Oil shock threatens Airline Recoveries

NEW YORK -- U.S. airlines had their best year in a decade in 2010, but with a mere 2% profit margin.

Now that razor-thin cushion is threatened by rising fuel prices -- and with it so is the industry's recent recovery

"While labor costs have been going down, fuel prices have been going up," said Frank Werner, a finance professor at Fordham University and a licensed pilot. "Fuel prices are now the highest cost for the airlines."

In recent days, travellers have started witnessing the industry's response.

Carriers have successfully **increased airfares four times** so far this year, exceeding the total number of airfare hikes for all of last year, according to Rick Seaney, chief executive of Farecompare.com. As a result, consumers are paying, on average, $40 more than they were at the end of 2010.

Airlines hike fares - again

Seaney said that industry is currently attempting a fifth air fare hike. The recently-merged United Continental (**UAL**) added a fuel surcharge of $20 on Wednesday and American Airlines (**UAL**) matched the fare a few hours later, he said. If consumers are willing to pay these higher fares, then rival airlines have a strong incentive to follow suit.

"At this point, the carriers can pass through more gradual oil price increases to their customers," said Raymond Neidl, independent airline consultant. "Where the airlines would have a harder time adjusting [would be] a rapid increase in oil prices or high volatility due to unpredictable political developments."

An oil shock last hit carriers in 2008, when fuel prices spiked. But the recession stymied their success in increasing fares. So instead, they added **ancillary fees** for services that once came for free, like baggage check, curb-side check-in, pets, food and non-alcoholic drinks. Passengers griped but paid the fees anyway, resulting in **billions of dollars** in airline profits.

Airlines also cut capacity: They eliminated their least efficient flights to make sure that remaining flights were packed full so they wouldn't lose money on empty seats. On top of that, six carriers merged into three, lessening competition.

"The number of legacy carriers has declined by half in the last decade," said George Hoffer, transportation economist at University of Richmond in Virginia. "So it's much easier to coordinate price increases."

Airlines post most profitable year in a decade

As a result, 2010 was the industry's most **profitable year in a decade**.

"But that's not saying much," said John Heimlich, chief economist with the Air Transport Association, noting that the industry's profit in 2010 was relatively modest 2%. "If we had to start with a 2% margin, we'll take it, but we're not going to stop with a 2%," he said.

The 2% profits equals about $4 billion worth of industry profits in 2010, but that follows an industrywide loss of $60 billion during the proceeding nine years, according to the ATA.

Airlines are now dealing with rising fuel prices, exasperated by the ongoing **turmoil in Libya** and other oil-producing countries, and the rising cost of refining oil into jet fuel.

Now, the industry faces a crossroads. Whether it fails or succeeds in 2011 depends upon two opposing factors: the strength of economic recovery versus the rise of fuel prices amid the political and economic mayhem that is roiling North Africa and the Middle East.

"I think what's going to happen is going to depend upon how long this Middle East crisis lasts and how long the U.S. economy continues to recover from this recession," said Werner. "The airlines are really hostages to the economic environment. When the economy goes south, one of the first things people cut is travel. Travel is a discretionary expense."