

# CASE 27

## Delta Air Lines (2012)

### NAVIGATING AN UNCERTAIN ENVIRONMENT

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Delta Air Lines Inc. (Delta), headquartered in Atlanta, Georgia, was the world's second-largest airline providing air transportation for passengers, cargo, and mail. Delta operated an extensive domestic and international network across all continents in the world except Antarctica. It was also a founding partner of the SkyTeam airline alliance.

Delta had used mergers and acquisitions (M&A) successfully to solidify its strong position as a leader in the airline industry. It had gone through five M&As since 1953, including the most recent acquisition of Northwest Airlines (Northwest), which turned Delta into an airline with major operations in every region of the world. On the other hand, the Northwest merger took a toll on Delta's financial position by contributing to its high long-term debt.

In 2012, top management was cautiously exploring opportunities for entering new markets, routes, and partnerships in order to boost market share. The airline industry was known for being extremely competitive with significant market share volatility, strong price competition, and low brand loyalty. Management was also searching for ways to reduce costs and expenses in an industry that was rapidly consolidating into fewer major national and international players.

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The authors prepared this case to provide material for class discussion rather than to illustrate either effective or ineffective handling of a management situation.

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# Delta Becomes the World's Second-Largest Airline

## Company History

Delta's history begins in 1924 with the formation of Huff Daland Dusters in Mason, Georgia. Huff Daland Dusters was the first commercial agricultural flying company in the US and commenced carrying passengers and mail as its business expanded. Recognizing the success and value of the company, C.E. Woolman, acquired the firm and renamed it Delta Air Services.

Throughout the 1930s and 1940s, Woolman focused on defining Delta's mission to ensure that it would be a viable company in the long term. During this period, Delta broadened its services and expanded its horizons: It secured a contract with the U.S. Postal Service to carry mail, participated in the war effort by modifying over one thousand aircraft, developed a regularly scheduled cargo service, and introduced night service. The company changed its name to Delta Air Lines. All these events laid a solid foundation for Woolman and his young company.

Over the next few decades, a series of mergers and key alliances enabled Delta to expand its operations and gain market share in the airline industry. The first merger took place in 1953 with Chicago and Southern Airlines, allowing Delta to become the first service provider in the United States with flights to the Caribbean and South America. The acquisition of Northeast Airlines in 1972 gave Delta a major presence in the northeastern United States. In 1984, Delta formed a strategic partnership with Comair Airline, which soon became a Delta wholly-owned subsidiary and connection carrier. Between 1986 and 1991, Delta acquired both Western Airlines and Pan American World Airways. With these acquisitions, Delta gained routes and became a major carrier on the U.S. West Coast and across the Atlantic to Europe. Finally, Delta was able to emerge from bankruptcy by acquiring Northwest Airlines in 2008, which made it the airline with the most worldwide traffic.

In 2012, Delta serviced 572 destinations in 65 countries on six continents, including North America, South America, Europe, Asia, Africa, and Australia. It operated 714 aircraft in 5,766 daily flights and employed more than 80,000 employees worldwide. With over 160 million customers every year, Delta was the world's second-largest airline. Delta was named domestic "Airline of the Year" by the readers of *Travel Friendly* magazine and was named the "Top Tech-Friendly U.S. Airline" by *PC World* magazine for its innovation in technology.

Delta attempted to operate low-cost carrier subsidiaries through launching Delta Shuttle in 1991, Delta Express in 1996, and Song in 2003. None of these subsidiaries were successful, however, and were discontinued not long after being established. In 2010, Delta sold Compass and Mesaba, two regional subsidiaries of Northwest Airlines. Delta continued to operate Comair as a wholly-owned subsidiary (based in Cincinnati) as part of its Delta Connection. Delta had originally bought 20% of Comair in 1984, followed by full ownership in 1999 for US\$2 billion, but by 2012 many of Comair's 50-seat turbo-prop aircraft were getting old and had high unit costs per flight hour.

## Merger with Northwest

In early 2008, Delta and Northwest announced a merger while both companies were emerging from Chapter 11 bankruptcy. This merger would permit Delta to gain all the routes, landing slots, gates, and other operational assets of Northwest, while allowing Delta to lay off excess personnel and reduce excess flights.<sup>1</sup> It would also enable Delta to compete more effectively against its two biggest rivals: United Airlines and American Airlines.

While many were hesitant about the merger, analysts predicted the annual savings would be US\$200 million in 2009, US\$500 to US\$700 million in 2010, US\$800 million to US\$1 billion in 2011, and US\$1 to US\$1.2 billion in 2012.<sup>2</sup> One of the major contributors to

these savings for Delta came from the streamlining of operations. The two airlines were able to combine technology and scheduling platforms, which reduced overhead costs for the larger Delta. The additional planes and resources gained from Northwest, combined with Delta's existing fleet and staff, allowed Delta to better match its services to travel demand. The company was able to designate its new, smaller planes to less popular destinations to eliminate empty seats, while utilizing the larger planes for more popular legs out of New York and Atlanta.

Another major financial benefit of the merger was the buying power it offered when purchasing contracts for jet fuel. Fuel was the largest operating expense of any airline company. All airlines used a hedging strategy in an attempt to secure and stabilize exposure to fluctuations in fuel costs. While Delta has historically hedged a larger percentage of its fuel consumption than Northwest, the combined fuel use of these two companies gave Delta a volume discount, resulting in significant savings.

Even though the merger was officially closed in October 2008 after receiving regulatory and shareholder approval, it took until January 2010 for Delta and Northwest to fly as a single carrier. On that date, all Northwest bookings were canceled and transferred to Delta—requiring computer engineers to perform 8856 separate steps over several days. More than 140,000 electronic devices had to be replaced. The new Delta had to reduce 1199 computer systems to about 600. Even though the pilot unions of both airlines had agreed to a common contract by the end of 2009, flight attendants continued to work during 2012 under separate agreements, each with their own work rules. Thus, attendants from Delta and Northwest could not work together on the same flights. It would take until May 2012 for the last Northwest airplane to be repainted as a Delta plane.

The cultures of the two airlines were different. Delta had always thought of itself as the gracious host—hence, flight attendants personally poured requested drinks. Since Northwest saw itself as the practical carrier, flight attendants just gave customers the drink cans. When implementing the merger, no difference between the two airlines was too small to cause problems. For example, Delta had traditionally cut its limes into 10 slices, while Northwest had cut them into 16. Richard Anderson, CEO of the combined airline, was informed at a meeting that Northwest had saved about US\$500,000 a year by cutting the limes into smaller slices. In the end, it was decided to stay with Delta's 10 slices, but to carry fewer limes on each flight. Compromises had to be made. Even though Northwest carried Pepsi and Delta carried Coke products (also based in Atlanta with Delta), it was agreed that the combined airline would serve Coke's drinks and Pepsi's snacks.

