic, hovering near a combined $5 billion.[5]

Stock prices have declined across worldwide markets over the past few years, but consider: In September of 1998, the Dow Jones Industrial Average closed a little above its current value, but the Dow Jones Airline Industry Index is down about 68 percent from its highs of September of 1998, with a cumulative decline of $28 billion in market value.[6]

Even at today's depressed values, stock analysts' research notes are headlined by "Steer Clear of Airline Stocks,"[7] while others simply offer predictions about which airlines will survive through the end of the year.

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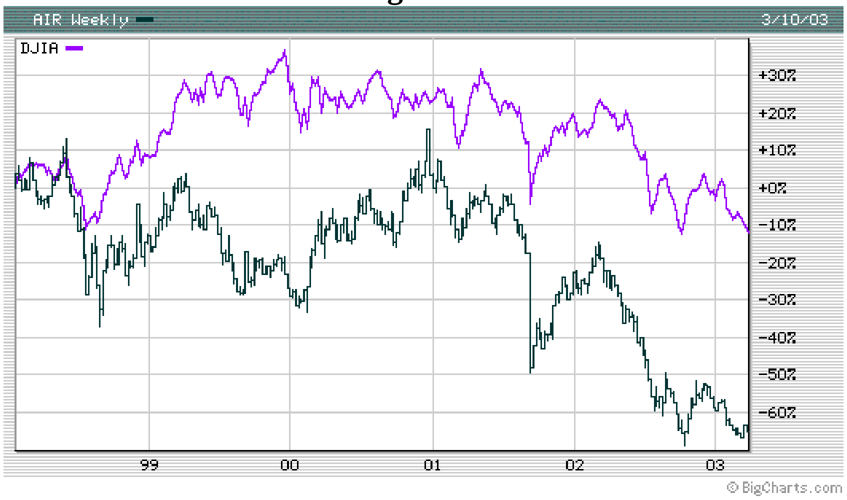
[1] "The Perfect Storm," a document produced by the Air Transport Association.
[2] Dow Jones U.S. Airline Index, September 11, 2001 – March 10, 2003.
[3] Dow Jones U.S. Airline Index.
[4] Dow Jones U.S. Airline Index.
[5] Joe Brancatelli, "Let's Buy an Airline," *USAToday*, February 25, 2003.
[6] Dow Jones U.S. Airline Index, 9/98 compared to 3/03.
[7] James J. Cramer, "Steer Clear of Airline Stocks," Real Commentary from TheStreet.com, February 24, 2003.

Dow Jones Industrial Average vs. Dow Jones Airline Index[8]



Balance Sheet Deterioration, Borrowing Capacity, and Credit Ratings

With the stock markets unkind to airline stocks, losses over the past few years have been funded by debt. Since 2000, the airlines have added a combined $22 billion in debt to their balance sheets,[9] which has increased the industry's debt-to-capital ratio by 44 percent.[10] The average carrier's leverage (the ratio of net debt to total capitalization) now stands at over 90 percent,[11] with total industry debt exceeding $100 billion.[12]

The airlines have all but exhausted their access to debt, and, with the exception of Southwest, the unsecured debt of every airline is rated as "junk." According to Fitch Ratings credit analyst William Warlick, "there has not been a significant unsecured debt transaction completed (by the airlines) in several months," meaning that any remaining debt must be raised by using planes and equipment as collateral.[13] Complicating that is the fact that the market value of planes has declined precipitously over the past year,[14] due to an oversupply of unused aircraft.

With the capital markets "virtually closed" to the major airlines,[15] most analysts' attention has turned to the amount of cash the airlines have on hand to estimate how long they can continue operations. American, for example, had $2.7 billion in cash on its balance sheet at the end of 2002, a figure its pilots' union estimates can only last until May, without accounting for declined bookings caused by the liberation of Iraq.[16]

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[8] Chart available at wsj.com.
[9] Martin J. Moylan, "Airlines borrowing more at higher rates to stay alive," *Knight Ridder/Tribune News Service*, February 8, 2003.
[10] Department of Transportation study cited in Brad Foss, "Airlines, facing grim future, shrink operations again," Associated Press Business News, October 18, 2002.
[11] Moylan.
[12] Statement of James C. May, President, Air Transport Association. *Statement before Subcommittee on Aviation, Senate Commerce Committee*, February 5, 2003.
[13] Warlick quoted in Moylan.
[14] Jenny Wiggins, "Airlines Take Cut on Debt Ratings," *Financial Times*, Feb 20, 2003.
[15] Warlick quoted in Moylan.
[16] Allied Pilots Association (APA) estimate quoted in Dan Reed, "AMR pilots willing 'to explore' salary cuts," *USAToday*, February 27, 2003.

