The U.S. Regional Airline Industry: Changes & Challenges

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ACI-NA Annual Airport Board Members and Commissioners Conference

Prepared by
InterVISTAS Consulting LLC

April 2010
• Opening credits
• State of the industry
• Regional airlines – a brief history, an example, and near-term forecasts
• Challenges facing the regionals
• Questions & comments
InterVISTAS Consulting

- Multi-disciplinary transportation consulting firm
- Specialize in strategic and economic aviation projects
- Completed over 1,500 consulting assignments for more than 200 government & private sector clients in over 30 countries
Since 9/11, the demand for air travel has shifted. The difference between pre- and post-9/11 demand is equivalent to having had no domestic revenue in 2007 and 2008.
For airlines, the last 10 years have been brutal

Terrorism, unemployment, under-employment, and a declining economy aren’t normally associated with a vibrant airline industry.
Half of the country is experiencing unemployment > 9%
The industry’s profitability is increasingly volatile. A swing of $42b in 3 years. The industry’s cyclicality has increased exponentially since deregulation.

Source: BTS, Form 41, Schedule P-12 – carriers with operating income of $20m or more.
Industry response: drop capacity

“When you find yourself in a hole….”

Source: BTS Form 41 and 298C summary data
Most of that capacity came out of the domestic market

Facing a difficult domestic economy and increasing competitive pressure from LCCs, network carriers have sought refuge in international markets.

ATA’s Chief Economist claims that the loss in domestic capacity is the greatest since 1942.
Total industry fleet shrank by 2,660 aircraft from 2000 -- 2009

# aircraft

Regional jets: -945
Turboprops: -820
Narrow body jets: -700
Wide body jets (not shown) drop from 713 to 516 (-197)
Average fleet size has declined

Source: MIT Aviation Project
Change in the fleet – 1994 vs. 2009

DC-9s have turned into CRJ-200s and EMB 145s....

% of annual departures

- 1994
- 2009
How does that translate to airports?
62 of 65 large & medium hubs lost flights
60 out of 71 small hub airports have lost flights

% Change in Scheduled-Service Departures: 2Q 2010 vs. 2Q 2008

Air Transport Association Industry Review (March 2010)
When will the capacity return?

No time soon.

“The cuts to domestic capacity in 2009 are likely to bring the industry back to levels not seen since the late 1990s. Furthermore, we think an economic recovery is not likely to result in meaningful capacity additions given other forces at play. Notably permanently higher energy costs, higher capital costs, higher environmental costs and higher regulatory costs are factors forcing managements to keep fleet growth flat to modest for at least the next several years. Until the current airline fleets start producing positive returns on the underlying invested capital, we don’t expect to see much growth in domestic fleets anytime soon.”

Michael Linenberg, Bank of America/Merrill Lynch (Oct. 9, 2009)

Consolidation doesn’t normally result in MORE capacity.
Regional Industry - overview

What is a regional airline?

• Cape Air
  - 42 9-seat piston aircraft
  - B6, CO alliances, EAS

• Great Lakes
  - 35 19-seat, 6 30-seat tps
  - EAS, pro-rate, UA/FL

• PSA
  - 49 50/70-seat jets
  - US Airways owned

• American Eagle
  - 222 30/70-seat jets
  - wholly AMR owned

• SkyWest
  - 280 a/c, jets & tps, UA/DL

• Republic Holdings
  - 6 airlines, own & 5 codeshares
  - 280 jets, 50-150 seats
### Top regional airlines

