



Recent falls in jet fuel prices mask real concerns about the long-term efficiency of the airline sector, says Peter Harbison.

Aviation fuel has become the single largest expense item for many airlines over the past couple of years, as higher demand and political uncertainty have pushed up the price of oil.

From levels below US\$40 a barrel in August 2004, oil peaked at just under US\$80 on July 14 this year. Since then, the trend has been markedly downwards, with jet fuel spot prices tumbling as a result (see graph).

Forecasting longer term oil prices is a precarious exercise. The variables, led by global economic activity, political uncertainty, and access to new reserves, can generate widely differing outcomes. However, over the next decade, it appears inevitable that the assumption of ready access to limitless fuel at reasonable prices will be replaced by an urgency to reduce consumption and to find alternative sources. It is likely that this trend will amplify as environmental forces become more aggressive towards the airline industry.

Higher jet fuel prices have forced a major rethink in the way the airline industry is heading. The prospect of oil at over US\$100 a barrel has led some analysts to doubt the very survival of the industry in its current form.

Yields up: Paradoxically, though, higher prices have not been all bad for the sector. Many airlines in the Asia-Pacific region have remained profitable over the past two years as a result of the increased financial discipline that higher fuel prices have forced upon them.

For the first time in over a decade, some airlines have actually achieved improved yields

(measured by the average price a passenger pays per kilometre travelled). They have achieved this by limiting capacity growth, disavowing market share battles in favour of profits, and imposing fuel surcharges on ticket prices.

Profits have been aided by strong economic growth, led in this region by China and supported by continuing strength in the US economy. Without this boost in demand the impacts of higher fuel costs on the industry could have been very different.

The oil price surge has also coincided with

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market liberalisation and more competitive conditions, pushing some of the older national flag carriers to reduce – or even cease – flying on unprofitable routes as they strive to achieve better financial results.

Airlines have also accelerated orders for new, more fuel-efficient aircraft, shedding older types earlier than previously planned. While this move is intended to reduce fuel

costs significantly, it has also increased capital requirements at a time when equity markets are increasingly restless about the sector.

As oil prices have slipped, one ominous sign has reappeared – the prospect of a serious economic downturn. In fact, one of the key reasons for the largely unexpected oil price slide has been a slowing in demand, implying that the recent, unusually long period of economic growth may be coming to an end.

A nudge into slower economic growth would reduce consumer spending on discretionary items like air travel, just as much of the new aircraft orders come into service. And there is no industry more sensitive to an economic downturn than the airline business.

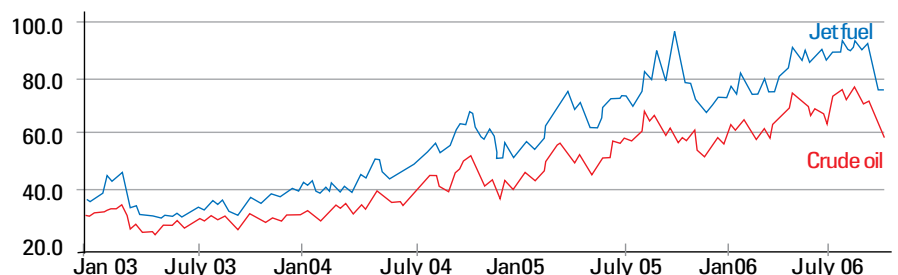
Many airline analysts argue that the 60-year-old international aviation system is in serious need of an overhaul. They say that there are too many international airlines and, despite the serious lack of profitability for many, unnecessary barriers to consolidation and merger continue, most notably on foreign ownership.

These constraints make it nearly impossible for a national airline of one country to merge with another country's carrier. In Europe, Air France and Dutch carrier KLM have embarked on a ground-breaking merger, but it will be some years before others outside Europe can imitate the move. Economic pressures may force some airlines to consider exiting the market, but this will be resisted given the protective attitudes of many governments towards their national carriers.

Airlines will continue to look for cost savings around the margins, such as improved air traffic procedures. But this is unlikely to be sufficient to avoid a big shift in fuel usage by the middle of the next decade, when higher fuel prices are likely to set in as a long-term reality.

Peter Harbison is the executive chairman of the Centre for Asia Pacific Aviation.

JET FUEL AND CRUDE OIL (\$US/BARREL)



The long view: While the recent falls in the prices of crude oil and jet fuel have been steep, information compiled by the International Air Transport Association (IATA) shows the long-term trend is up.