Industry Economics

Fixed Costs

The airline industry differs from most other sectors of the economy because of its enormous fixed costs, as the General Accounting Office (GAO) recognized in a recent report. The GAO estimates that 80 percent to 90 percent of an airline's costs are fixed in advance of individual flights.[17] Such costs – regardless of whether planes are full or half-empty – include the aircraft (either depreciation and interest costs if the plane was purchased, or the rent payment if it is leased), jet fuel, pilots and crew, the aircraft hanger and tying costs, local airport fees for gates and airport slots, and insurance.

As a result, an airline's ability to respond to fluctuations in consumer demand is very limited compared to a traditional manufacturer, which can limit the items produced, labor hours, and other variable costs. This makes airlines much more susceptible to boom-and-bust cycles.

The flexibility afforded the airlines by deregulation in 1978 has helped to dampen the amplitude of such cycles to a large extent. For example, pre-deregulation route restrictions imposed by the Civil Aeronautics Board (CAB) prevented airlines from increasing capacity during economic booms or curtailing service during troughs.

According to the most authoritative study on the subject, airline deregulation has led to an annual $20 billion savings for air travelers and increased the number of air passengers by 75 percent.[18] However, deregulation has also forced airlines to live with the decisions they are now free to make: airline bankruptcy has gone from a rare event to one that has claimed 155 carriers since 1978.[19]

The flexibility afforded by deregulation contributed greatly to the current malaise as airlines greatly increased capacity to meet surging demand during the economic boom of the 1990s. Over the course of the decade, the U.S. airline industry expanded its number of available seat miles – the industry's key capacity metric, defined as one seat transported one mile – by 25 percent.[20]

Between 1995-2000, the commercial airline industry made a record $23 billion in profits and annual capital spending on aircraft deliveries peaked at just over $11 billion in 2000, as industry traffic set records.[21] Owing to the industry's high fixed-cost structure, once these capacity increases are made, they can only be reversed under significant duress. Airlines cannot sell and repurchase planes, or fire and hire pilots and crew, at their discretion. Moreover, an

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[17] General Accounting Office, *Aviation Competition*, GAO-01-832, July 2001.
[18] Robert Crandall and Jerry Ellig, *Economic Deregulation and Customer Choice: Lessons for the Electric Industry* (Fairfax, Va.: Center for Market Processes, 1997), p. 2.
[19] Air Transport Association compilation of bankruptcies available at: http://www.air-transport.org/public/industry/display1.asp?nid=6207.
[20] James L. Casey, Deputy General Counsel, Air Transport Association of America, in testimony before the House Aviation Subcommittee concerning H.R. 1407, April 26, 2001.
[21] Statement of James C. May, President of the Air Transport Association, "U.S. Airlines: The Road to Resuscitation," available at http://www.airlines.org/public/industry/bin/Econ102.pdf.

airline's actual schedule is its primary asset, the integrity of which it must guard to reassure consumers, even during downturns.

Labor Costs

The industry's record profits and dramatic capital spending increases in the last decade led the industry's major unions – including pilots, mechanics, cleaners, and flight attendants – to demand, and attain, record labor deals. Annual salary increases of 25 percent became the industry norm. The airlines expected to raise business fares to make up for this cost increase, but just as the labor increases took effect the economy began to slow. Depressed business spending made business fare increases impossible as the airlines began to witness a fall-off in existing business fares, a trend that has yet to reverse itself.[22]

Beyond current labor costs is the question of the airlines' defined-benefit pensions, the financing of which may be their biggest dilemma. According to airline analyst Christopher Struve of Fitch Ratings, airline pensions have $28 billion in assets to cover $46 billion in obligations, placing the funding level at a perilously low 60 percent.[23] A bankruptcy judge has already placed the USAirways pension under the control of the Pension Benefit Guaranty Corporation (PBGC), the taxpayer-financed pension insurance agency, with other airlines' pension plans likely to be assumed by the PBGC.