Although the merger had been deemed a financial success by both Delta's management and industry analysts, with the new Delta earning its highest profit in years in 2011, Delta's operations continued to struggle. Customer complaints per passenger were double the industry average in 2009. By 2011, Delta had the worst record among large carriers for on-time arrivals and accounted for a third of all customer complaints, the worst of any airline, for categories like service and lost bags.<sup>3</sup>

## Competitors

Over the past decade, there have been a number of mergers and acquisitions among the major airlines in North America and Europe. For example, Air France and KLM merged in 2004, US Airways and America West in 2005, Delta and Northwest in 2008, plus Southwest and AirTran, and British Airways and Iberia in 2010. According to industry analysts, US Airways and Delta were expressing some interest in each other in early 2012, while independently considering American Airlines.<sup>4</sup>

Delta's major competitors in the United States were United Airlines and American Airlines at the high end, US Airways in the middle, and carriers such as Southwest and JetBlue

at the low end. American Airlines, United Airlines, US Airways, and Delta had similar business models with hub-and-spoke service, extensive hubs and network infrastructure, global operations, broad service portfolios and relatively high ticket prices. They constituted what was called “legacy,” major, or traditional network carriers.

Southwest and JetBlue had point-to-point connections between cities that permitted direct, nonstop routing, minimizing connections, delays, and total trip time. These carriers did not offer many of the amenities that major carriers offered, but were known as budget airlines because of their low fares.

*United Continental Holdings* was the holding company for United Airlines, the largest air carrier in the world, as well as United Express. United Continental was headquartered in Chicago, Illinois and employed about 88,253 people. United and Houston-based Continental Airlines had merged in July 2011, but was still in the process of combining the two companies using 33 merger teams. Prior to the merger, it had been agreed that Continental’s CEO Jeff Smisek would become CEO of the combined airline. It was also agreed that the airline would retain its United name and be based in Chicago. All other implementation decisions, such as information systems and labor negotiations, had been postponed until after the merger was approved. Continental had built a culture around making its employees happy while catering to customers. In contrast, United’s relations between management and workers had been openly hostile. United’s new management saw the merger as an opportunity to examine how things were done and to correct any problems.

The new United Airlines operated 5574 flights each day to 377 domestic and international airports through its mainline and United Express services. It had 10 hubs throughout the United States including four of its largest cities. It was rated the world’s most admired airline on *Fortune* magazine’s 2012 airline industry list of the “World’s Most Admired Companies.” It was a member of the global Star Alliance network, which contained 27 member airlines from around the world. United’s management proudly stated that United had the world’s “most comprehensive global network.”

United Continental Holdings generated US\$37,110 million in revenues, US\$1822 million in operating income, and US\$36 million in net income during 2011.<sup>5</sup>

*AMR Corporation* was the holding company for American Airlines and American Eagle. The company provided domestic and long-haul flight services throughout the United States, Mexico, Puerto Rico, the Caribbean, and Canada, and the Latin American, European, and Pacific region. It was headquartered in Fort Worth, Texas, and employed 80,100 people.

American Airlines was also an important scheduled air freight carrier and provided a range of freight and mail services to shippers. It operated five hubs in Dallas/Fort Worth, Chicago O’Hare, Miami, St. Louis, and San Juan (Puerto Rico). American was the largest airline in the United States in 2007, but by 2012 had fallen to become the third-largest airline.

AMR Eagle owned and operated two regional airlines, American Eagle Airlines and Executive Airlines. American Eagle carriers provided connections at American Airlines’ hubs and other major airports such as the Boston/Logan and New York/John F. Kennedy airports. It also conducted business with three independently owned regional airlines, which collectively operated as the AmericanConnection. American Airlines was a founding member of the One World Alliance network.

American Airlines, AMR Eagle, and the AmericanConnection airlines served 250 cities in 50 countries with more than 3400 daily flights. The combined network fleet numbered approximately 900 aircraft. AMR Corporation generated revenues of US\$23,979 million, US\$1054 million in an operating loss, and US\$1979 million in a net loss during 2011. 2011 was AMR’s fourth straight year of net losses. Not surprisingly, AMR filed for Chapter 11 bankruptcy in November 2011.<sup>6</sup> Immediately, rumors surfaced that US Airways was seriously interested in acquiring AMR. Although US Airways CEO Doug Parker had not yet made a formal bid for AMR in early 2012, he was working to reach labor agreements with American’s three largest labor unions.<sup>7</sup>

*US Airways* was the smallest of the major U.S. airlines. Based in Tempe, Arizona, it was a member of the Star Alliance Network. The airline utilized a fleet of 338 mainline jet aircraft and 285 regional jet and turbo-prop aircraft, connecting 204 destinations in North America, South America, Europe, and the Middle East. The carrier operated the US Airways Shuttle, a US Airways brand providing hourly service between Boston, New York, and Washington, D.C. Regional airline service was branded as US Airways Express, operated by contract and subsidiary airline companies.

US Airways and America West Airlines merged in 2005. As of 2012, US Airways employed 32,306 people worldwide and operated 3197 daily flights (1268 US Airways Mainline and 1929 US Airways Express). Among the 10 largest domestic airlines, consumers scored US Airways last for overall customer satisfaction in a May 2011 *Consumer Reports* survey. Conversely, US Airways earned the top spot in the 2011 Airline Quality Rating (AQR) report among the hub-and-spoke major carriers.

US Airways Group generated US\$13,055 million in revenues, US\$426 million in operating income, and US\$71 million in net income during 2011. In January 2012, CEO Doug Parker expressed interest in taking over bankrupt American Airlines. In terms of capacity, both American and US Airways were significantly smaller than both Delta and United. A US Airways/American combination would be slightly larger and very competitive with both United and Delta. Whereas US Airways had lower unit labor costs than either United or Delta, American had the highest labor costs in the industry. Aircraft on order for both American and US Airways would move American from having one of the oldest, inefficient fleets to one of the youngest and most fuel-efficient fleets. It was estimated that fuel expense would be reduced by 10%–20% as newer aircraft replace the current old fleet.<sup>8</sup>

*Southwest Airlines* was the largest and most successful of the low-cost U.S.-based airlines. Headquartered in Dallas, Texas, Southwest employed more than 46,000 people and primarily provided point-to-point, high-frequency, low-fare services to 103 destinations in 41 states, the District of Columbia, Puerto Rico, and six near-international countries. In addition to serving major airports, Southwest served many secondary or downtown airports such as Dallas Love Field, Houston Hobby, Chicago Midway, and Baltimore-Washington International. Southwest took pride in differentiating itself from other low-fare carriers by providing excellent customer service in terms of on-time arrivals and no baggage fees.