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<td>1</td>
<td>1</td>
<td>SkyWest Airlines</td>
<td>UA/DL/UYX</td>
<td>20,668,204</td>
<td>33,125,090</td>
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<td>Atlantic Southeast</td>
<td>DL</td>
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<td>American Eagle</td>
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<td>17</td>
<td>Executive Airlines</td>
<td>AA</td>
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<td>3</td>
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<td>Republic Holdings</td>
<td>AA/CO/DL/UA/US</td>
<td>7,599,581</td>
<td>18,794,634</td>
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<td>Chautauqua Airlines</td>
<td>F9/US/YYX</td>
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<td>Republic Airlines</td>
<td>DL/WW/UA</td>
<td>4,193,120</td>
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<td>14</td>
<td>Shuttle America</td>
<td>D/JW/UA</td>
<td>14,848,078</td>
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<td>4</td>
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<td>ExpressJet Airlines</td>
<td>CO/DJ/UA/AV</td>
<td>13,057,975</td>
<td>17,970,957</td>
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<td>Mesa Airlines</td>
<td>U/VUS</td>
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<td>20</td>
<td>Freedom Airlines</td>
<td>DL</td>
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<td>38</td>
<td>Air Midwest</td>
<td>US/YYV</td>
<td>64,377</td>
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<td>6</td>
<td>6</td>
<td>Pinnacle Airlines</td>
<td>D/UNW</td>
<td>10,331,557</td>
<td>12,867,690</td>
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<td>18</td>
<td>Colgan Air</td>
<td>CO/UA/US</td>
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<td>Comair</td>
<td>DL</td>
<td>8,101,300</td>
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<td>US Airways Group</td>
<td>US</td>
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<td>PSA Airlines</td>
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<td>Piedmont Airlines</td>
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<td>Northwest Airlines</td>
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<td>12</td>
<td>Mesaba Airlines</td>
<td>NW</td>
<td>5,293,662</td>
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<td>19</td>
<td>Compass Air</td>
<td>NW</td>
<td>2,132,875</td>
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<td>10</td>
<td>Horizon Air</td>
<td>AS</td>
<td>7,389,899</td>
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<td>11</td>
<td>Air Wisconsin</td>
<td>US</td>
<td>5,593,952</td>
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<td>12</td>
<td>Trans States Airlines</td>
<td>UA/AA/US</td>
<td>4,986,457</td>
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<tr>
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<td>15</td>
<td>Trans States Airlines</td>
<td>UA/AA/US</td>
<td>3,495,153</td>
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<td>21</td>
<td>GoJet Airlines</td>
<td>UA</td>
<td>1,491,304</td>
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Source: RAA 2009 annual report
Founded in 1973 by Joel and Gloria Hall, operating under a code-share agreement with Allegheny Airlines, the carrier flew Jamestown, NY to Buffalo, NY and Pittsburgh, PA with 2 new 15-passenger Beech 99 aircraft.

1978 - Industry Deregulation

1984 - Chautauqua adds five 19-passenger Fairchild Metro III aircraft to the fleet.

1986 - Chautauqua is purchased by GAC, and purchases 12 30-passenger Saab 340 aircraft.

1994 - Chautauqua renews its code-share with US Airways

1998 - Wexford Capital, LLC purchases Chautauqua.

1999 - Chautauqua purchases ten Embraer ERJ-145s.

1999 - Chautauqua seals a 10-year code-share agreement with TWA to operate at least 15 Embraer 145s.
American Airlines buys TWA and renews existing RJ service with Chautauqua.

2001 - Chautauqua announces a new partnership with America West, flying 12 EMB 145s out of Columbus.

2002 - Chautauqua announces RJ service in Florida for the Delta Connection network.

2004 - Chautauqua is named ATW and Regional Airline World’s Airline of the Year.

2006 - Chautauqua begins operating 44 50-seat RJs as Continental Express.

Chautauqua and Republic Airlines begin United Express operations, and begin operating new 70-seat EMB 170 aircraft.

Chautauqua becomes a subsidiary of Republic Airways.

1,600 Flights
121 Cities
11,000 Employees
What is the prototypical “regional aircraft”? 

- **1995**
  - Beech 1900D
  - Avg. seats = 19
  - $n = 262$

- **2000**
  - Saab 340
  - Avg. seats = 35
  - $n = 267$

- **2009**
  - CRJ 100/200
  - Avg. seats = 50
  - $n = 667$
The lines between regional airlines and larger carriers -- and between RJs and mainline jets -- are not self-evident.

Source: John Hansman, MIT Aviation Project
The regional industry is growing

The aircraft are getting larger

RPMs have tripled
Much regional growth is a replacement for network carrier’s domestic capacity.

Since 2000, the regional carriers’ share of domestic capacity has increased from 5.3% to 13.8% of ASMs.

Source: FAA
The regional industry has been majority-jet since 2004

Small turbo-props continue to disappear from domestic service

Source: FAA Forecast
FAA forecasts that the number of regional aircraft will continue growing over the next 20 years. Little of that total increase will be turbo-prop growth.

FAA projects continued growth in total regional aircraft

Source: FAA Forecast
Boeing projects a sharp decline in smaller aircraft by 2028

The total North American jet fleet will grow, and most of that will be in 737-type aircraft.

Of the 2,896 regional jets in the worldwide market in 2008:

- 2,100 will be replaced
- 2,860 will be retired.

The RJ fleet will shrink to 2,220 in 2028.

The North American RJ fleet will shrink to 880.

Source: Boeing Commercial Aircraft Forecasts, Nov. 2008
Bombardier projects growth in the market for small aircraft

Bombardier projected a total of 12,400 aircraft deliveries between 2009-2028 worldwide.

