BY PETER BALDWIN

The airline cycle

OEMS PROMOTE START-UPS THAT DRIVE DOWN TICKET PRICES

At least half of the remaining U.S. legacy airlines have filed for bankruptcy as of now. I guess that if they did not do this, they would be at a competitive disadvantage against the new bankruptcy status and their contemporaries.

What's going on here?

I have been flying a lot these days. This is hard work, and I don't get to fly the newer start-up airlines because they don't yet go where I want to go. It does not make any difference which of the legacy airline carriers I fly; the usual topic of conversation with employees is the plight of the airlines, theirs in particular of course, with most of the criticism aimed at their industry executives, usually cited as the "real" cause of the problem. I have never actually bought this. But, you do have to admit that, as a group, these industry leaders have not distinguished themselves lately.

I used to think that the airline industry didn't know how to price its product; that their preoccupation with cost-based pricing has been their undoing. That, if the gas turbine manufacturers were to provide them with more cost-effective products and services, as suggested by August W. Henningsen, chairman of the executive board at Lufthansa Technik AG, in his Vienna 2004 TurboExpo Plenary comments, the industry would just give any profit enhancement opportunity away in their ticket price. I still think that's true, by the way.

If you ask the question about who actually does set the price, we would all agree that, various variable-cost "deal of the day" ticket pricing mechanisms aside, the market pricing is typically set by the start-up airlines.

The legacy carriers all complain about the new start-up airlines, with their new equipment and their non-union environment, and that this forces them to aggressively pursue major cost reduction initiatives. This, of course, has led to the very public and largely unsuccessful union strike by Northwest maintenance personnel, and a continuing stream of staff and benefit reduction efforts throughout the industry.

I have always viewed these reductions as inevitable and required in order to bring what appears to me to be artificially generous compensation plans into balance with the rest of the world. Part of the Northwest strategy appears to have been to extend the life of older equipment, but it looks like the recent dramatic fuel price increases may now have tipped the break-even pricing balance on this strategy toward unfavorable.

I have now concluded that the real issue is that the barrier to market entry is very low. It is just too easy for start-up airlines to get into the business. Well, why is that?

Simply put Boeing and Airbus, along with GE and Rolls-Royce, want to sell equipment. Everyone knows that you must land the first order from one of these fledgling carriers because they almost assuredly standardize for all future purchases. This is the successful business model popularized by Southwest Airlines and apparently still valid. I'm buying it, anyway.

I have never been inside one of these deals, but I am quite sure that the financing package is critical to receiving a commitment and that this is the reason why start-ups get "started."

From the equipment manufacturer's perspective, these are probably better customers than the legacy carriers. The legacy carriers do much of their own service work and probably use non-OEM part suppliers where they can, while the start-up companies have very limited service capability and are likely to buy all their parts through some form of long-term service agreement. All their equipment is new and presumably requires less service in a game driven by cash flow.

For these manufacturers, this is not exactly a high-risk deal. It is not like having to call in the "repo-man" to locate and repossess the equipment. Ending up with the keys to some partially paid off, fully factory-maintained equipment is not the worst outcome in the world, and by any measure, this sure beats missing out on a long run of future airplane or engine orders.

I don't think this problem goes away. In fact it appears to be the new business model of the unregulated airline industry, like it or not. And, we will continue to see carriers come and go as new carriers evolve, age and then decline. TI

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