In May 2011, Southwest purchased Air Tran Airways. At the time, Southwest operated about 3400 flights per day, with Air Trans operating nearly 700 flights. This gave Southwest its first service to Atlanta, Delta's headquarters. Management expected to spend the next several years integrating the two airlines. This acquisition made Southwest a "national" discount airline and better positioned it to attract more business travelers. Southwest Airlines generated US\$15.7 billion in revenues, US\$693 million in operating income, and US\$178 million in net income during 2011.<sup>9</sup>

## Corporate Governance

The Board of Directors of Delta Airlines, Inc. was composed of 11 people, three of whom were employed by the corporation. Richard Anderson served as Chief Executive Officer. Edward Bastian served as Delta's President. Kenneth Rogers was a Delta Pilot who had been nominated by the Delta MEC (Master Executive Council of ALPA, the pilot's union). Although the Board did not have a formal policy on whether the same person should serve as the Chairman of the Board and the Chief Executive Officer, these roles had been separated since 2003. Daniel Carp served as Chairman of the Board. The Board established the following committees: audit, corporate governance (proposed nominations to the board), finance, personnel & compensation, and safety & security.

The directors and executive officers as a group beneficially owned 1.3% of the 849,639,086 shares of common stock in 2012. None of the Board members or executive officers owned

more than 1% of the shares. Five institutional investors were each beneficial owners of more than 5% of the common stock: BlackRock, Inc. (5.51%), Janus Capital Management, LLC (7.50%), Janus Overseas Fund (6.37%), and Wellington Management Company, LLP (6.67%) for a total of 26% of Delta's common stock. For their service on the Board of Directors, non-employee (inside) directors received during 2011 an annual retainer of US\$85,000, approximately US\$115,000 in restricted stock, plus US\$10,000 retainer for each committee membership. Committee chairs received US\$20,000 as retainers, while the board chairman received an annual retainer of US\$175,000. The board required each non-employee director to own at least 35,000 shares of Delta common stock no later than three years after his or her election to the Board.

The board had established pay for performance as a key component of executive compensation. The CEO compensation mix for 2011 was composed of salary (7%), annual incentive (11%), and long-term incentive (82%). The vast majority of compensation for Delta's executive officers was determined by the company's financial, operational, customer service, stock price performance, and the officer's continued employment with Delta. This at-risk compensation constituted 93% of the CEO's compensation and 85% of other executive officers' compensation.

Two of Delta's executive officers had previously been employees of Northwest Airlines. CEO Richard Anderson had served as Northwest's CEO from 2001 to 2004 before he became Executive Vice President of UnitedHealth Group. Mickey Foret had served as executive vice-president and Chief Financial Officer of Northwest from 1998 to 2002 before he joined a consulting firm as its President.

## Financial Results

Net income earned by Delta in 2011 was US\$854 million, US\$261 million higher than in 2010 despite higher fuel costs. Total operating revenue increased US\$3.4 billion on an 11% increase in passenger mile yield, primarily due to higher passenger revenues. Total operating income decreased to US\$1975 in 2011 from US\$2217 million in 2010. Total operating expense increased US\$3.6 billion, driven primarily by a US\$2.9 billion increase in fuel expenses. (See Exhibits 1, 2, and 3 for Delta's financial statements.)

**EXHIBIT 1**  
Delta Airlines, Inc.  
Consolidated  
Balance Sheets  
(In millions,  
except share data)

|  | December 31, |              |
|--|--------------|--------------|
|  | 2011         | 2010         |
| <b>Assets</b>  |              |              |
| <b>Current assets:</b>   |              |              |
| Cash and cash equivalents  | \$ 2,657     | \$ 2,892     |
| Short-term investments   | 958          | 718          |
| Restricted cash, cash equivalents, and short-term investments  | 305          | 409          |
| Accounts receivable, net of an allowance for uncollectible accounts of \$33 and \$40 at December 31, 2011 and 2010, respectively               | 1,563        | 1,456        |
| Expendable parts and supplies inventories, net of an allowance for obsolescence of \$101 and \$104 at December 31, 2011 and 2010, respectively | 367          | 318          |
| Deferred income taxes, net   | 461          | 355          |
| Prepaid expenses and other   | 1,418        | 1,159        |
| <b>Total current assets</b>  | <b>7,729</b> | <b>7,307</b> |

**EXHIBIT 1**  
(Continued)

|  | December 31,     |                  |
|--|------------------|------------------|
|  | 2011             | 2010             |
| <b>Property and equipment, net:</b>  |                  |                  |
| Property and equipment, net of accumulated depreciation and amortization of \$5,472 and \$4,164 at December 31, 2011 and 2010, respectively                | 20,223           | 20,307           |
| <b>Other assets:</b>   |                  |                  |
| Goodwill   | 9,794            | 9,794            |
| Identifiable intangibles, net of accumulated amortization of \$600 and \$530 at December 31, 2011 and 2010, respectively                                   | 4,751            | 4,749            |
| Other noncurrent assets  | 1,002            | 1,031            |
| Total other assets   | 15,547           | 15,574           |
| Total assets   | <u>\$ 43,499</u> | <u>\$ 43,188</u> |
| <b>Liabilities and stockholders' (deficit) equity</b>  |                  |                  |
| <b>Current liabilities:</b>  |                  |                  |
| Current maturities of long-term debt and capital leases  | \$ 1,944         | \$ 2,073         |
| Air traffic liability  | 3,480            | 3,306            |
| Accounts payable   | 1,600            | 1,713            |
| Frequent flyer deferred revenue  | 1,849            | 1,690            |
| Accrued salaries and related benefits  | 1,367            | 1,370            |
| Taxes payable  | 594              | 579              |
| Other accrued liabilities  | 1,867            | 654              |
| Total current liabilities  | <u>12,701</u>    | <u>11,385</u>    |
| <b>Noncurrent liabilities:</b>   |                  |                  |
| Long-term debt and capital leases  | 11,847           | 13,179           |
| Pension, postretirement, and related benefits  | 14,200           | 11,493           |
| Frequent flyer deferred revenue  | 2,700            | 2,777            |
| Deferred income taxes, net   | 2,028            | 1,924            |
| Other noncurrent liabilities   | 1,419            | 1,533            |
| Total noncurrent liabilities   | <u>32,194</u>    | <u>30,906</u>    |
| <b>Commitments and contingencies</b>   |                  |                  |
| <b>stockholders' (deficit) equity:</b>   |                  |                  |
| Common stock at \$0.0001 par value; 1,500,000,000 shares authorized, 861,499,734 and 847,716,723 shares issued at December 31, 2011 and 2010, respectively | —                | —                |
| Additional paid-in capital   | 13,999           | 13,926           |
| Accumulated deficit  | (8,398)          | (9,252)          |
| Accumulated other comprehensive loss   | (6,766)          | (3,578)          |
| Treasury stock, at cost, 16,253,791 and 12,993,100 shares at December 31, 2011 and 2010, respectively  | (231)            | (199)            |
| Total stockholders' (deficit) equity   | <u>(1,396)</u>   | <u>897</u>       |
| Total liabilities and stockholders' (deficit) equity   | <u>\$ 43,499</u> | <u>\$ 43,188</u> |

SOURCE: Delta Airlines, Inc. 2011 Form 10-K, pp. 46-47.