Revenue

Into this downward cycle came the September 11th terrorist attacks, which collapsed air travel. Although traffic has rebounded from the initial 30-percent drop, revenue at the nine major U.S. airlines fell 17 percent to $79.6 billion last year from $96.4 billion in 2000, and there is no sign of it returning to pre-September 11th levels.[24]

While airline revenue was tracking Gross Domestic Product (GDP) in the years after deregulation, since September 11th that correlation no longer exists, in part because the decision to fly has become more emotional.[25] The decoupling of GDP and airline revenue has the makings of a post-September 11th structural shift in the industry, as former CAB Chairman Alfred Kahn noted in his testimony before the Senate Commerce Committee in January.

Nominal airfares are at their lowest level since 1987,[26] due in part to Internet travel sites, which have exposed the airlines' pricing system and limited network airlines' ability to manage passenger yields, especially high-yielding (business) traffic. According to Professor Darryl Jenkins of the Aviation Institute at George Washington University, if an airline loses "just 1 or 2 percent of that high-yielding [business] traffic, [its] profits are gone."[27]

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[22] Andrea Rothman, Lois Jones, and Andrzej Jeziorski, "Airlines may lose for year; Business travel down as costs soar," *Chicago Sun-Times*, July 01, 2001.
[23] Struve in Danielle DiMartino, "Airline crisis bedevils pension insurer," *Dallas Morning News*, March 16, 2003.
[24] Scott McCartney, Stephen Power, John D. McKinnon and Susan Carey, "As War Deepens Airline Crisis, Split Develops Over Rescue Plan," *The Wall Street Journal*, March 24, 2003.
[25] McCartney, Scott, "A War in Iraq Could Take Heavy Toll on U.S. Airlines," *The Wall Street Journal*, March 5, 2003.
[26] *The Perfect Storm*, Air Transport Association.
[27] Jenkins quoted in Torbenson.

Salomon Smith Barney airline analyst Brian Harris estimated that without factoring in the cost to the airlines of the liberation of Iraq, to break even for the year American Airlines would have to reduce its labor costs 26 percent, while Delta, Northwest and Continental would have to cut their labor costs by 20 percent, 13 percent, and 4 percent, respectively.[28] Of course, these substantial cost reductions would have to come on top of an estimated $4.5 billion reduction in operating expenses, $5.6 billion in capital expenditures, and 90,000 job cuts already implemented since September 11, 2001.[29]

Low-Fare Carriers and Political Constraints

It is important to recognize that during the industry downturn, low-cost carriers like American Trans Air, Frontier, JetBlue, Spirit, and Southwest have made significant gains. Several of these airlines have been profitable every quarter since the September 11th attacks, and all of them have been adding capacity to their networks during the current downturn.[30]

The conjunction of increased air fare transparency via the Internet and the growth of low-fare carriers have put downward pressure on the fares of 75 percent of the network carriers' routes even though low-cost carriers cover only 20 percent of the network carriers' markets.[31]

For instance, even though Southwest Airlines does not have any gates at Boston's Logan International Airport, its presence in Manchester, New Hampshire and Providence, Rhode Island (both airports are approximately 50 miles from Boston) tempers the fares that network carriers may charge to and from Boston. According to a Department of Transportation (DOT) report released last April, Southwest's entry into Manchester and Providence reduced the average ticket price in those markets by 25 percent and 27 percent respectively.[32]

Such competitive developments have made it clear that coveted gate and landing assignments at primary airports are not as valuable as many once believed. Southwest seeks entry at airports with the largest possible "catchment area," defined as the population of the area served by the airport, and lowest airport fees.[33] To save money, both business and leisure travelers have demonstrated a surprising willingness to drive long distances for lower fares, particularly in the northeast.[34]

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[28] Harris in *Airline Financial News*.
[29] Statement of James C. May.
[30] Jeffrey Shane, Assistant Secretary of Transportation, in testimony before the Senate Commerce Committee on the future of the U.S. Airline industry, January 9, 2003.
[31] Donald J. Carty, chairman and CEO, American Airlines, in testimony before the Senate Commerce Committee on the future of the U.S. Airline industry, January 9, 2003.
[32] *Domestic Airline Fares Consumer Report*, U.S. Department of Transportation. April 11, 2002
[33] David Kesmodel, "New Hub for DIA?" *Rocky Mountain News*, March 7, 2003
[34] US DOT report.

