Fuel has historically been the single largest expense at most airlines. Now, with fuel costs declining, employee labor has become the greatest expense for airlines.

Declining fuel prices in the past two years drove carriers to record profits—a development very few predicted. With unexpected capital available, airlines returned profits to owners, signed new labor agreements with big pay hikes, and made significant investment in new planes and products—from upgrading premium offerings to returning amenities previously eliminated. The question remains, how long will this last? More importantly, how well positioned are airlines to absorb costs if fuel prices return to previous levels?
RECENT DEVELOPMENTS IN FUEL PRICES

As a result of rising fuel prices in the wake of the September 11, 2001 terrorist attacks, airlines adopted significantly lower cost structures to operate in that high fuel cost environment. Fuel costs continued to rise, reaching a peak in 2008. Then in 2014, oil prices posted their largest annual decline, mostly due to weaker demand and strong global crude output. Prices decreased by more than 50 percent in a single year and 2015 marked the lowest average fuel price since 2004. Airlines, particularly those without fuel hedges, enjoyed an unexpected windfall and have been in the unique position of deciding how to spend excess cash.

Recent developments suggest that fuel prices will rebalance, or stabilize at higher price levels experienced in previous years. Late in 2016, the Organization of the Petroleum Exporting Countries (OPEC) agreed to its first production cut in eight years. Under the agreement, member nations agreed to curtail production by ~1.2M barrels per day, or about 2 percent of global production. While past OPEC agreements have often seen incomplete adherence by member nations, recent headlines report that Saudi Arabia, the cartel's biggest producer, has honored and even exceeded reduction promises.

LOW FUEL ENVIRONMENT DRIVES RECORD INDUSTRY PROFITABILITY

Given the perception that fuel is an airline’s single largest cost item, industry insiders were surprised when fuel costs plummeted and income statements took off. But not all airlines were able to enjoy low fuel costs equally. While all carriers benefitted from the downturn, costly fuel hedging contracts purchased years before kept many airlines from achieving profits. Airlines spent billions on hedging contracts, locking in prices and reducing their exposure to fuel price increases, thus better managing risks associated with their greatest cost.

Unfortunately, these contracts prevented airlines from lowering their fuel tab once prices collapsed. In 2015, Delta Air Lines recorded a $2.3 billion loss on its fuel hedges – derivative contracts locked the carrier’s fuel prices in at levels significantly higher than the unexpected lower market price. United Airlines similarly lost $960 million. Conversely, American Airlines, which had adopted a ‘no-hedge’ policy in 2014, recorded a $5 billion net gain on fuel during the year.

While most US airlines had elaborate fuel-hedging strategies in place just recently, the industry’s attitude toward the practice has changed dramatically, with both Delta and United continuing to unwind remaining hedges. This, however, is not to suggest that airlines will refrain from re-entering the derivatives market in the future if any expected fuel cost increases are convincing and significant enough to offset the price of hedging contracts.

FIGURE 1. ‘BIG 4’ EBITDA, 2012–2016

Notes: EBITDA is Earnings before interest, tax, depreciation and amortization
NEW AGE OF PROFITABILITY: INVESTMENT IN OWNERS, MANAGERS, EMPLOYEES AND CUSTOMERS

Profits in 2015 and 2016 were record-breaking. With 2016 industry net profitability expected to be marginally higher than 2015, IATA analysts view industry profits to have reached a cyclical peak in 2016. Nevertheless, 2017 is expected to be the eighth year in a row of aggregate airline profitability.

Four trends accompany the airlines’ newfound financial freedom, namely, the investment in: owners, managers, employees and customers.

Investors have not gone home empty-handed. To reward shareholders, US carriers have increased dividend payouts and, in some cases, enacted aggressive share repurchase programs. While paying a modest dividend, JetBlue has recently announced a $500 million stock buyback, which the airline will complete by 2019. Southwest just paid out its 161st consecutive quarterly dividend, though smaller than some peer carriers. In the past year, Delta has raised its dividend payout, and within the next year, will wrap up a $5 billion stock repurchase, which it began in May 2015. American Airlines leads US carriers with $9 billion in stock buybacks authorized since mid-2014. United Airlines, on the other hand, is the only major US carrier that doesn’t pay a dividend; the airline prefers stock buybacks, with a $2 billion repurchase authorized in July 2016, following a previous buyback in 2014.

Next in line, airline executives have also been rewarded. While some airlines use non-financial performance metrics, such as customer satisfaction or on-time performance, to determine executive incentive payouts, the majority continue to drive payouts based on profitability, which a low fuel cost environment actively supports. When you consider executives’ realized pay, which includes the value of any stock options they exercise as well as the value of their restricted stock that vests, the strong alignment with airline profitability continues. Figure 2 shows the change in Named Executive Officer (NEO) realized pay at US airlines over the last decade, as well as the change in airline profits and total labor costs. The rise in realized pay mirrors the changes in industry profitability, including the record profits beginning in 2013.

This is due to both the payout of cash incentives tied to airline profitability, as well as the significant increase in value of stock options and restricted shares granted in prior years. The amount includes stock options granted five or more years ago that had little to no value prior to 2013.