**EXHIBIT 2**  
Delta Airlines,  
Inc. Consolidated  
Statements of  
Operations  
(In millions, except  
per share data)

|   | Year Ended December 31, |                |                   |
|---|-------------------------|----------------|-------------------|
|   | 2011                    | 2010           | 2009              |
| <b>Operating Revenue:</b>                             |                         |                |                   |
| Passenger:  |                         |                |                   |
| Mainline  | \$ 23,864               | \$ 21,408      | \$ 18,522         |
| Regional carriers                                     | 6,393                   | 5,850          | 5,285             |
| Total passenger revenue                               | <u>30,257</u>           | <u>27,258</u>  | <u>23,807</u>     |
| Cargo   | 1,027                   | 850            | 788               |
| Other   | 3,831                   | 3,647          | 3,468             |
| Total operating revenue                               | <u>35,115</u>           | <u>31,755</u>  | <u>28,063</u>     |
| <b>Operating expense:</b>                             |                         |                |                   |
| Aircraft fuel and related taxes                       | 9,730                   | 7,594          | 7,384             |
| Salaries and related costs                            | 6,894                   | 6,751          | 6,838             |
| Contract carrier arrangements                         | 5,470                   | 4,305          | 3,823             |
| Aircraft maintenance materials and<br>outside repairs | 1,765                   | 1,569          | 1,434             |
| Passenger commissions and other<br>selling expenses   | 1,682                   | 1,509          | 1,405             |
| Contracted services                                   | 1,642                   | 1,549          | 1,595             |
| Depreciation and amortization                         | 1,523                   | 1,511          | 1,536             |
| Landing fees and other rents                          | 1,281                   | 1,281          | 1,289             |
| Passenger service                                     | 721                     | 673            | 638               |
| Aircraft rent   | 298                     | 387            | 480               |
| Profit sharing  | 264                     | 313            | —                 |
| Restructuring and other items                         | 242                     | 450            | 407               |
| Other   | 1,628                   | 1,646          | 1,558             |
| Total operating expense                               | <u>33,140</u>           | <u>29,538</u>  | <u>28,387</u>     |
| <b>Operating income (loss)</b>                        | 1,975                   | 2,217          | (324)             |
| <b>Other (expense) income:</b>                        |                         |                |                   |
| Interest expense, net                                 | (901)                   | (969)          | (881)             |
| Amortization of debt discount, net                    | (193)                   | (216)          | (370)             |
| Loss on extinguishment of debt                        | (68)                    | (391)          | (83)              |
| Miscellaneous, net                                    | (44)                    | (33)           | 77                |
| Total other expense, net                              | <u>(1,206)</u>          | <u>(1,609)</u> | <u>(1,257)</u>    |
| <b>Income (loss) before income taxes</b>              | 769                     | 608            | (1,581)           |
| <b>Income tax benefit (provision)</b>                 | 85                      | (15)           | 344               |
| <b>Net income (loss)</b>                              | <u>\$ 854</u>           | <u>\$ 593</u>  | <u>\$ (1,237)</u> |
| <b>Basic earnings (loss) per share</b>                | <u>\$ 1.02</u>          | <u>\$ 0.71</u> | <u>\$ (1.50)</u>  |
| <b>Diluted earnings (loss) per share</b>              | <u>\$ 1.01</u>          | <u>\$ 0.70</u> | <u>\$ (1.50)</u>  |

SOURCE: Delta Airlines, Inc. 2011 Form 10-K, p. 48.

**EXHIBIT 3**  
Delta Airlines, Inc.  
Consolidated State-  
ments of Cash Flow

|  | Year Ended December 31, (in millions) |                |            |
|--|---------------------------------------|----------------|------------|
|  | 2011                                  | 2010           | 2009       |
| <b>Cash Flows From Operating Activities:</b>   |                                       |                |            |
| Net income (loss)  | \$ 854                                | \$ 593         | \$ (1,237) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                       |                |            |
| Depreciation and amortization  | 1,523                                 | 1,511          | 1,536      |
| Amortization of debt discount, net   | 193                                   | 216            | 370        |
| Loss on extinguishment of debt   | 68                                    | 391            | 83         |
| Fuel hedge derivative contracts  | 135                                   | (136)          | (148)      |
| Deferred income taxes  | (2)                                   | 9              | (329)      |
| Pension, postretirement and postemployment expense (less than) in excess of payments     | (308)                                 | (301)          | 307        |
| Equity-based compensation expense  | 72                                    | 89             | 108        |
| Restructuring and other items  | 142                                   | 182            | —          |
| Changes in certain assets and liabilities:   |                                       |                |            |
| Receivables  | (76)                                  | (141)          | 147        |
| Hedge margin receivables   | (24)                                  | —              | 1,132      |
| Restricted cash and cash equivalents   | 153                                   | 16             | 79         |
| Prepaid expenses and other current assets  | (16)                                  | (7)            | (61)       |
| Air traffic liability  | 174                                   | 232            | (286)      |
| Frequent flyer deferred revenue  | 82                                    | (345)          | (298)      |
| Accounts payable and accrued liabilities   | 303                                   | 516            | 143        |
| Other assets and liabilities   | (373)                                 | (98)           | (138)      |
| Other, net   | (66)                                  | 105            | (29)       |
| Net cash provided by operating activities  | \$ 2,834                              | \$ 2,832       | \$ 1,379   |
| <b>Cash Flows From Investing Activities:</b>   |                                       |                |            |
| Property and equipment additions:  |                                       |                |            |
| Flight equipment, including advance payments   | (907)                                 | (1,055)        | (951)      |
| Ground property and equipment, including technology                                      | (347)                                 | (287)          | (251)      |
| Purchase of investments  | (1,078)                               | (815)          | —          |
| Redemption of investments  | 844                                   | 149            | 256        |
| Other, net   | (10)                                  | (18)           | (62)       |
| Net cash used in investing activities  | (1,498)                               | (2,026)        | (1,008)    |
| <b>Cash Flows From Financing Activities:</b>   |                                       |                |            |
| Payments on long-term debt and capital lease obligations                                 | (4,172)                               | (3,722)        | (2,891)    |
| Proceeds from long-term obligations  | 2,395                                 | 1,130          | 2,966      |
| Fuel card obligation   | 318                                   | —              | —          |
| Debt issuance costs  | (63)                                  | (19)           | —          |
| Restricted cash and cash equivalents   | (51)                                  | —              | —          |
| Other, net   | 2                                     | 90             | (94)       |
| Net cash used in financing activities  | (1,571)                               | (2,521)        | (19)       |
| <b>Net (Decrease) Increase in Cash and Cash Equivalents</b>                              | <b>(235)</b>                          | <b>(1,715)</b> | <b>352</b> |

