Testimony before the Subcommittee on Aviation
U.S. House of Representatives
Committee on Transportation and Infrastructure

"Impact of Consolidation on the Aviation Industry, with a Focus on the Proposed Merger Between Delta Air Lines and Northwest Airlines"

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Good afternoon, Mr. Chairman, members of the Subcommittee, ladies and gentlemen; thank you for the opportunity to testify today.

The U.S. airline industry once again faces a financial crisis, this time caused mostly by very high jet fuel prices and a weak economy. The managements of Delta Air Lines and Northwest Airlines suggest that the proposed merger of their companies will help them survive these challenges. My testimony will address:

- The magnitude of the financial problem facing U.S. airlines;
- How the proposed merger seeks to address that; and
- What broader effects this transaction (and others that may follow) may have on the rest of the airline industry, its employees, and the traveling public.

In 2007, the ten U.S. airlines rated by Standard & Poor's spent over $30 billion on jet fuel, higher than the previous year and more than triple the level in 2002. Yet, they reported their best profits since 1999. How was this possible? They cut non-fuel costs, including painful restructuring in bankruptcy for many, and they were able to raise fares and fill more seats. This year, their progress is in danger of being wiped out by a further surge in jet fuel prices. The Energy Information Administration's recent forecast of $136 per barrel jet fuel in 2008 is 50% higher than last year. That means that the ten rated airlines could face $15 billion higher fuel costs in 2008. That is triple the $5 billion of pretax profits they earned last year. Absent any other changes (such as higher revenues), this fuel price shock could bring many of them close to bankruptcy by early next year.

My first slide shows our current long-term corporate credit ratings on U.S. airlines, all of which are rated in speculative grade, except for Southwest Airlines, which is rated investment grade. The second slide shows a simplified example of the financial pressures facing the airlines. I start with the unrestricted cash and bank line availability at the end of last year for the nine airlines we rate in speculative grade. I add operating cash flow, assuming for the moment that the airlines repeat in 2008 what they generated last year. I then subtract the approximate damage from 50% higher fuel costs. I also deduct debt payments due this year and commitments for capital expenditures on new aircraft. The result of this scenario is that, by the end of the year, the airlines' cash would be slightly below what we would judge to be a safe minimum level of cash on hand. In other words, in this simplified example, the airlines, as a group, would be at risk of bankruptcy. I should emphasize that this is not our forecast for these airlines, but rather a simplified example that shows how serious a threat they face if they cannot offset the higher fuel prices through higher revenues or cost reductions.

The airlines' choices of how to respond are limited. One method that airlines have used to cut fuel expense is to ground the least fuel efficient planes. That helps only if the airlines can also cut other operating expenses (like labor and overhead costs) proportionately and if the revenues foregone by not flying are less than the cost savings. Delta and Northwest have announced plans to ground some older planes used in the domestic market later this year. Beyond this, the airlines' choices are to try to cut their total non-fuel expenses and to try to raise revenues—the same strategies they used before. Unfortunately, there are problems with each choice. Having squeezed expenses (including labor compensation) for years, airlines are, in our view, running out of places to cut costs. The other strategy, increasing revenues, means filling more seats on already crowded planes and raising fares in the midst of a weak economy.

Would merging Delta and Northwest help them respond to this situation? The companies suggest that the combination would generate at least $1 billion of revenue and cost synergies annually by 2012. Most of this would be in the form of higher revenues, as shown in my third slide. We agree that the more complete route network created by combining these two airlines should allow the combined airline to compete more effectively and capture some market share from competitors. It is also plausible that reallocating planes and flights throughout the enlarged system will create some revenue gains. I will address later whether we think this implies higher fares for passengers. On the cost side, the combination of any two airlines provides an opportunity to cut overhead costs somewhat, and this case is no exception in our view.

However, we also see significant risks in this proposed transaction. The managements acknowledge that combining the two airlines will require a one-time investment of up to $1 billion to integrate information systems, fleets, and for other merger-related expenses. Although this transaction, as an all-stock merger, does not require adding acquisition debt, it also does not provide for any new equity investment to cover the merger costs. In our view, depending on the timing of the up-to-$1 billion one-time investment for merger integration, and the timing of the ramp-up of merger benefits, cash outlays could exceed benefits in the first year of the merger.

