Together We Fly
US AIRWAYS
UPDATE
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The East joins the low-fare bazaar

Editor's Note: On Feb. 8, the New York Times offered a lengthy objective review of the growth of low-cost airlines on the East Coast. Because the issue is so important to US Airways, the article is reprinted here with permission.

By Micheline Maynard
The New York Times

Like well-dressed wallflowers at a Valentine's Day ball, travelers on the East Coast once watched with envy as people in other parts of the country were courted assiduously with low fares.

Not that the airlines shunned their business. In fact, the East Coast has long been the industry's top market for corporate travel, with flights to and from New York, Boston and Washington accounting for huge chunks of the airlines' revenue.

Therein lay the rub. Major airlines could afford to keep prices low on the West Coast and in the South, areas dominated by vacation travel, knowing that they could milk the East Coast with high fares that business travelers had no choice but to pay.

Not anymore. In the last three years, the East Coast market has become the equivalent of an air-fare bazaar. Low-fare airlines, led by JetBlue, Southwest and AirTran, are luring customers with prices that in some cases are 50 percent less than the going rate in 2000.

To protect their turf, major airlines like American and Delta are fighting back, expanding service, offering more free tickets to frequent fliers and slicing fares to once-unimaginable levels, like $79 each way from New York to Los Angeles.

And the price wars are just heating up. "The East Coast is shaping up to be a real slugfest," said Darin Lee, a senior managing economist at LECG, a consulting firm in Cambridge, Mass.

Already, that brawl has drawn blood. Song, the much-ballyhooed low-fare carrier started last year by Delta, said last week that it would reassess its expansion plans. And analysts say US Airways, which emerged from bankruptcy last year, could be toppled right back in if it cannot come up with a new strategy.

New competition is stacked up like planes in a holding pattern over La Guardia, just waiting for its chance to land. Southwest, the nation's sixth-largest airline and the low-fare leader, will begin flying out of Philadelphia in May. Ted, the low-fare airline from United that begins service in the West this week, said that it would add flights at Washington Dulles International Airport later in the year.

Independence Air, an offshoot of Atlantic Coast Airlines, a regional carrier for United, is scheduled to begin service in November, from Dulles — or sooner if Atlantic Coast's agreement with United, which still has six years to run, is severed.

Even foreign airlines want into the game. Last week, WestJet, the Canadian low-fare airline, said it would begin flights to Florida and other destinations. And Sir Richard Branson, the British entrepreneur and founder of Virgin Atlantic, is considering Boston, Washington and San Francisco as the base for a low-fare contender that he hopes to start in the United States.

The competition on the East Coast could not come at a worse time for the major airlines, which have lost $15 billion since the downturn in the travel market began in 2000. In past decades, they used their financial power to fight off the low-fare airlines, undercutting their fares, expanding service on the same routes served by the newcomers and reeling in passengers with double and triple frequent-flier miles.

Continued on page 2

Low-cost airlines post profits, while US, other network carriers in the red

The seismic changes taking place in the airline industry were starkly highlighted in the fourth quarter as every network carrier reported losses before unusual items were counted, while the low-cost airlines again posted profits.

US Airways was the last network airline to report its results. While the net loss of $98 million was dramatically lower compared to the previous year's loss of $794 million, the company fell short in its plan for achieving sustained profitability.

"Although we are encouraged by our positive cash flow and liquidity, we are operating in a fundamentally changed industry," Dave Siegel told Wall Street analysts in a Feb. 6 conference call to discuss the results. "Any airline that wants to continue flying over the long term must be able to meet the expectations of its customers. And customers today are clearly voting with their dollars to give more and more of their business to carriers that have low and simplified fares."

Siegel said US Airways made great strides in 2003. Passenger revenue per available seat mile was up 7.4 percent for the quarter compared to 2002 and mainline cost per available seat mile, excluding fuel and unusual items, was down 7.2 percent. "But, regrettably, we are behind in our plan for achieving sustained profitability," he said.

Continued on page 4

The East joins the low-fare bazaar (continued)

But this time, the newcomers are in better shape than the majors they are staring down. Last year, JetBlue, AirTran, ATA Airlines and Southwest registered increases in numbers of passengers, while Northwest, Delta, American, United and US Airways all had decreases, in part because of a falloff in international business, a category in which the low-fare airlines generally do not compete.

As tough as fare wars are for airlines, East Coast passengers could not be happier. Juley Fulcher, the Washington director of Break the Cycle, a nonprofit organization that works with youth against domestic violence, says her ability to fly on business comes down to finding an affordable fare. Her reason for choosing an airline, she said, is "price, short and sweet."