(continued)

**EXHIBIT 3**  
 (Continued)

|  | Year Ended December 31, (in millions) |                 |                 |
|--|---------------------------------------|-----------------|-----------------|
|  | 2011                                  | 2010            | 2009            |
| <b>Cash Flows From Operating Activities:</b>             |                                       |                 |                 |
| Cash and cash equivalents at beginning of period         | 2,892                                 | 4,607           | 4,255           |
| Cash and cash equivalents at end of period               | <u>\$ 2,657</u>                       | <u>\$ 2,892</u> | <u>\$ 4,607</u> |
| <b>Supplemental disclosure of cash paid for interest</b> | \$ 925                                | \$ 1,036        | \$ 867          |
| <b>Non-cash transactions:</b>                            |                                       |                 |                 |
| Flight equipment under capital leases                    | \$ 117                                | \$ 329          | \$ 57           |
| JFK redevelopment project funded by third parties        | 126                                   | —               | —               |
| Debt relief through vendor negotiations                  | —                                     | 160             | —               |
| Debt discount on American Express agreements             | —                                     | 110             | —               |
| Aircraft delivered under seller financing                | —                                     | 20              | 139             |

SOURCE: Delta Airlines, Inc. 2011 Form 10-K, p. 49.

Fuel price volatility continued to plague Delta's management. Fuel cost per gallon increased 31% from 2010 to 2011 and amounted to 36% of Delta's total operating expense, compared to 30% in 2010. During 2011, gains from Delta's hedging program reduced fuel expense by US\$420 million. Including fuel hedging activity, the company's average cost per fuel gallon in 2011 was US\$3.06 compared to US\$2.33 in 2010. (See **Exhibit 4**.)

In finalizing its merger with Northwest, Delta took on US\$904 million in debt.<sup>10</sup> In order to make this debt more manageable, Delta made an offering to sell US\$500 million of five-year secured bonds to help the company recover from its massive debt accumulation. Most of the proceeds from this offering went toward refinancing the Northwest bank loans as a result of the merger.<sup>11</sup> Management was working diligently to reduce this debt. For example, the company sold two of its wholly owned regional subsidiaries, Mesaba and Compass Airlines, for a total of US\$82.5 million in July 2010. By the end of 2011, total debt and capital leases, including current maturities, was US\$13.8 billion, a US\$1.5 billion reduction from 2010 and a US\$3.4 billion reduction from 2009.

Delta's management admitted in the corporation's 2011 annual report that "our substantial indebtedness may limit our financial and operating activities and may adversely affect our ability to incur additional debt to fund future needs." They also admitted that a significant

**EXHIBIT 4**  
 Delta Airlines, Inc.  
 Fuel Cost and  
 Consumption

|                         | 2006    | 2007    | 2008    | 2009    | 2010    | 2011     |
|-------------------------|---------|---------|---------|---------|---------|----------|
| Gallons Consumed        | 2111    | 2534    | 2740    | 3853    | 3,823   | 3856     |
| Cost (US\$ Millions)    | \$4,319 | \$5,676 | \$8,686 | \$8,291 | \$8,901 | \$11,783 |
| Average Cost Per Gal    | \$ 2.04 | \$ 2.24 | \$ 3.16 | \$ 2.15 | \$ 2.33 | \$ 3.06  |
| % of Operating Expenses | 25%     | 31%     | 38%     | 29%     | 30%     | 36%      |

SOURCE: Delta Airlines, Inc. Annual Reports for 2008 and 2011.

portion of the corporation's assets were currently subject to liens, which could further limit management's ability to obtain additional financing on acceptable terms for working capital, capital expenditures, and other purposes.

## Marketing

Delta's target market was the business class passenger segment. Delta's SkyMiles was a free program that allowed members to earn miles or points accrued for free travel, upgrades, or other products and services. Members could earn miles by flying with Delta or any of Delta's over 20 affiliate airlines, including Air France, Korean Air, Aeromexico, Alitalia, and Alaska Air. Delta had also teamed with other businesses such as Budget Rent-A-Car and several leading hotels to provide SkyMiles members with new mileage-earning opportunities that encompass their global travel experience.

The SkyMiles program encouraged return purchases and increased brand loyalty. A customer could choose Delta or an affiliate over another airline for the added benefit of earning miles, even if the flight was slightly more expensive. Also, by creating and maintaining this membership program, Delta was able to distribute information and updates to its customers directly via e-mail or to a physical address, both of which were items required for registration with the program.

Delta also provided special services and amenities to its business travelers through the Business Elite Services program. This program was similar to flying first class with other airlines. When a member booked a flight, the passenger can choose to fly coach or business/first class. By branding what other airlines would typically call first class as "Business Elite," Delta created a higher perceived value for this service for its customers. Business Elite passengers received premium service during their travel experience from start to finish. There were Business Elite check-in desks; larger, more comfortable seats; free food and beverages on most flights; access to the Delta Sky Clubs in participating airports; flat bed seats for transatlantic flights; priority baggage claim; and 150% earned miles over the typical SkyMiles member flying in coach.

Another marketing strength employed by Delta was its use of affiliate marketing. Affiliate marketing allowed Delta to join forces with other businesses to advertise and promote its services. Even for small businesses, Delta paid a commission for every ticket sale that resulted in a referral from another business' website displaying a link to Delta. Delta also paired with large organizations such as the PGA tour, Walt Disney World, and the Minnesota Twins, where it was advertised as the airline of choice. By creating these relationships, both Delta and its affiliates reaped the advertising benefits of reaching more people and the hope of potential sales.

Following the online revolution, Delta jumped on board by creating a blog to post the airline's news and events. The blog allowed its followers to directly comment on any of the posts and participate in any discussion. With an entity as large as Delta, this gave customers a feeling of worth and inclusion by being heard and being allowed to participate. The subject of the blog posts included day-to-day living to service upgrades, green initiatives and new plane paint jobs to snack selection and destination reviews, as well as many other topics.