Fewer Competitors, More Competition

In 2000, United Airlines and USAirways proposed to merge but were forced to abandon the merger after the Department of Justice filed a challenge. Both carriers are now in bankruptcy.

One of the key arguments against the merger was the deleterious effect it would have on point-to-point competition in discrete northeast markets where United and US Airways had huge advantages in gate and slot assignments. However, low-fare carriers' market share increased dramatically in Buffalo, Albany, Manchester, Baltimore and Rochester, NY at the same time the Justice Department was weighing the competitive effects of the merger.[35]

Although the DOT report on low-fare carrier penetration was not published at the time the merger was scuttled, it is an important lesson on the effects of government intervention into the airline industry. Had United and USAirways been allowed to merge, it quite possibly would have resulted in more competition, as the combined airline took advantage of improved efficiency and economies of scale to compete more vigorously with the low-fare carriers who had successfully entered their markets.

Online Travel Phenomenon

The other major development in the airline industry in the past several years has been the rise of Internet travel sites and the airfare pricing information they provide. Today, consumers can search sites such as travelocity.com, cheaptickets.com, expedia.com, and orbitz.com in addition to the web sites of the individual airlines to find the lowest prices and most suitable itineraries.

Recognizing the effect the rise of the Internet would have on their ability to manage yields, the five major national airlines in 2001 joined to create the travel website orbitz.com. Online competitors and travel agencies immediately assailed Orbitz and demanded an antitrust investigation. Before Orbitz was allowed to launch in June of 2001, it underwent a lengthy review from the DOT.[36] Antitrust scrutiny continued until the airlines agreed to provide their lowest available price, or "webfares," to other travel sites.

Antitrust action was again used in this instance to prevent the airlines from adapting to new competitive realities. By agreeing to have their lowest prices available only at Orbitz, the airlines wanted to make it the industry's ticket clearing house, something that would have lowered commission and distribution fees, but may have made established travel agents and online travel sites slightly less competitive. Deprived of its "webfare" advantage, Orbitz is now hardly different than any other online service in a remarkably competitive industry.[37]

Code Sharing

To reduce capacity without limiting travel options for customers, several airlines have entered code sharing agreements to sell and market seats on each other's flights. Such agreements

[35] US DOT Report.
[36] Brian Krebs, "Travel Agents To Orbitz: Feds Will Be Watching," *Newsbytes*, April 16, 2001.
[37] James DeLong, "Online Travel Services," *The Cato Institute*, Policy Analysis No. 441, June 6, 2002.

typically offer frequent-flyer reciprocity, use of each other's airport lounges, and some coordination with gate and slot assignments.

To assuage competitors' antitrust concerns, the Department of Transportation earlier this year sought to impose strict restrictions on a code sharing alliance involving Delta, Continental, and Northwest. When the carriers refused, DOT attempted to block the alliance in its entirety. The carriers and DOT are now in negotiations to settle the matter.

Airports and Air Traffic Control

Although rates, service, and entry were deregulated in 1978, airlines remain tethered to a bureaucratic aviation infrastructure. Congress, the Federal Aviation Administration (FAA), and hundreds of locally managed airports across the nation make critical decisions about airport and runway expansion, new airport gates and terminals, and the technology used to control and direct aircraft. As a result, the airlines exert very little influence over questions fundamental to their own industry's financing and capacity.

As the congressionally-appointed National Airline Commission wrote in 1993, "In the history of American business, there has never been a major commercial industry whose minute-by-minute operating capacity was capped by the daily operating efficiency of the federal government – except the airlines."[38]

While a persuasive case can be made that the industry is overtaxed and underfunded by government, the underlying questions about the optimal level of air transportation investment and capacity will remain unknowable as long as they are answered by political, rather than market-based, transactions.

Post-September 11th Environment

Taxes

The aforementioned government interventions illustrate that the airline industry does not operate in a totally free-market world devoid of political considerations and control. Though labor costs in particular are self-induced, one cannot presume that all of the industry's troubles are just a private matter: government intervention clearly has curtailed the industry's ability to reorganize in the face of new realities.