> *'The East Coast is shaping up to be a real slugfest.'*
> —Darin Lee, LECG economist

In the past, depending on her destination, that meant hoping for a fare sale on United or Delta. But now, Ms. Fulcher often chooses between two low-fare competitors: JetBlue, which serves Dulles, and Southwest, which flies from Baltimore.

She prefers JetBlue, with its seat-back video systems and seat assignments, to Southwest, which does not assign seats in advance. "You have that cattle-call feeling of having to run over people to get to your spot," she said.

That analogy applies to the East Coast aviation field, where history shows just how hard it is to compete for passengers. Since 1981, a dozen new low-fare airlines have started East Coast service, but one-third of them no longer exist.

Nobody is ruling out the possibility that another airline will disappear. "The list is bound to get a lot shorter before this is over," said Michael S. Allen, chief operating officer of Back Aviation Solutions, an industry consulting firm.

On top of nearly everyone's most endangered list is US Airways, the seventh-largest American airline. Its beleaguered chief executive, David N. Siegel, has vowed to come up with "a big surprise" to fend off Southwest, which begins service on May 9 from Philadelphia, one of US Airways' three hubs.

But defeating Southwest, the industry's most profitable player, will not be easy. Even as US Airways has promised to stand toe to toe with Southwest, it has put its hubs and other assets, including its East Coast shuttle, on sale.

"They'll probably drive US Airways out of business," Charles A. O'Reilly III, a business professor at Stanford, said of Southwest. US Airways, Professor O'Reilly said, had no excuse for not responding sooner to low-fare airlines' assault on the East Coast, which began when JetBlue, based at Kennedy Airport in New York, began flying in 1999.

Even competing industry executives readily credit JetBlue for bringing lower fares to Eastern cities. "You have to look north to JetBlue," said Kerry Skeen, the chief executive of Atlantic Coast, based in Dulles, Va.

Sean Donohue, the United executive in charge of Ted, said: "You have to be candid here. JetBlue added a lot of competition up and down the Eastern Seaboard."

That may be putting it mildly. During the four years JetBlue has been flying on the East Coast, fares from New York to cities it serves have fallen by 30 to 50 percent, Dr. Lee, the LECG analyst, said.

David G. Neeleman, who founded JetBlue in 1999, said the market was ripe for the kind of low-fare competition already found in other parts of the country. "We knew if we could touch a nerve with low fares and good service, there would be an explosion in air travel," he said. "And that's what's happened."

JetBlue cites the example set by Southwest, whose consistent profitability belies the idea that low-fare companies cannot make money. "It is one of our strengths, to be low-cost and efficient," said Gary Kelly, the chief financial officer of Southwest, based in Dallas. And in words that might chill his competitors, Mr. Kelly continued, "We are a growth company, and we have places we don't serve."

In fact, the sound financial situation of Southwest, JetBlue and other low-fare airlines is in sharp contrast to their East Coast precursors, like People Express, which tried to bring cheap fares to the market two decades ago.

"What you've had are stronger players who've been able to come in at a time of weakness for the larger players, and have been financed sufficiently to withstand competitive responses," Mr. Allen said.

Dr. Lee says Southwest, as well as airlines overseas, like Ryanair in Europe and Virgin Blue in Australia, have provided a template that People Express lacked. "Fifteen years ago, it wasn't clear to a start-up airline how to successfully run a low-fare airline," he said.

In 1981, People Express was the darling of its aviation day. Founded by Donald Burr three years after the government deregulated the airline industry, it lured hordes of passengers to the dingy North Terminal at Newark with dirt-cheap fares.

> *'Price, short and sweet.'*
> —Passenger Juley Fulcher on how she chooses an airline.

Despite the long lines and uncomfortable seats, it had a cult following among passengers and industry experts who praised its no-frills approach as visionary. But passengers eventually grew tired of the crowds and chaos, while major airlines ganged up on it, undercutting its fares and outwitting it with more sophisticated reservations systems. By 1987, People Express was gone.

Why couldn't something similar happen this time? For a simple reason: the new low-fare airlines are more aware of mistakes they must avoid. Mr. Skeen at Atlantic Coast says the trick is to keep a lid on costs as well as ticket prices. Aside from streamlined labor contracts, the keys to controlling expenses include the Internet.

In the past, Mr. Skeen said, it cost airlines $15 to $20 per passenger to book a reservation, either through their own reservation centers or through travel agents. But tickets booked on the Web site of the new Independence Air will cost the airline 50 cents each to process, he said.