One of Delta's marketing weaknesses, however, was a lack of differentiation with respect to its services. While air travel was a commodity, some of Delta's competitors had differentiated their services from the competition, while Delta failed to set itself apart from other airlines. Because of this, Delta was forced to compete on price and quality to earn its customers and their loyalty. In addition, the use of television advertising was almost nonexistent for Delta; whereas, other airlines used television as their primary source of advertising.

## Operations

Delta was a founding member of SkyTeam, a global airline alliance that included Aeroflot, Aeromexico, Air France, Alitalia, China Southern Airlines, CSA Czech Airlines, Delta Air Lines, KLM Royal Dutch Airlines, Korean Air, Air Europa, and Kenya Airways. Combined, this alliance offered over 13,000 flights daily to almost 900 destinations worldwide. This expansive network gave Delta flexibility to fly literally anywhere in the world with the support of the other SkyTeam carriers. It also allowed shorter connections and consolidated hubs that share gates and baggage transfer systems to increase efficiency and reduce costs for the airlines. Furthermore, Delta was able to offer cargo customers a consistent international product line through its SkyTeam Cargo membership.

Delta had a significant number of U.S. domestic hub airports, plus three foreign hubs in Amsterdam, Paris, and Tokyo. Hub operation required more gates, and therefore, acted to shut out competition from many lower-fare competitors.<sup>12</sup> Delta's hub operations in Atlanta, Cincinnati, Detroit, Memphis, Minneapolis-St. Paul, New York-JFK, and Salt Lake City took place at some of the busiest and largest airports in the United States, thus preventing many other carriers from competing in those markets.

In early 2009, Delta and newly merged Air France-KLM created a joint venture (JV) agreement to expand transatlantic travel for both companies. This agreement gave the two companies a total of 25% of the global transatlantic air travel market. It allowed them to share revenues and costs for transatlantic flights and should boost both partners' revenues by US\$150 million, according to both Delta and Air France-KLM CEOs.<sup>13</sup> It also allowed the companies to share pricing and marketing data to better improve their international travel.

As part of the operations strategy, Delta's management worked to strengthen the company's position in New York. In December 2011, Delta traded 42 slots at Reagan National plus the rights to operate additional daily service to Sao Paulo, Brazil, and US\$66.5 million in cash to US Airways for 132 slot pairs at LaGuardia Airport in order to operate a new domestic hub at LaGuardia. This enabled management to announce the expansion of Delta's domestic service at LaGuardia to include more than 100 new flights and 29 new destinations. In addition, Delta was creating a "state-of-the-art" facility at New York's John F. Kennedy International Airport for international travelers. The project would cost approximately US\$1.2 billion and would be completed over a five-year period beginning in 2010.

Delta also operated a maintenance and service division, Delta TechOps. This service division provided airframe maintenance, component and part maintenance, engine maintenance, line maintenance, logistics, fleet engineering support, and technical operations training to not only Delta, but other commercial airlines as well. Having these services in-house was a tremendous strength for Delta, which could maintain the quality of its fleet in-house and then market these services to other airlines to make a profit.

Delta struggled to effectively match capacity and demand. In order to provide good service to its customers, the company offered flights to as many destinations as possible. In order to be profitable, however, management must fill planes with enough travelers to cover, and hopefully exceed, the fixed operational expenses of that specific flight. While the recession made this match difficult with lower demand and higher fuel prices, Delta tried to combat this by using smaller planes and retiring older ones.<sup>14</sup> It also tried to reduce costs by eliminating some of its operations staff. Thanks to various codesharing agreements and its merger with Northwest, Delta increased its passenger load factor from 68.1% in 2001 to 83% in 2010 and 82.1% in 2011. A combination of raising the load factor and cutting costs helped reduce the airlines' operating cost per available seat mile from 18.72 cents in 2008 to 14.12 cents in 2011 (compared to 12.41 cents for Southwest Airlines).<sup>15</sup>

Delta had learned over the decades that it was incapable of operating as a low-cost carrier to compete with airlines like JetBlue and Southwest. Its attempt in the early 2000s to operate Song Airline was a major failure that forced Delta to return to relying on its original operating structure. In its attempts to establish a budget airline, Delta had pulled resources away from its main business. While trying to be more competitive, it had essentially created a competitor to its own mainline business.<sup>16</sup>

## Human Resources and Social Responsibility

Delta has struggled with people problems. Most of its workforce, except for flight operations personnel and pilots, was non-unionized. With unionized employees, compensation and benefits had always been a hot topic of discussion. Over the years, Delta had attempted to impose pay cuts to lower operating costs. While in bankruptcy court, Delta pilots, represented by the Air Line Pilots Association, fought hard for fair compensation, even threatening total liquidation of Delta if an agreement could not be reached.<sup>17</sup> During the merger with Northwest, both airlines met with the union to garner their support for the agreement. Although Delta has not experienced the same degree of domestic labor disruptions that other airlines have experienced, its workers in European countries are much more active in labor unions and political protests.

Delta's corporate governance policies promoted diversity inside and outside of the organization. It participated in an initiative to promote small businesses, minority- and female-owned businesses. Top management understood that the global economy depended on the well being of all businesses and tried to distribute its sales to promote and grow these smaller companies.

Delta's focus on social responsibility was exemplified through Delta's Force for Global Good program. In this program, Delta supported global diversity, global wellness and health, improving the environment, and promoting arts and culture. It participated in and sponsored thousands of events every year and partnered with well-known organizations like the Red Cross, Habitat for Humanity, UNICEF, the Nature Conservatory, the Tribeca Film Festival, the National Black Arts Festival, and many other charitable organizations.

## Technology

Delta had a lengthy history of embracing technology, from early adoption of jet aircraft to the use of mainframe computers, and most recently, integrating the Delta and Northwest websites, operations and reservation systems. Delta was at the forefront of developing technologies to increase the total customer experience. Passengers were able to view, select, or change seat assignments at its online website. They could also receive boarding passes via self-service kiosks. Delta, along with the Transportation Security Administration (TSA), initiated the paperless mobile check-in for domestic travel from some airports in the United States. It was now offering upgraded video, music, game, and power options on many of its newer aircraft.<sup>18</sup>

## The Airline Industry

### Deregulation

The U.S. domestic airline industry was largely deregulated in 1978,<sup>19</sup> and entry barriers for new entrants were lower from a legislative standpoint. Airlines were free to negotiate their own operating arrangements with different airports, enter and exit routes easily, and set fares and flight volumes according to market conditions.

