

Evolution & Aviation-Darwin Lives

The U.S. airline industry in the late 20th century & the dawn of the 21st century

No industry attracts more public and media attention than the airline business. Every day, the headlines tell of bankruptcies, reorganizations, restructurings and more. That's true not only in the United States but also here in Europe and around the world.

Of late, the news has not been pleasant. In the United States Midway and Vanguard Airlines have stopped flying. American has absorbed TWA. US Airways is in Chapter XI proceedings. United Airlines may join them in bankruptcy court if it cannot cut its operating costs quickly and deeply. In Europe we have seen the failure of Swissair and the dissolution of Sabena. In Asia and the Pacific we see similar changes.

Such events were unheard of in prior years, when European nations routinely stepped in to prop up and perpetuate their loss-making flag carriers. In the United States, low-price operators Southwest, JetBlue and AirTran continue to add aircraft to their fleets and cities to their systems. Low-cost, cut-price carriers continue to grow rapidly in Europe as well.

It is both a perilous and fascinating time to be in the airline business. The rapid evolution of the industry in the last 25 years offers many lessons. The history of the business in the United States may offer a glimpse into the near-term future of the airline industry in Europe and elsewhere. Let's review a few of the historical highpoints.

In 1978 the United States Congress passed the Airline Deregulation Act. This landmark legislation ended government regulation of airline pricing and marketing in the United States. It left in place the safety regulation of the Federal Aviation Administration as well as the special laws governing relations between airline companies and their organized labor groups. The Civil Aeronautics Board, an independent agency that was the economic regulator of the industry, disappeared in 1985, the first major regulatory body to end up in the dustbin of history. Its remaining functions were absorbed into the United States Department of Transportation (DOT).

If I could mix a metaphor, this caused a sea change in air commerce unlike anything that had ever happened before.

Prior to 1978, the U.S. airline industry was an exclusive club. Entry by a new company was difficult if not impossible. Prices were regulated in the manner of public utilities. Capacity was artificially restrained. But for those lucky enough to be in the club, life was good. To a great extent, economic survival and the opportunity to generate profits were assured to those fortunate enough to hold route rights.

Deregulation brought on a new regime of open entry to the industry and to airline markets for new airlines. It also allowed unfettered expansion by incumbent carriers. The result was quick and tumultuous, and much of it was unforeseen.

The architects of deregulation predicted that opening up economic competition would bring many new participants into the industry. That happened, as promised. In the past couple of decades literally hundreds of new airlines started up in the United States.

And... almost all of them failed -- most disappearing overnight. Deregulation made it easier to get into the airline business, but also made it much harder to stay in, let alone succeed.

As the legendary investor Warren Buffet once quipped, the best way to make a small fortune in the airline business is to start out with a large one. Buffet's wise observation notwithstanding, one of the more interesting American economic oddities is that there never seems to be a shortage of new operators eager to risk their money on new airline ventures. As evidence of this we have just seen the pension fund of the state of Alabama outbid the professional investor David Bonderman for the right to finance US Airways during its chapter XI process! But starting an airline in the U.S. or anywhere else continues to be an enterprise that combines a prohibitively high economic cost of entry with the prospect of fairly dismal economic returns even in the best of times. Most new entrants fall quickly by the wayside, their founders' equity lost in the great game to see who can give away the product fastest at a price far below the cost of production.

Established airlines responded to the competitive threat of the new entrants by expanding their networks at a dizzying pace throughout the '80s and '90s. Each of the half-dozen or so "major" network carriers raced to build a ubiquitous international network. Each hoped to attract as many of the hundreds of millions of additional customers annually as possible. But all this new seat capacity quickly turned into overcapacity. As the number of seats offered for sale almost tripled, the number of customers willing to pay an economically compensatory fare to travel grew little, if at all. This in turn has led to ever-decreasing (inflation adjusted) unit revenues for the surviving air carriers. Astoundingly, according to the United States Air Transport Association, the average price of an airline ticket is lower in nominal dollars today than it was twenty years ago. Using inflation-adjusted dollars, the average ticket price has plunged more than 50 percent!

Today low-cost producers such as Southwest or JetBlue set prices in many key markets. These airlines enjoy two critical advantages over the network carriers. First, their work forces tend to be either largely non-unionized (as at JetBlue) or under labor agreements that have been fashioned to recognize the economic realities of the post-deregulation industry (as at Southwest). Because of this, their workers are far more productive and their unit labor costs far lower. Second, they operate as niche players in terms of route structure, serving only the largest and therefore potentially most profitable markets. They are happy to leave to the legacy network carriers the task of offering ubiquitous service to the less profitable (and more expensive) small and medium markets.