Another contrast is on the tarmac. Conventional wisdom among low-fare airlines has been to pick one type of jet and stick to it. Southwest has famously used just one family of airplanes, the Boeing 737, allowing it to simplify repairs and keep ground time short. That strategy has been mirrored by Delta's Song, which flies 199-seat Boeing 757's, and Ted, which will fly 156-seat Airbus 320's.

But the advent of small, nimble regional jets is setting the single-plane theory on its ear. On Monday, Embraer, the Brazilian aircraft maker, will begin producing the first of the 100 planes that JetBlue has ordered, with options to buy 100 more. JetBlue expects to deploy the planes, with 100 seats - twice the capacity of the most-used regional jets today - to some of the 800 cities clamoring for its business, many of which have airports too small to easily accommodate the bigger planes it flies now.

New planes will let JetBlue, and potentially other low-fare airlines expand quickly. " Are they going to antagonize the majors? No. They are going to terrify the majors," Professor O'Reilly said. "They are going to get into those cities before the majors can."

'Are they going to antagonize the majors? No. They are going to terrify the majors.'
—Stanford Professor Charles A. O'Reilly III regarding JetBlue's order of Embraer 190s.

John Selvaggio, the president of Song, acknowledges that the airline was begun by Delta as a defensive measure so that it could retain leisure travelers flying between New York and Florida, rather than let them defect to JetBlue and others. But Song has become more than an airline for vacationers.

Business travelers, evidently happy with its low fares, fill a good portion of its East Coast seats. "There's been a tremendous blurring of that line" between leisure and corporate fliers, Mr. Selvaggio said. "When they fly Song, they like it," he said of the airline's frequent travelers.

As long as Song and other low-fare airlines are present, Mr. Selvaggio said, East Coast fares will not creep up once the economy comes back. With all the competition, he said, few airlines expect business travelers to pay top dollar for the convenience of getting on planes at a moment's notice. "People don't want to pay those high fares," he said. "Corporations are not approving those budgets. Everybody is looking for a deal. To the cities that these carriers fly to, the days of a $1,200 walk-up fare are gone."

That is a double-edged sword for Delta, which still carries 70 percent of its passengers in its traditional hub-and-spoke system. Delta would prefer to have revenue increase, a prospect Song may not offer. Yet, without Song, it might lose business altogether, Professor O'Reilly said.

Mr. Kelly at Southwest says the East Coast is hardly the only market where travelers have become resistant to high fares. "I think everywhere in the United States you're eventually going to have fares offered at much lower prices than we've seen in the past," he said.

What could stymie the East Coast expansion? For one thing, a further decline in customers. Despite the flurry of competition, overall air traffic has fallen 7 percent since 2000, the industry's peak year for travel. The terrorist attacks of Sept. 11, 2001, continue to depress travel 30 months later.

And without a robust economic recovery, all the airlines' hopes of finding passengers to fill their planes may not be realized, said Dr. Lee at LECG.

"The one thing you can say about the airline industry," he said, "is that there are no guarantees."

Indeed, Delta has already had to rethink its plans for Song. Last week, even as Ted, the new United operation, announced that it would use Dulles as a second hub, Song revealed its plans to end its Dulles service, which it began in September. Further, the airline is conducting a review of all its operations and will determine whether routes should be flown by the main airline or by Song, Mr. Selvaggio said.

Ted, too, has already had to adjust. Even before it began flying, the airline was forced to scale back its fares, which were supposed to top out at $414, one way, for last-minute tickets with no restrictions. Instead, no one-way fare on Ted will be more than $299. That matched the cap that Frontier, a low-fare rival based in Denver, placed on its fares. And it is the most that Southwest charges for any one-way ticket nationwide, although the airline does not serve Denver. Not yet, anyway. The major airlines, meanwhile, are trying to figure out their role in all this. Until recently, they argued that their extensive route systems, frequent-flier programs and potential first-class upgrades would keep passengers loyal. But the prospect of $250 tickets on routes that once cost five times more has eroded that customer fealty.

Now that United and Delta have waded into the battle with low-fare operations, the industry is wondering if and when the market leader, American, will do the same. The airline has been battling the low-fare competitors by matching fares when necessary, streamlining operations and aiming its appeal at its vast array of frequent fliers. In a move aimed at undercutting JetBlue's push west from New York and Boston, American offered a deal this winter, matched by Delta and Song, that gives travelers a free ticket, with restrictions, anywhere in its system after two paid trips from New York (or Boston) to California or Florida. American said last week that 150,000 people had signed up for the offers. Mr. Neeleman acknowledged that the major airlines' aggressive response was a reason JetBlue's transcontinental revenue fell during the fourth quarter, raising analysts' eyebrows.

