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Subject: AMR and Airline Cost Structure
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Scott - interesting article. There are some aspects of deep airline cost structure you might want to investigate because they aren't surfacing in the coverage of the airline problems but are actually the things leading to so many challenges.

In analyzing air operations cost structures at Fedex we found that a critical driver was the nature and structure of the network. A hub-and-spoke system offers lower average and marginal costs for a sufficient volume across the entire total network traffic volume. However it can raise costs on particularly point-to-point routes, and sometimes significantly.

The problem is similar to network traffic routing in a telecommunications network. Do you have one central switching point or put the capital equipment in place to allow each origin to link to each destination. At lower overall volumes if your basic business value proposition is any-to-any then a single central hub made sense but as volumes grew additional regional hubs to bleed off additional investments in the central hub were possible. You'll find that this is exactly the cost- and capital-conscious strategy that Fedex started following in the late 80s.

In the airline business the majors seem to be thinking that their main value lies in the total network. Fine - but that allowed Southwest and now others to cherry-pick key city pairs without the huge capital investment of hubs and charge much lower fares. That dance has been going on for over a decade and is little recognized or acknowledged. What the airlines are doing now is 'trimming' the costs on the margins without addressing the deeper structural drivers that would require them re-thinking their entire operation and business model.

Associated with the network driven costs is the nature of the links in the network - the shorter the link the more time the planes spend bouncing up and down. The main drivers of plane costs are taxi, takeoff and landing because of fuel consumption, wear & tear and maintenance. Hence because US Airways serves many smaller cities in the Northeast it has an inherently higher cost structure that is very difficult to work around.

There are two other factors that were built on these structural characteristics are inflexible labor costs based on complex work rules. Only the pre-Reagan FAA had worse labor relations and a bigger gap between management and labor. Having met Frank Borman long past his Eastern days I can see where the combat pilot approach to labor relations might have led the workforce to the thought that management regarded them as expendable. You'll find that bad labor relations are endemic thruout the industry - the story about the Northworst mechanic who ran to the Dallas DC10 crash without permission and getting fired is true. Our guy was given time-off, a bonus and a public reception.

And the other was the 'take'em- for-all-their-worth' approach to pricing reflected in the huge efforts are yield management. When Delta started charging and enforcing \$600-700 instead of \$300 for NYC-ATL flights it was no longer possible to switch from AirTran for me no matter how much more congenial I found it. That was rather typical and while that environment is gone the mis-perception is not.

Both these management tactics represent, to me at least, a fundamental management arrogance that Don Carty displayed in his retirement arrangements. A sense of seperateness, entitlement and aggrandizment that put management interests ahead of the entepriese, the customers and the workforce. If you've ever met and worked with Bob Crandall you'll recognize the style. Even the railroad's managers have more respect for the institution and their fellow workers.

Finally, and something that has never made sense to me, is the pro-cyclic over-investment in capacity. It's almost as if the airlines have never wanted to make money. As Warren Buffett has pointed out several times they've never returned their cost of capital. My only hypothesis is that too many people are seduced by the glamour of flying and too much keeps getting poured into the capital structure. If someone were really sensible they'd make capital investments in a counter-cyclical fashion, rather like Intel does. Or at least project and manage their capital investments to where they could make money 80% of the time in a downturn instead of only 20% of the time in an upturn and never pay for their capital.

Think about it on that last statment - as long as it's true the airline industry is a huge collapse waiting to happen. And until the majors re-think and re-vamp their deep cost structures all they're doing is holding a costing umbrella over the heads of the discounters.