Of the government interventions into the airline industry, none have been as profound as the changes in security made in the aftermath of the September 11th terrorist attacks. Airline screening and plane security improvements instantly became a top national security priority. It is worth noting that, in the aftermath of September 11th, the federal government relieved the airlines of several hundred million dollars in costs for airport screeners. Indeed, the federal government has already spent approximately $12 billion on airline security since September 11th. But it should also be noted that improvements paid for through taxes on the airlines have further discouraged air travel and weakened the airline industry.

[38] Gerald L. Baliles and Greg Principato, "Ever Get the Feeling We're Flying in Circles." *The Washington Post*, March 2, 2003.

Taxes now account for 25.6 percent of the average airline ticket,[39] a tax take nearly double what it was a year ago and comparable to that imposed on tobacco products.[40] Just as tobacco taxes discourage the use of tobacco products, airline ticket taxes discourage air travel, particularly in today's economic environment. But in the high fixed-cost economic world in which the airlines operate, they have absorbed most of the tax increases to avoid further reductions in demand.

Major U.S. Taxes and Fees on Air Travel[41]

As of January 1, 2003	RATE	UNIT OF TAXATION
PASSENGERS		
Federal Ticket Tax (1)	7.5%	Domestic Airfare
Federal Flight Segment Tax (1)	$3.00	Domestic Enplanement
Federal Security Surcharge (2)	$2.50	Enplanement at U.S. Airport
Airport Passenger Facility Charge (3)	up to $4.50	Enplanement at Eligible U.S. Airport
International Departure Tax (1,4)	$13.40	International Passenger Departure
International Arrival Tax (1,4)	$13.40	International Passenger Arrival
INS User Fee (5)	$7.00	International Passenger Arrival
Customs User Fee (6)	$5.00	International Passenger Arrival
APHIS Passenger Fee (7)	$3.10	International Passenger Arrival
SHIPPERS		
Cargo Waybill Tax (1)	6.25%	Waybill for Domestic Freight
SALES/OPERATIONS		
Frequent Flyer Tax (1,8)	7.5%	Sale of Frequent Flyer Miles
APHIS Aircraft Fee (7)	$65.25	International Aircraft Arrival
Jet Fuel Tax (1)	4.3¢	Domestic Gallon
LUST Fuel Tax (9)	0.1¢	Domestic Gallon
Air Carrier Security Fee (2)	TBD	Domestic/International Enplanement

New Security Costs

The Aviation and Transportation Security Act (ATSA, P.L. 107-71), signed into law on November 19, 2001, imposed security service fees of up to $5 per one-way trip, with an additional carrier fee, apportioned by market share, to take effect in 2005.[42] The airlines estimate the total cost of the tax is $1.6 billion, with the anticipated carrier fee adding up to $600 million more.[43]

On top of these new taxes, the DOT also imposes discretionary fees every month for the cost of additional screening, which cost the airlines $330 million in 2002. Reinforced cockpit doors, ramp security, aircraft inspections, checkpoint document verification, queue management,

[39] Air Transportation Association, Ticket Tax Illustration, available at: http://www.airlines.org/public/industry/display1.asp?nid=5077
[40] Aaron Karp, "ATA projects Dollars 9-10bn loss for year," *Air Transport Intelligence*, November 13, 2002
[41] Produced by the Air Transport Association.
[42] Bartholomew Elias and Daniel Morgan, Aviation Security, CRS Terrorism Briefing Book.
[43] Leo F. Mullin, Chairman and CEO, Delta Airlines, in testimony before the Senate Commerce Committee, October 2, 2002.

exit lane monitors, fingerprinting, background checks and employee IDs, and other private-sector mandates impose an additional $910 million cost on the airlines.[44]

Other security measures also impose an opportunity cost on the airlines of an estimated $610 million. Restrictions on mail over 16 ounces and other freight carriage account for $400 million of this total, while lost revenue on seats devoted to the Air Marshal program account for the other $210 million.[45] In addition, if Congress fails to extend the temporary airline war risk insurance authorized by last year's Department of Homeland Security statute (P.L. 107-296), terrorism insurance costs would increase by $800 million industry-wide as insurers dramatically recalibrate risk models.[46]

Foreign Investment

The industry cannot address these security costs through accessing global capital markets, an avenue most domestic industries take for granted when seeking additional sources of financing. This is because of existing legal barriers to foreign sources of capital. Under current law, only 25 percent of a domestic airline may be foreign owned.

