

Big airlines ought to stop flying solo

By RAJEEV DHAWAN

With a little help from some corporate friends and pilot negotiations, it looks as though Delta Air Lines has avoided bankruptcy, at least for the near future. However, Delta's woes and those of United Airlines, which continues to struggle to emerge from Chapter 11, remind us that the airline industry is undergoing extreme changes. Unless the major players in the industry change the way they do business, the handwriting may be all but written on the wall for the large "legacy" carriers.

Young airlines such as JetBlue and AirTran have been able to purchase new, fuel-efficient airplanes and hire workers at much lower salaries than the larger airlines. In addition, the larger carriers, especially Delta, are facing a daily problem of funding their fuel costs.

Delta's price for a gallon of jet fuel has doubled since 1999, which has pushed the cost of fuel from 10 percent of Delta's total cost to 15 percent. Given the tenuous financial situation of all big airlines and their heavy debt loads, hedge funds have been unwilling to extend another below-market fuel contract. Southwest, for example, with its good credit rating, has been able to secure hedging at half the current market rate. These discounts give low-cost airlines a tremendous advantage over their competitors.

The dot-com bust in late 2000 and the Sept. 11, 2001, terrorist attacks were a double whammy for the legacy carriers. They first lost a few business travelers when the economy slowed, then the rest followed — along with regular, short-haul passengers — in the



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wake of the new Sept. 11 security requirements.

This change in flying habits is a permanent shift. In terms of basic supply and demand language, the demand frontier has now moved permanently downward.

But all may not be lost.

Yes, the general economic recovery so far has been tepid, especially in corporate revenues.

This has kept the business sector in a cost-cutting mode, which reduces the demand for business travel and its propensity to pay a premium. And yes, the big airlines must continue to compete with low-cost upstarts in the domestic leisure travel market.

But there is still one segment where they can charge a premium price — international. This is the comparative advantage they still have if they are clever about it.

The old practice of using a hub-and-spoke system for domestic travel to feed international flights is now archaic. There are too many airlines in the market, and government subsidies have allowed them all to survive.

The time has come for some of the airlines to either merge or liquidate so that the excess capacity can be reduced to profitably manage the new demand frontier.

Consolidation is the first step.

But will consolidation alone save the big boys? Maybe three years ago it might have worked, when the upstarts weren't as powerful as they are now.

Today, the only way out is a radical shift in thinking by the big airlines: outsource to low-cost airlines and allow them to bring passengers to your hubs. Then fly these travelers on your planes at premium prices to international destinations, where there is no competition from Southwest and the other upstart airlines.

Won't consumers then have to pay a higher price? The answer is no. The low-cost airlines provide us the best service at the domestic level, and when legacy airlines exit that business, the competi-

tion from new entrants with their low fixed and labor costs will either keep the price at a low level or even drop it. We already pay a premium for international travel, so I doubt any more will be charged. It might even be reduced when the legacy airlines stop milking

it to pay for their losses from domestic operations.

Price premiums drop, we pay less, airlines make profits, workers are happy. Does it sound like something for nothing? No, because this is the result of redeployment of assets or capital to their better use based on the principle of comparative advantage. We do that all the time in our daily lives when we make changes in our asset portfolio, so why can't they?

The best scenario for them, and the industry, is to think outside the box, quickly, as time is running out.

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