Deregulation resulted in spectacular industry growth. The number of air passengers increased from 207.5 million in 1974 to 721.1 million in 2010. Unfortunately, this growth resulted in a flight-choked Northeastern U.S. corridor, overcrowded airports, delays, and terrorist risks. More competition led to fare cutting. For example, the cheapest round-trip New York–Los Angeles flight in 1974 was US\$1442 (inflation-adjusted dollars). By 2010, that same flight cost US\$268. Consequently, this resulted in an average decrease in revenue per passenger mile from an inflation-adjusted 33.3 cents in 1974 to 13 cents in 2010.<sup>20</sup>

Deregulation did not free airlines from oversight by a number of domestic and international agencies. A short list included the U.S. Department of Transportation, the U.S. Department of Homeland Security, and air transport and safety organizations of the various countries the airlines served. For example, Delta was a member of the International Air Transport Association (IATA) and was subject to applicable conventions such as the “Warsaw Conditions of Contract and Other Important Notices.” It was also subject to scheduling and landing slot rules by the foreign countries it serves and various airport management authorities.

## Entry Barriers

There was a large amount of bureaucracy involved in setting up a new airline. For example, a new company in the United States must apply to the Federal Aviation Authority (FAA) for an air carrier certificate. In order to operate aircraft, new airlines must obtain an operating license, which was usually a lengthy process. These procedures dissuaded many from entering the industry because generation of revenues can take a long time.

The large capital outlay that was required to start an airline business can also be a serious deterrent for new entrants. An entrant must have sufficient resources to pay the staff required and to either lease or buy a fleet of aircraft.

Even if a new entrant had the capital to launch a business, it would encounter obstacles in accessing airports. Established airlines had an edge over potential entrants, for they held a monopoly over time slots at certain airports, making it harder for new airlines to gain entry to those airports. This created immense difficulties for new airlines to negotiate prime slots at busy airports and may result in a new airline being restricted to offering flights only at off-peak times, or having to fly to airports further away from popular destinations.

Established airlines formed strategic alliances such as SkyTeam, Oneworld, and Star, in order to be more competitive both locally and globally. Airlines partnered with one another not only to achieve network size economies through initiatives such as code sharing, but also to achieve scale economies in the purchase of fuel and even of aircraft. A new entrant faced a potentially high cost of operation because it took a long time to gain access to these types of arrangements and take advantage of the cost reductions that resulted from alliance building.

## Fuel Economy

The cost of fuel had become a significant and growing cost of doing business for the entire airline industry. If oil once again significantly rose in price, the effects could be profound and long lasting. Analysts openly contemplate the end of mass international air travel, an event that could reconfigure world economics and make flying an option for only the wealthy. A flight across the Atlantic can easily consume 60,000 liters of fuel—more than a motorist would use in 50 years of driving—and generate 140 tons of carbon dioxide. The world fleet of jetliners burned about 130 million tons of fuel each year.<sup>21</sup>

Until recently, the airline industry predicted a doubling of flights by 2050.<sup>22</sup> But another war in the Middle East, the world’s largest source of oil-derived products, could devastate supplies and easily lead to a severe curtailment in flights worldwide. Even without armed conflict,

there were leaders who could use oil—and the threat of shutting down production—for political purposes. Finally, rising economies, such as those in Brazil, India, and China, were using more of these limited resources.

## Brand Loyalty

The airline industry was highly competitive. The key buyers in the airline industry were leisure and business travelers. While the leisure pool was somewhat fragmented and lacked real bargaining power, business travelers from major corporations had some leverage. Since customers were sensitive to price and could easily switch from one airline to another, brand loyalty in the industry was low. As a counter move, airlines had used loyalty schemes to entice and retain customers.

Even with loyalty programs, airlines were still struggling to keep customers on board. The recession of 2008 dampened demand for air travel.<sup>23</sup> In a bad economy, individuals were able to substitute air travel with other choices—car, bus or train, or by using lower-cost regional airlines, such as Southwest. Customers were far less loyal today than in former years. Travel sites such as Orbitz and Travelocity could be instructed to search by lower fares, fewer connecting flights, and so forth. Air and credit card rewards programs were less generous than in years past, so there was less incentive for passengers to remain loyal to any one airline.<sup>24</sup>

## Supplier Power

Fuel suppliers, aircraft manufacturers, and skilled employees were the key suppliers in the airline industry. The industry was characterized by strong supplier power, given the duopoly of the large, jet engine-powered aircraft manufacturers of Boeing and Airbus. Airlines entered into contracts when buying or leasing aircraft from suppliers, and breaking these contracts often invoked heavy financial penalties.

Fuel suppliers were also in a strong position, since no viable substitute for jet fuel had yet been discovered. Staffing costs for an airline were substantial, with large numbers of highly trained flight and ground personnel, including mechanics, reservation, and transportation ticketing agents being required in order to provide an efficient service. Labor costs were difficult to cut, given that most large airlines were unionized.

## Consumer Attitudes

Customers in recent years had become increasingly hostile toward the airline industry as a result of travel delays, intrusive screening, and “nickel and dime” issues such as checked baggage fees and even a recent proposal by Spirit Airline to charge for overhead baggage.<sup>25</sup> Both Delta and United led the industry by charging US\$100 for a second checked bag on international flights. U.S. airlines collected US\$3.4 billion in baggage fees in 2011, helping to offset fuel costs and reducing the need for baggage handlers.<sup>26</sup> Customers were increasingly vocal in their discontent with “cattle car” treatment and multiple fees. Consumer groups, such as the International Airline Passengers Association, the Air Travelers Association, FlyerRights.org, and the Coalition for an Airline Passengers’ Bill of Rights, had been fighting for increased oversight of airlines. In 2009, a video on YouTube titled, “United Breaks Guitars,” received widespread notice.

One professor argued that compared to the early 1980s, air fares were lower in 2012, but everything else (except for in-flight entertainment) was worse. There was less leg room, less food, less service, more-crowded airplanes, and more time wasted going through the airport.<sup>27</sup>

Calls for an airplane passenger's "Bill of Rights" had become more frequent, culminating in 2011 with U.S. legislation stating that if a boarded international commercial airplane sat on a runway for more than four hours, the airline would be charged up to US\$27,500 per passenger. The law also stated that airlines must prominently post bag, meal, and cancellation fees on their website and compensate "bumped" passengers at least double the price of their ticket.

According to the American Customer Satisfaction Index, the airline industry as a whole received a score in 2011 of 65% out of 100% possible. This compared to 82% for the full-service restaurant industry. In order of highest customer satisfaction for 2011 were Southwest (81%), Continental (64%), American (63%), US Airways and United (61%), and Delta (56%).