For competitive reasons, the network airlines have no choice but to match the low prices in JetBlue and Southwest markets. So the losses for the legacy network airlines increase as the new carriers make ever-greater inroads into their largest markets. The consumers vote with their wallets, opting for the low prices and further exacerbating the problems of the older airlines until these carriers simply deplete their cash resources. In good economic times, the network carriers have managed to squeak by, doing things their old, inefficient way. But in times of recession the basic laws of economics overtake them and we see the Chapter XI filings and cessations of service.

The resources of aircraft, gates and personnel are not forever lost to the system. They are recycled as they get into the hands of managers who can use these resources more efficiently than the previous holders. The losers tend to be the equity holders in the airlines, and the workers who are forced into new careers at lower wages and probably less rigid working conditions. The winners are the consumers who enjoy lower prices as a result of this transfer of wealth from the workers and older companies to the new companies and their customers.

The changes we are seeing in the airline industry today have been accelerated by the events of September 11, 2001, but most likely would have occurred anyway. At the end of the process, air travel will continue to grow,

prices will continue their long-term decline and new opportunities for entrepreneurs with realistic business plans and adequate funding will present themselves. The ongoing drama as to whether the network carriers and their work forces will be able to adapt and survive not only this downturn but also the next one (and the one after that, and the one after that) will continue to be played out in the daily press and the bankruptcy courts.

Older airlines have a remarkable ability to survive (or, to take a dimmer view, to prolong their death throes). This ability is enhanced in no small measure by the United States bankruptcy laws and by the political clout of organized labor. But in each recession we see a few more of the less adaptable operators become extinct. In the early '80s Braniff disappeared. In the early '90s Eastern and Pan Am fell. In the current downturn we have seen TWA's demise and the bankruptcy of US Airways, with more shoes yet to drop. The ultimate survival of the remaining legacy carriers will depend largely on whether their managements and the leaders of their labor unions can work together to change their businesses in a way that keeps pace with changing economic reality and allows these operators to produce at a cost level that is competitive. Thus far, the track record of managers and labor leaders at the legacy airlines has not been all that good.

I think it might be useful at this point to focus briefly on two of the most notable airline failures of the last decade, namely Pan Am and TWA. Many in Europe were especially amazed by the disappearance of these two longtime industry stalwarts. In their heyday, Pan Am and TWA arguably were the most powerful airlines in the world. I am often asked how these two could have disappeared from the world's airways while their long-time contemporaries such as British Airways, Air France, Varig, China Airlines, etc., are all still flying and competing internationally with new US flag carriers such as Delta, American and United.

How can that be? What happened? What did they do to merit such a fate? More importantly, what lessons do their stories hold for legacy carriers still flying in Europe and elsewhere? While we have seen similar failures in Europe with the closure of Sabena and Swissair and isolated instances elsewhere such as the fall of Viasa, Canadien and Ansett, these pale into insignificance when compared with the decline and fall of what were the two largest transatlantic operators and, in the case of Pan Am, the largest Inter-Americas airline and a major trans-Pacific operator. It is as if in the space of the same decade we witnessed the collapse of the Holy Roman Empire and the Ottoman Empire.

To understand what happened to these two giants after 1978, it is important to shift back into aviation history and remember how these airlines evolved through the decades before 1978. For their first fifty years, these two giants of the skies grew up in an environment of heavy-handed regulation where route rights -- especially international ones -- were difficult to come by and competition based on price was unheard of. That is not to say that there was no economic competition between carriers. Rather, such competition was subtle; involving middlemen, groups, etc., all artfully designed to get around regulators. Their labor groups were proud to be part of these companies and were well paid for their efforts - in part because the regulatory regime of the period made spending very generously to maintain labor peace an economically reasonable option for airline managements. After all, the increase in cost was simply passed on to the consumer in the form of officially approved higher prices.

TWA, Pan Am and the others learned to live well in that world. But then, the world changed. Longtime competitors TWA and Pan Am ultimately found that they could not change with it.

The U.S. airline industry was de-regulated by politicians for political reasons - not by businessmen for business reasons. From the business point of view deregulation was not an attractive option. After all, why would a business person opt for a hard life as a fierce competitor when life as a benevolent oligopolist was already so pleasant? The purpose of the exercise was simply to lower prices to consumers (for which political leaders could then claim credit). At the time in the big U.S.A. states of Texas and California, airlines that operated solely within each state's boundaries - and thus were not subject to federal regulation -- were charging much lower prices than the inter-state carriers regulated by the federal government. It was this disparity that was being addressed.