But American hasn't been able to protect its position on one of its most important battlegrounds, Kennedy Airport. Last year, JetBlue nudged past American to become the largest airline serving JFK. Dominance there was a point of pride for American, whose New York operations, decades ago, contributed one-quarter of its revenue.

Gerard J. Arpey, chief executive of AMR, American's parent, would not rule out the possibility of starting a low-fare operation. "I take seriously everything our competitors are doing," he said last month.

"The low-fare carriers are well capitalized and willing to sustain" their growth, said Mr. Allen at Back Aviation Solutions. But major airlines will not sit back on their hands and watch the East Coast market fall to invaders, he added: "It's not going to be a cakewalk."

East Coast passengers, meanwhile, no longer need to feel like children who didn't get Valentines from everyone in their class.

Low-cost airlines post profits, while US, other network carriers in the red *(continued)*

On a pre-tax basis, the loss was $99 million compared to $848 in last year's fourth quarter.

Chief Financial Officer Neal Cohen said that while US Airways continues to meet the cost goals of its plan, the industry revenue environment has changed "fundamentally." The continued growth of low-cost, low-fare airlines in the Northeast has permanently reduced yields.

To compete and be profitable, Cohen said US Airways costs must come down a further 25 percent and that the company is scrutinizing all elements of the business, from aircraft scheduling to labor. Labor expense, for example, represented 42 percent of revenue compared to an average of 33 percent for the low-cost carriers, he said.

Analysts expressed caution following the earnings report. "These guys are getting close to the edge and something has to be done quickly," said Ray Neidl of Blaylock & Partners.

Phillip Baggaley of Standard & Poor's credit rating agency said, "Long-term prospects remain difficult, given the company's limited route network and increasing exposure to low-cost competition."

"They've gone as far on the revenue side as they can get. The battles will be on the cost side," said Josh Marks of the aviation consulting firm Velocity Group.

Lower costs lead to profits for discounters

Q4 2003	US Airways	Southwest Airlines	America West	jetBlue	AirTran
Operating revenue $million	1,764	1,517	563	263	239
Operating expense $million	1,838	1,406	551	228	218
Operating income $million	(74)	111	12	35	21
Pre-tax income $million	(99)	101	7	31	6
Unit cost (ex fuel) cents	10.22	6.52	6.20	5.00	6.44

Siegel said, "Our employees are victims of a reality in an industry that is difficult to adjust to, which is that employees at the only profitable airlines are willing to work for lower pay, fewer benefits and with more efficient work rules."

He re-emphasized US Airways' determination to take any necessary action to remain in compliance with covenants of the loan guaranteed by the Air Transportation Stabilization Board, the first of which comes due in June.

"While we recognize it's going to be another intensive 18 months to get to where we need to be, the challenges are not insurmountable," Siegel said.

US Airways to upgrade Philly baggage system

A fix for the nagging bag processing problems at the Philadelphia International Airport is in sight.

The company last week announced that it is ready to start a $2.7 million upgrade of the bag system, pending final approval by the Transportation Security Administration (TSA) and the airport.

"None of us wants a repeat of the summer of 2003, where staffing changes, equipment breakdowns, and new security procedures all contributed to frustrating experiences for some of our customers," said Al Crellin, executive vice president of operations. "Those failures were simply unacceptable, and we want to assure our passengers that this summer will be a much more positive experience."

As part of the project, US Airways and TSA will relocate several of the agency's screening machines to new positions; and connect the conveyor system from the International Arrivals Building to a newly configured and expanded baggage handling area. The system upgrade will also provide redundancies so that a failure in one part of the system will not impact operations like it did last year, when portions of the system were inoperable.

The redesign and upgrade of the system will enable US Airways to make more efficient use of personnel and equipment while maintaining the higher security standards being implemented by the TSA. US Airways hopes to begin construction in early March, with work to be completed in time for the start of the peak summer travel season.

US Airways and US Airways Express operate almost 400 daily departures nonstop from Philadelphia, including 301 weekly flights to 31 destinations in Europe, the Caribbean, Canada and Mexico.

US Airways files for DCA slots

US Airways has filed an application with the U.S. Department of Transportation for slot exemption authority to begin nonstop service between Ronald Reagan Washington National Airport and Asheville, N.C., Chattanooga, Tenn., San Francisco and San Juan.

Additionally, US Airways reiterated its request for the two slot exemptions originally awarded for travel between Reagan National and Wilmington, N.C., as currently operated by US Airways on a temporary basis.

US Airways would operate the flights between Reagan National and San Juan and San Francisco with Boeing 757 aircraft. US Airways Express would operate the flights between Reagan National and Asheville and Chattanooga using 50-seat regional jet aircraft.

UPDATE

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