

# Departures

Opinions On Current Issues In Aviation

## Fuel Surcharges: Can Rising Fuel Prices Support Fare Hikes?

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Amid record fuel prices, there have been many recent calls for airlines to raise prices. Indeed some new fare hikes have succeeded, typically couched to the public in terms of oil cost recovery. Yet if airlines could charge more whenever they felt a need or a wish, fares would have increased years ago. As much as airlines need revenue to cover rising fuel bills, the price of oil by itself will not be enough to sustain higher fares.

If costs alone don't allow fares to increase, then how can the industry respond? We contend that high fuel costs will cause a decrease in capacity, which will in turn increase unit revenue. More precisely, capacity will grow at a slower rate than demand, leading to new market-clearing prices. This same phenomenon — tight capacity relative to demand — has supported fare increases in the first half of 2005, when flights have been more full than ever before.

This could appear to be a question of semantics. After all, when airlines raise prices, fewer passengers buy tickets, which in turn allows airlines to remove capacity. But there is an important difference. In a competitive environment, airlines must remove capacity before they can raise prices, else competitors will steal their customers and the price increase will fail. This leads to two important questions for the airlines: Does removing capacity really raise unit revenue; and which airlines should remove capacity?

Reducing capacity in relation to demand most obviously improves unit revenue by increasing load factors as the same customers chase fewer seats. More subtly, capacity reductions eliminate the least profitable routes, raising the average revenue per seat mile. Moreover, reduced supply raises the equilibrium price between supply and demand. In most years before the recent downturn, decreases in capacity correlated with increases in unit revenue.

SH&E quantified this relationship using multiple regression analysis to control for changes in national income and periods in which the federal ticket tax was suspended. The results showed that a 1% decrease in capacity is associated with a 0.7% increase in revenue per seat mile. Clearly, a decrease in capacity will raise

unit revenue.

How then will capacity be reduced?

There is no indication that airlines will voluntarily decrease their own capacity to benefit the industry's profitability. Suppose that a carrier operating 10% of industry capacity cut back by 10%, reducing industry capacity by 1%. Unit revenue for the industry would be expected to rise by 0.7%. But while our noble carrier would share the 0.7% gain in unit revenue, it would lose over 9% of its own revenue base.

Rather than airlines individually volunteering to reduce capacity for the good of the industry, capacity will be cut on the weakest routes and by the weakest carriers. For all airlines, high fuel costs will push marginal routes into the red, and these routes will tend to be curtailed. Given the difference in financial performance and fuel hedges between low cost and legacy carriers in the U.S., it is

likely that marginal routes lie disproportionately with the legacy carriers, who would be among the first to cut capacity.

For an individual carrier to benefit from reducing capacity, it must be able to shed the associated costs. Therefore, capacity reduction is easier for airlines that own their aircraft outright, because they can ground them without having to pay mortgage debt or leases.

In many cases, though, the airlines that are best able to reduce their schedules have fewer unprofitable routes to cut because they are financially healthier. An alternative for weaker airlines is bankruptcy, which allows aircraft leases and debt to be rejected or restructured.

Whether through route reductions, consolidations and/or bankruptcy, rising fuel prices will ultimately make an impact by realigning capacity and demand, most likely affecting the least profitable routes and the least profitable carriers. When the capacity growth is realigned, our analysis shows that unit revenue will respond, moving the industry toward profitability.

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