Given very real concerns about terrorism and the role that domestic pilots and carriers play in our national security,[47] it is unlikely, and potentially unwise, for the Congress to change this ownership rule.[48] But it would be just as unwise to pretend that the cost does not exist or that absent the restriction, foreign investors would not jump at the opportunity to buy access to the U.S. market.

Impact of the Liberation of Iraq on the Airline Industry

Recent Developments and Lessons from the First Gulf War

Uncertainty due to the current military activities has further deteriorated the financial position of the airlines. Several airlines have seen bookings down 20 percent to 30 percent from a year ago.[49] It is not hyperbole to suggest that if such traffic declines persist, a wave of bankruptcies will wipe out much of the industry.

The first Gulf War, which lasted approximately six weeks in 1991, caused seven carriers to file for bankruptcy, some of which did so prior to the war because of rising fuel prices. Four of those carriers ultimately failed.[50] Total airline industry losses attributable to the war were $13 billion, a sum it took the industry four years to earn back.[51]

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[44] *The Perfect Storm.*
[45] Ibid.
[46] Mullin.
[47] In the Gulf War, U.S. airline pilots flew over 5,000 missions with U.S. aircraft to deliver troops and supplies to the region and are now flying missions in support of our current military action.
[48] Duane Woerth, President of the Airline Pilots Association, on CNN Market Call, January 31, 2003.
[49] McCartney, Scott, Stephen Power, et al.
[50] Emily Rehring, "Outlook for Airlines Bleak as War Approaches, Fuel Costs Soar," *Oil Daily,* March 11, 2003.
[51] Rehring.

According to pre-conflict industry estimates, if this war follows the pattern of the first, quarterly losses will increase by $4 billion. This figure is based on declines in traffic of 15 percent during the conflict, and declines, respectively, of 10 percent and 7 percent for the following two quarters. Unfortunately, given the 20 percent-to-30 percent traffic declines already experienced by some carriers, these estimates may prove optimistic. Several major carriers have reduced capacity by up to 15 percent since hostilities commenced,[52] and the potential for up to 70,000 job losses remains real.[53]

Death Spiral Scenario

These circumstances could yield a "death spiral," where a wave of bankruptcies ultimately leads to far less air travel. Bankruptcy gives carriers a cash advantage: they face lower costs from court-imposed labor concessions,[54] and they do not have to make debt payments. They can use this relief to compete for business travelers by keeping business and walk-up fares low to increase market share.

This not only forces competitors to lower their prices, but also to seek bankruptcy protection themselves. Earlier this month, American Airlines, which is United's biggest competitor, began to look for debtor-in-possession (bankruptcy) financing even though it has the cash on hand to make debt payments through May.[55] With three of the six major carriers competing under the protection of bankruptcy, the "healthy" remaining carriers will be under increased pressure.

If the war lasts longer than expected, or if passengers continue to avoid air travel, the lower revenues and lack of access to any funding could translate into a half dozen or more bankrupt airlines. As a recent research note from Deutsche Bank explains, "the current post-September 11th revenue/cost environment points to an inability of many, if not most, of our airlines to survive financially if the Iraqi conflict lasts more than six to eight weeks."[56]

Potential Remedies

Air Transportation Safety and Stabilization Act

In the week following the September 11th terrorist attacks, Congress passed the "Air Transportation Safety and System Stabilization Act" (ATSSSB) (P.L.107-042) to provide $5 billion in direct funds to compensate for airline losses when the system was shut down following the attack, and $10 billion in guaranteed loans to qualified carriers. As a result, and because some of the airline labor costs are a self-induced problem, there is some skepticism about providing additional funds for the airlines now, even in the face of a possible industry death spiral.

[52] David Jones, "Coping With the Threat of War," *The New York Times,* March 4, 2003.
[53] *The Perfect Storm.*
[54] Judge Whitaker quoted in Thomas Donlan, "U.S. airline stocks need to ditch extra baggage," *National Post*, February 18, 2003.
[55] Elizabeth Wine, "Diplomatic impasse saps buyer conviction," *Financial Times*, March 12, 2003.
[56] Caroline Daniel, "War fears add further blow to American," *Financial Times,* March 11, 2003

While there is little doubt that the airlines increased their spending far too dramatically at the end of the 1990s boom, it is also true that since the September 11th attacks, Congress has forced the airlines to absorb an estimated $4 billion in security and insurance costs at a time when the industry's consumer base was at its most frail. The safe operation of the airlines has also taken on critical national security ramifications, but instead of treating it as such, current policy has forced the airlines to absorb it themselves.