Of those, 2,300 will be turboprops and 3,800 will be 20- to 99-seat jets.

Of the 2,300 turboprop deliveries predicted worldwide, 2,150 will be in the 60 to 99-seat segment.

In North America, Bombardier estimates demand of 2,725 aircraft under 100 seats. Only 140 will hold less than 60 seats.
What are the key challenges facing the regional industry?

- Scope clause changes at mainlines
- Adapting to increasing amounts and new types of risk, notably
  - Financial risk
    - Global / national economic recovery
    - Fuel costs
  - Operational risk
    - Uncertainty with demand for regional jets by mainlines (including risks associated with possible network airline bankruptcy or merger)
    - Work stoppage (organized labor – contract issues)
    - Change in government regulations
Scope clauses establish key parameters for regional flying

<table>
<thead>
<tr>
<th>Carrier</th>
<th>50 Seats or Less</th>
<th>51 - 76 Seats</th>
<th>77 Seats +</th>
<th>Additional Restrictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMERICAN</td>
<td>May not exceed 110 percent of mainline narrowbody aircraft. May not exceed 64,500 pounds.</td>
<td>Exception for CRJ-700s flown by American Eagle</td>
<td>Flying between listed cities may not exceed 1.25 percent of mainline block hours</td>
<td></td>
</tr>
<tr>
<td>CONTINENTAL</td>
<td>Limit of 274. Additional RJs may be added with mainline growth.</td>
<td></td>
<td></td>
<td>No Express flying between hubs</td>
</tr>
<tr>
<td>DELTA</td>
<td>No limit</td>
<td>255 aircraft between 51-70 seats. 120 with 71-76 seats (may increase with mainline fleet).</td>
<td>85 percent of flying less than 900 miles. 90 percent of flying will be to/from hubs.</td>
<td></td>
</tr>
<tr>
<td>UNITED</td>
<td>No limit</td>
<td>No limit up to 70 seats</td>
<td>Regional block hours less than mainline block hours. No new feeder flying on UA routes flown in last 24 months unless UA could not earn an adequate return.</td>
<td></td>
</tr>
<tr>
<td>US AIRWAYS East</td>
<td>150 Small RJs. Defined at max weight of 53,000 pounds. Small RJs seat 40-44. Medium RJs defined at 45-50 seats. Large RJs: 51-88 seats.</td>
<td>Medium and Large RJs up to 315. Can be expanded on mainline fleet.</td>
<td>Limits on flying for US Airways or another carrier. 80 percent of nonstop flights limited to less than 950 miles.</td>
<td></td>
</tr>
<tr>
<td>US AIRWAYS West</td>
<td>Permitted up to 88</td>
<td>Permitted up to 88 two-class or 90 one-class</td>
<td>Merger agreement allows up to 93 CRJ-900 or equivalent aircraft.</td>
<td>Source: Bill Swelbar, MIT Aviation Project</td>
</tr>
</tbody>
</table>
What’s been the outcome?

• Scope clauses, originally intended to protect jobs, may have produced unintended adverse consequences

• Between 2000 and 2008:
  • Legacy airlines parked nearly 800 narrowbody aircraft
  • Over 14,000 legacy airline pilot jobs were lost

• Between 2000 and 2009:
  • Regional industry ASMs grew by 178 percent, while mainline domestic ASMs dropped by 27 percent
  • Regional industry RPMs grew by 243 percent, while mainline domestic ASMs dropped by 16 percent

Source: MIT Airline Project
The battle looms...

- Multiple pilot contracts are amendable now
- Recall projections of little flying with < 60 seat aircraft and most growth in the 90-149-seat range
  - If mainline pilot unions cede that flying, they will be relegated to “trunk” routes and international service
    - This means addressing the issue of 14,000 pilots now on furlough

- But for mainline pilot unions to win that flying, they may need a new economic framework. Questions:
  - This means needing to re-scale all the flying, especially for larger equipment
Over the past several years, mainline and regional carriers have significantly changed the terms of their partnerships. Mainlines are offloading risk.

- **Who flies where?**
  - Mainlines no longer depend solely on one regional partner to feed particular hubs. Regionals operate in more than one region.

- **And for what partners?**
  - Mainline carriers have diversified the number of regional code-share partners
  - Regional carriers are flying for more than one mainline

- **Under what terms?**
  - The mainlines are forcing the regional airlines to accept more financial and operational risk
Diversifying isn’t just good for your portfolio. Delta’s experience with Comair taught the industry a valuable lesson about the need to diversify.
Who flies where (part 2)? And for what partners?