## Natural and Social Calamities

Some events, such as blizzards, earthquakes, and even a volcanic eruption in Iceland, were beyond the control of any airline. There were no technological "fixes" for these natural disasters. The enormous ash cloud from the Icelandic volcano that shut down European air space in 2010 cost U.S.-based airlines tens of millions of dollars per day. Since Delta had the biggest presence in Europe, it lost the most money—up to US\$6.5 million per day.<sup>28</sup>

Airlines also faced threats from wars, political instability, and social unrest. Protesters in Thailand, for instance, forced the closure of its main airport terminal in 2008, causing airport operations to cease for a time.<sup>29</sup> Similarly, the 2001 terrorist attacks in the United States caused all air traffic to be halted for a period of several days and led to a sharp decline in the economy and air travel.<sup>30</sup>

## Industry Outlook

According to *IBISWorld's* "2012 Domestic Airlines in the U.S. Industry Market Research Report" the U.S. airline industry had been unstable over the past decade with revenue growing marginally at an annualized rate of 0.3% over the five years leading up to 2012. Revenue was up 9.0% during 2010 and 3.6% in 2011. The overall trend over the past five years had been an increase in market share for low-cost carriers such as US Airways, JetBlue, and Southwest Airlines, to the detriment of American and United Airlines.

The *IBISWorld* report predicted that the U.S. airline industry should experience a modest recovery and positive growth over the next five years. Nevertheless, high fuel costs should continue cutting into profitability. Major carriers were expected to continue merging in order to boost profitability and gain a competitive advantage.

Outside the United States, many nations had traditionally subsidized their national air carriers. There had been an economic benefit in having a nationally branded airline flying the flag overseas, bringing tourists into the country, and generating income for local businesses. National pride also played a role. An increasingly competitive global airline industry meant that small national airlines had become less cost effective. Airlines had been forced to ask for more money from their governments or else go out of business. This was why New Zealand stepped in to prop up Air New Zealand in 2001. For their part, many governments no longer had the money to support airlines as they did in the past. In January 2012, Spain's Spanair and Hungary's Malev foundered when their governments reduced airline subsidies. State investors in Sweden's SAS, Ireland's Aer Lingus, Portugal's TAP, and the flag carriers of Poland and the Czech Republic indicated in 2012 that because of the European debt crisis they would be reducing financial support and seeking new investors. Turkish Airlines was working to buy a stake in LOT Polish Airlines from the Polish government, which had been trying to sell its 25% share of the carrier since 2009. These state-supported European airlines found themselves falling behind Europe's three big airline groups: Air France-KLM

Group, Deutsche Lufthansa (including carriers in Austria, Belgium, and Switzerland), and International Consolidated Group (merger of British Airways and Iberia). It was logical to expect that mergers among state-supported airlines would soon occur as governments chose to privatize their national airlines by selling their ownership shares.<sup>31</sup>

The International Air Transport Association (IATA) forecasted that the global airline industry would post a second consecutive year of net profit declines in 2012 as the deepening European debt crisis would offset lower fuel prices, stronger-than-expected growth in passenger traffic, and an improved freight market. Although the IATA expected modest profit growth for carriers in North America, carriers in the Asia Pacific region should see the most increase in net profits in 2012. In contrast, European airlines should report a US\$1.1 billion loss. According to John Leahy, Chief Operating Officer for Airbus, "There's no doubt about it that 2012 is a softer year than 2011 in terms of orders and in terms of the health of some of the airlines."<sup>32</sup>

## Challenges Facing Delta

Delta had emerged from bankruptcy and proven that it could be a profitable company. The SkyTeam Alliance, a substantial flight network, and the recent merger with Northwest had contributed to its success in this industry. Like many successful companies, however, Delta continued to struggle with how to remain a viable company in the long term. While mergers and acquisitions had enabled the company to become the world's largest airline carrier, Delta still needed to focus on maintaining its profitability. Significant challenges for Delta remained.

## Possible Strategic Options

Delta was competing in an uncertain environment with many players, limited growth prospects, and little room to differentiate itself from others. The company's cost structure, service portfolio, brand loyalty, and ability to manage debt and crises will affect its future development. Further exploration of new business initiatives was also essential for Delta to move out of this crowded, stagnant market to create a new space for itself. With the successful merger of Northwest, the JV with Air France-KLM, and its ongoing success with SkyTeam, should Delta's management continue to pursue other M&A and JV opportunities, such as pursuing a merger with bankrupt American Airlines? While Delta's history has shown that it cannot successfully maintain a low-cost subsidiary on its own, a main question became, would it be beneficial to acquire or merge with a low-cost carrier, such as JetBlue, while keeping the carrier's current business model and brand?

In early 2012, Delta's top management became aware of an intriguing business opportunity. ConocoPhillips was planning to sell or close its 185,000 barrels-per-day Trainer, Pennsylvania, refinery, the latest struggling East Coast refinery to fall victim to low profit margins. East Coast refineries were typically reliant on expensive Brent crude oil imports from the North Sea and West Africa and could no longer compete with Midwest refineries that used cheaper West Texas Intermediate crude oil. No pipelines existed to bring highly discounted crude oil from the Bakken shale field of North Dakota. The Trainer refinery near Philadelphia was the third-largest of 12 East Coast refineries. Two of the twelve were idled in 2010 and two more, including Trainer, were idled in 2011.

Conoco's management announced that they would close the Trainer refinery if they didn't soon find a buyer. They planned to make Conoco's downstream operations (including pipelines, refineries, and retail stations) a separate company in 2013 and had repeatedly said that they were prepared to sell less sophisticated refining assets and other oil and gas properties they considered obsolete. Conoco's management said that they would entertain offers to

buy the Trainer refinery through May, 2012. It was common knowledge in the industry that except for a brief period from 2005 to 2008, refining was an unprofitable business. This would explain why no new refinery had been built in the United States in decades.

Preliminary meetings between Delta and Conoco revealed that Delta could purchase the Trainer refinery for US\$180 million. Delta's management realized that even if they bought the refinery, they would have to spend another US\$100 million to modify the refinery to maximize its production of jet fuel. On a positive note, any environmental cleanup risks previous to a sale would stay with the refinery's previous operator. The State of Pennsylvania announced that it would be willing to contribute US\$30 million in job creation assistance to anyone who would buy and operate the refinery with at least 402 full-time workers for at least five years. A purchase of the refinery would also include the pipelines and transportation assets necessary to supply fuel to Delta's operations throughout the northern United States.<sup>33</sup>

Delta's management was aware that operating a refinery profitably would be a tougher business than profitably operating an airline. The refinery was not making money and probably wouldn't in the future without a series of investments to make it competitive. Nevertheless, it would be one alternative to reduce the high cost of jet fuel, a major issue in airline profitability in 2012 and probably for many years to come. But, was this the best use of Delta's limited funds, especially when it was already committed to spending large sums of money to upgrade its New York facilities?

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