As Yale Law Professor Michael E. Levine has said, "there is some wariness about the boy who cried wolf." Having just provided such a sizable package a year ago, it does not seem necessary to do so again just 18 months later. But, as Levine continues, "the irony is they have got to this point when the government is taking a series of actions that are impacting the industry in special ways" and is not considering the effect on the industry.[57]

Air Transport Association Proposal

The Air Transport Association (ATA), the trade group representing the major hub-and-spoke carriers, as well as their low-fare rivals, has presented Congress with a comprehensive and fairly ambitious aid package. The ATA requests that Congress reimburse the airlines for their security costs, repeal the security taxes imposed since September 11th, and suspend other taxes on air travel for a period of one year. The ATA also requests that Congress instruct the Secretary of Energy to release the Strategic Petroleum Reserve (SPR) to attenuate the run-up in fuel prices. Further, it asks Congress to permanently reauthorize the temporary aviation insurance package included in the Department of Homeland Security statute passed last year. In total, the package would cost an estimated $9 billion to $10 billion.

Other Considerations

Some others have suggested a less ambitious proposal, under which Congress would appropriate approximately $1 billion to reimburse certain security costs, extend the subsidized insurance package, and make unused loans from the ATSSSB available to help airlines address rising fuel prices. Of the $10 billion in guaranteed loans authorized by the ATSSSB, only $1.6 billion have gone to carriers.[58]

Fuel generally accounts for between 10 percent and 15 percent of operating costs for airlines. This percentage has increased over the past 12 months for most carriers as jet-fuel spot prices on the New York Mercantile Exchange (NyMEX) have increased by 113 percent since last year.[59] According to the ATA, a one-percent increase in jet fuel costs the industry $180 million, based on the 18 billion gallons purchased last year.

While this proposal would provide some help to the airlines, it would benefit some at the expense of others and would fail to address the industry's real problems. All airlines recognize that jet fuel is their key input and the price of that input fluctuates relative to the price of oil.

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[57] Caroline Daniel, "Industry requests for financial aid are likely to go unheeded by the government," *Financial Times*, February 13, 2003.
[58] Caroline Daniel, "The 1991 Gulf war led to the collapse of three big carriers. This war could be even worse." *Financial Times*, March 26, 2003.
[59] Melanie Trottman, "U.S. Airlines Show Disparity in Hedging for Jet-Fuel Costs," *The Wall Street Journal*, March 10, 2003.

Thus, airlines are exposed to the risk that geopolitical factors, or production and transportation problems, will greatly increase their operating costs. To address this risk, many airlines "hedge" fuel costs by locking in fuel at prearranged prices through future contracts, derivatives, and other financial arrangements.

Some airlines have pursued this strategy more aggressively than others and, as a result, are far less exposed to increased fuel costs than others. For example, Northwest and Southwest are 100-percent hedged and pay the same price for fuel today as they did a year ago.[60] By contrast, United Airlines has no hedges in place because its forward contracts were liquidated when the carrier filed for bankruptcy in December. United stands to pay an estimated $100 million more in fuel costs this quarter than it did for the same period last year. So relief based on fuel costs may be problematical, given the differences among airlines.

Principles for Congressional Action

Although the White House did not include assistance for the airlines in its $74.7 billion wartime supplemental request, this does not preclude congressional action on this subject. Given the increased strains on this important industry due to the war, it may be appropriate for Congress to include some limited airline relief, along the lines outlined below, in the supplemental spending bill.

As Congress considers whether to provide the airlines with any relief, several principles could guide our thinking: (1) any relief should apply on a pro-rata basis that does not pick winners and losers among the various companies; (2) any relief should be as targeted as possible to the real economic impact of the war, instead of the broader and ongoing economic woes of the airline industry – most of which are unrelated to the war; and (3) any relief should be temporary so as not to interfere with the industry's ongoing restructuring, nor establish the precedent that the federal government should socialize all of the security costs in a post-September 11th world.

A narrowly tailored package that provides the industry with a few months' worth of relief from some of its security-related costs would allow the Congress to provide the industry immediate assistance consistent with the above principles.

[60] Trottman.