**FIGURE 2. TOP 5 EXECUTIVE REALIZED PAY VS. INDUSTRY PROFITABILITY & LABOR COST, 2006–2015**

Notes: includes AA, DL, UA, WN, AS, B6, HA; Source: BTS Form 41 data
Employees have also asked to share in the rewards. In the past two years, many US airlines have signed new labor agreements with represented employee groups. Since 2015, the four largest US carriers have signed contracts with their pilots. In 2015, American Airlines reached an agreement with the Allied Pilots Association, offering 23 percent wage increases. United signed a 2-year contract extension in January 2016, which granted immediate 13 percent pay raises, with additional increases in subsequent years. Southwest Airlines’ four-year agreement signed in 2016 aligned pilot pay with the ‘Big 3’.

Most recently, after going through negotiations, Delta pilots voted in favor of a new four-year agreement, which provides 30 percent raises by 2019 and maintains an industry-leading profit sharing plan. Delta pilots originally rejected the company’s offer, which would have reduced profit sharing in times of profitability. These trends extend beyond pilots; airlines have also reached agreements with flight attendants, mechanics, flight dispatchers and ground workers. In many cases, percent pay increases secured by other labor groups exceed those given to pilots. Unions argue that increases won by pilots and other employee groups are to compensate for the significant pay cuts employees endured during the bankruptcies and restructurings of the mid-2000s and return pay to where it was.

To the surprise of some travelers, the customer is not forgotten in this. Recent travelers will notice that airlines have invested in the customer experience. Competition between the major US carriers has intensified in recent years with investment and product upgrades often following in lockstep. Carriers now have the capital available to make product investments. While Delta Air Lines never eliminated free snacks from its main cabin, in 2016, United announced the return of complimentary snack items in economy class, in addition to its “for purchase” menu. American Airlines quickly followed suit, realigning policies at the Big 3 carriers.

Delta Air Lines announced in January 2017 the return of free hot meals in coach on certain domestic routes; American has since followed.

Each of the Big 3 carriers is also investing heavily in their premium passengers, both in service and product. United Airlines launched its new business class experience, Polaris, at the end of 2016 and is introducing a fleet of new Boeing 777-300ERs that will offer additional amenities, such as a walk-up bar.

American Airlines is making significant investments that include new cabins on their 777-300s (also a stand-up bar), upgraded amenity kits and improved food in premium cabins. Delta will soon debut private business class suites on some of its long-haul routes to further differentiate their product.

In an effort to better compete with low-cost carriers, United, Delta and American introduced Basic Economy products. In addition to the network carriers, low-cost carriers have made significant investments as well. JetBlue’s introduction and expansion of Mint, its premium product, competes with the Big 3, who have traditionally dominated this segment.

Competition on high-revenue routes (e.g., JFK – LAX) is fierce, with airlines taking steps to stand out. Each carrier offers lie flat seats, improved dining and additional amenities in all cabins, which are not included on standard domestic routes. Not to be left out, Alaska Airlines recently introduced its own Premium Economy class and will begin offering free inflight messaging (via iMessage, WhatsApp and Facebook Messenger).

Southwest Airlines is adding inflight entertainment and plans to have Wi-Fi on all planes by the end of 2017. The market is becoming more defined with separation among service classes – with each tailored toward a specific segment of the market, giving travelers have more choices than ever before.
RETURN OF HIGHER FUEL COSTS AND THE IMPACT ON AIRLINES

No one truly knows where fuel prices are headed – the recent collapse is evidence of that. Investment firms, private and public companies, and governments spend millions of dollars each year to make educated predictions about projected price trends. Economic models use countless inputs to make predictions, including oil production trends, geopolitical developments, changes in consumer demand, environmental factors and proposed legislation. While we still don't know where fuel is headed, recent inputs suggest prices may be due for an increase.

In addition to scheduled decreases in output, like the OPEC agreement, conflicts in some regions have also stymied oil production. Political instability in Venezuela, rebel attacks in Nigeria and the civil war in Libya are examples. Whereas cost structures adapted to high fuel prices before 2015 drove the industry to current record profits, the opposite could happen in the near future.

There is a risk that fuel prices rebound and airlines find themselves in financial strain. Higher prices could put pressure on recently signed labor contracts, and force airlines to think more about replacing aging planes with more fuel-efficient aircraft.

During the last cycle, airlines resorted to aggressive restructurings—and even faced bankruptcy. While the industry has changed, the underlying economics of operating an airline have not. Fuel and labor cost cannot be ignored. As evidenced by airlines getting burned by hedging contracts, fuel cannot be managed by the same degree as less opaque factors, such as labor. Taking proactive steps to position the airline for scenarios where higher fuel prices return will be fundamental to long-term prosperity.

ORGANIZATIONS SHOULD ASK THEMSELVES QUESTIONS ABOUT:

• **Leadership alignment** – are the right people in the right positions, are they focused on the right things? Are the right people involved in key decision making?

• **Organizational alignment** – do you have the right talent to achieve your long-term business goals? Does your organizational structure support your customer strategy? Does the organizational structure support efficient business processes?

• **Performance alignment** – Are key performance metrics used to drive decisions? Is technology properly leveraged to streamline processes? Do your reward systems reward the right people in the right way?

With answers to these questions, airlines will define who they are and how they fit into the industry.

ARE AIRLINES READY AND WILLING TO TACKLE THESE CONSTANTLY EVOLVING CHALLENGES?
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