Perhaps more important in our view, airline mergers have a checkered track record, rarely delivering on expected gains and usually creating labor unrest and service disruption. US Airways, the product of a 2005 merger with America West, is still trying to overcome these kinds of problems. In the case of Delta and Northwest, our main concern is that the cost of new labor contracts could offset merger synergies to a greater extent than management forecasts. Labor groups at both airlines made deep sacrifices in bankruptcy, and will want better compensation in their new contracts. Therefore, we expect that the actual synergies may be less than Delta and Northwest forecast. However, bear in mind that not meeting projected financial benefits is not the same thing as not providing any benefits at all. In the case of US Airways and America West, despite their labor troubles, the combination did generate higher revenues and probably saved US Airways from liquidation. For Delta and Northwest, we expect that a merger would, over time, be a net financial positive for the combined company, but perhaps not to the extent currently expected by management. We also think that the labor unrest and service problems that plagued other airline mergers remain a risk here, as well.

What about the effect on air fares? One understandable concern is that a merger could create market domination sufficient to allow big fare increases. On this point, the merger of Delta and Northwest appears less problematic than other possible combinations, as the two airlines have very little direct route overlap. That is not to say that this merger, and any that follow, would not have any effect on fares. First, airline hubs often compete against each other indirectly, even where there is no direct overlap. To the extent that passengers today have a choice of connecting through, say, Delta's hub in Cincinnati or Northwest's in Detroit, they would presumably see less price competition between those two hubs following a merger. However, connecting flights often have more than two alternatives, such as Continental's hub in Cleveland or United's in Chicago. For that reason, connecting traffic is often very low priced and unprofitable for airlines.

Another way in which airline industry consolidation could affect pricing is by changing the likelihood of general fare increases and decreases. We think that a U.S. airline industry with fewer large participants would be more stable and, on average, charge somewhat higher prices. That is because a successful fare increase requires that all major airlines participate, while any single large airline can set off a general fare cut. Fewer major airlines, each of which would have substantial, defensible competitive positions, would make a proposed fare increase more likely to succeed.

That conclusion may cause concern, but needs to be put it in perspective. First, the ability of the large, so-called "legacy carriers" to charge higher fares would likely be limited by general economic conditions and by competition from low-cost carriers. Southwest and the other low-cost airlines have penetrated almost all domestic markets and generally serve as a check on how high fares can go. Even though they, too, have been raising fares recently, prices remain well below the levels of the late 1990's.

The second issue to bear in mind is the airline industry's fuel price problem I described earlier. With opportunities for cutting non-fuel prices limited, airlines' best hope lies in generating higher revenues. If these companies were carrying freight, instead of passengers, the means to do so would already be in place. Freight carriers, such as railroads, trucking lines, and package express, have contracts with their corporate customers that usually include fuel surcharges. When an index tied to diesel fuel or some other benchmark rises above a certain point, the surcharges typically take effect automatically. Airlines, by contrast, mostly sell their tickets one at a time to individual passengers, and there is no automatic increase for higher fuel prices. They have to try to raise fares or other fees, instead.

The magnitude of the potential increase in fuel prices this year means that air fares will almost certainly increase. This could occur in a combination of at least three possible ways, as shown in my next slide:

- Airlines might raise fares and pack more passengers into planes sufficient to cover higher fuel costs, as they did during 2007. This looks increasingly unlikely, given the state of the economy and the scale of the higher fuel costs.
- Airlines might fail to increase revenues sufficiently, forcing some to file for bankruptcy or even shut down. That would reduce the supply of seats and make it easier for the survivors to raise fares.

- Or, airlines might find it somewhat easier to raise fares in a consolidated industry.

  [NB: this change from “could” to “might” is designed to avoid any misimpression that we’re advising the airlines on what actions to take]

Most likely, there will be some combination of these three outcomes. However, the important point is that revenues, and thus air fares, will likely have to increase if the industry is to remain solvent. There is likely no other way to make the numbers add up, in our view. If this were a regulated utility, the companies would be applying for rate increases based on higher input costs. However, the percentage increase in revenues does not have to equal the percentage increase in fuel prices. The $15 billion higher fuel expense I mentioned earlier is equal to about 13% of 2007 revenues for the ten rated airlines.

To sum up, there are three key points to bear in mind:

- The U.S. airline industry faces a potential financial crisis if it cannot offset the dramatic increase in fuel prices;
- The proposed merger of Delta and Northwest offers potential financial gains in our view, but also material risks; overall, it is probably neither as beneficial as its supporters promise, nor as dire as its critics suggest; and
- One way or another ticket prices are likely to rise if fuel prices stay close to current levels or increase further.

Thank you for your attention. I will be happy to address questions you may have on my testimony.

Note: Standard & Poor’s Ratings Services does not take positions on matters of public policy. This testimony addresses the credit implications of airline mergers and certain industry risk factors, such as higher fuel prices.