Diversification also protects some regionals. SkyWest flies for United out of multiple hubs. It also flies for Delta and now even AirTran.

Pinnacle flies for DL/NW, CO, UA, and US.

Wholly-owned subsidiaries are a vanishing breed.
Most regional flying has been under Capacity Purchase Agreements (or “Fixed Fee” arrangement) for nearly 20 years.

- CPAs: mainlines pay for all direct expenses -- including labor, fuel, and aircraft rentals -- in exchange for completed departures or block hours
- Allowed regionals to avoid considerable financial risk
- Allowed mainlines to serve spoke markets at less cost

Increasingly, CPAs do not reflect the economic competitiveness of the market

- LCC incursion into many markets makes regional flying unprofitable
- Small RJs’ CASM not competitive against LCCs’ larger aircraft

As a result, mainlines are renegotiating contracts with regionals for more pro-rate or “revenue sharing” operations to balance CPAs
Pro-rate agreements pass more uncertainty to regionals

• Under a revenue-sharing arrangement, the regional airline receives a percentage of the ticket revenues for those passengers traveling on the regional airline.

• This can vary for local vs. connecting passengers.

• The regional carrier bears substantially all costs associated with the flight.

• The regional airline’s profits increase as ticket prices and passenger loads increase or fuel prices decrease.

• The regional airline’s profits decrease as ticket prices and passenger loads decrease or fuel prices increase.

  • SkyWest: all 39 Brasilia turboprops and 14 CRJ200s: pro-rate
  • Pinnacle (Colgan): all Saab 340 turboprops: pro-rate for UA and CO
  • Trans States: 3 ERJ 145s for US
With the imbalance of demand & supply for RJs, will we see more branded flying?

- The problem comes from the economics of 50-seat RJs combined with consolidation in the industry.
  - Hundreds may be off contract within the next 5 years

- The experience to date is mixed, at best
  - Independence Air
  - ExpressJet
  - CapeAir

Does Republic count?
The airline industry is subject to ongoing legislative oversight. Changes in law and/or regulation will likely affect carrier costs. Areas recently subject to legislative scrutiny and regulatory issues include:

- Passenger bill of rights / tarmac delay
- Environmental concerns (GHG)
- Regional airline crew rest / training (Colgan #3407 accident)
- Security (cargo and passenger screening)
What might this mean for airports?

- Airports are being encouraged to help share/mitigate risk
  - Revenue guarantee
  - Well planned marketing dollars
  - Fee waivers/discounts
  - Community assistance/promotions
  - Technology installation
  - Equipment acquisition costs
  - Zero cost startup
  - Direct subsidy
  - Travel Banks
  - In-kind marketing (website, FIDS, baggage carousels)
Background

• The role of & need for Air Service Development (ASD)
• Challenges to viable air service at small communities

Structuring an effective ASD program

• Assessing the market
• Determining available resources
• Establishing & validating goals
• Selecting appropriate ASD tools
• Making a compelling case to airlines
• Evaluating & improving the ASD program
What information do carriers want to hear from small communities?

Carriers want to know what drives demand

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<tr>
<th>Category of information</th>
<th>High Priority</th>
<th>Low Priority</th>
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<tr>
<td>Economic &amp; demographic data</td>
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<tr>
<td>Actual or potential market demand</td>
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<tr>
<td>Airport operating cost data</td>
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<tr>
<td>Airport infrastructure (e.g., gates, runways)</td>
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<td>Slots or congestion</td>
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<td>Incentive programs</td>
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Continental Express

allegiant air

FRONTIER

AirTran Airways

UNITED EXPRESS

Delta Connection

EXPRESSJET
Conclusions

• Carriers have survived the meltdown, but major challenges remain
  • Unemployment and a weak economy don’t bode well for survivable revenue levels, although we’re seeing some signs of premium traffic returning
  • Fuel prices are rising slightly, still highly volatile. Savings from decreased fuel costs over the last 2 years more than offset by fall in demand. Demand curve has not recovered to pre-2001 levels.
  • Carrier survival depended on capacity cuts and/or shifts to regional flying. For most communities, this translates into a loss of service.
• The mainline carriers are increasingly shedding as much risk as possible
  • Mainlines have diversified their regional contracts and structure
  • Some are moving away from PCAs to pro-rate agreements
• Major uncertainties revolve around labor agreements
  • Renegotiating scope clauses and addressing potential pilot pay, training, rest issues
How far will carriers try to push consumers?

Nothing is out of the question

Ryanair is considering charging passengers £1 ($1.40) to use the lavatory on its flights.
Thank You