Deregulation proponents either did not realize or chose to ignore the fact that these higher prices were propping up experienced, highly-paid work forces not only in the USA but also here in Europe and elsewhere. The companies that had to cope with the new regulatory regime were suddenly thrust into a business environment of fast-paced change. None of the constituencies were ready - not management, not labor, not airports, not the regulators, least of all the politicians!

In the old, clubby airline world, the political savvy and clout to win route rights and maintain them was paramount. In the rough and tumble new airline world, what counted more was the nimbleness to be able to move quickly into profitable markets and just as quickly out of unprofitable ones. Providing what the customer wants became the name of the game.

In the old airline world of DC-7s, Constellations and even 707s, the ability to cater lavishly to the whims of the few who could afford to fill those scarce seats counted. In the new world of 747s, L-1011s and DC-10s, what counted more was the ability to maintain seat-mile costs at a level below the cut-price yields that would consistently attract enough customers to fill and pay for those jumbo jets.

Neither TWA nor Pan Am proved to be sufficiently nimble, and they could not compete on costs. For the first 50 years of their existence it was not what the business had required them to do or rewarded them for. While airlines like TWA and Pan Am staggered about trying to figure out just what had hit them, others jumped at the opportunity to become a part of the game. That is when I became involved with founding People Express Airlines, a low-price high-density operator offering services at 25% of then-existing fares! All this was occurring during a time of worldwide recession, high inflation and cheap used aircraft. The incumbents and the rest of the industry were never the same again.

TWA with its domestic network was able to adapt better than Pan Am. Pan Am tried to position itself by acquiring National Airlines (A story best left for a future APG conference!). By the time that the acquisition had been accomplished all the reasons for it had been overtaken. Pan Am was worse off than when it started. Pan Am in the midst of battling the forces of deregulation, recession, high fuel prices and high interest rates, was burdened with the task of integrating two very different companies, each with different fleets, starkly different cultures, different traditions and different markets.

During my own tenure at Pan Am - between 1982 and 1985 -- we accomplished a number of positive financial transactions that enabled the airline to continue. These included some major fleet transactions, refinancings and issuance of debt, and culminated with the billion dollar sale of the Pacific Division to United in 1985. Selling the Pacific Division infused needed liquidity into the airline, but the underlying reason for the sale was that Pan Am simply could not afford to buy the new B747-400 that was to revolutionize Pacific travel. It was still flying its original 747-100's.

Pan Am got out of the Pacific because it could not afford to stay in - a harbinger of things to come. The billion dollars went quickly.

The continued push by the USA for more international route rights and unfettered pricing made it more and more difficult for Pan Am and TWA to compete in the major transatlantic markets as well. New competitors across the Atlantic were free to come and go, and did so unfettered by the need to maintain the expensive European infrastructure that Pan Am and TWA had built up over the years. Prices across the Atlantic dropped, but Pan Am and TWA's costs did not. The onset of terrorism and several highly visible terrorist incidents eroded the confidence of the very customer that these companies most needed to keep - the business traveler. In order to maintain ridership the companies had to discount their prices further. New competitors matched these prices with newer planes, systems and facilities and most importantly, lower costs

As the industry became more information technology dependent, Pan Am and TWA could not afford to design and implement the latest frequent flyer programs, baggage handling systems and various other systems. They could not afford to renew themselves in the classic sense because they were spending all their money and then some on maintaining the old way of doing things. In the meantime through various means the heretofore mainly domestic carriers such as American and United had made progress in adapting to the new environment. They were busy renewing their fleets and were sufficiently credit worthy so that they could make these necessary investments. They were growing while Pan Am and to a lesser extent TWA were treading water. The Pan Am and TWA fleets were growing older and their workforces likewise with all that implies in terms of increasing costs.

For Pan Am the final shock was the Gulf War. It simply did not have the wherewithal to survive. It had no cash, no bank lines and no hope of getting any. Nor was the US Government a potential source of liquidity. The American tradition of laissez faire was allowed to work. There were many other US airlines ready to replace Pan Am on its still vast route structure, and they were allowed to do so. United ended up with Pan Am's Heathrow operation as well as its South American operation. Delta acquired the European operation. The Intra-German operation centered on Berlin had previously ended up with Lufthansa as a result of German unification. The Pan Am name is still used by an airline in the USA but it has nothing to do with what those of us who were involved, fondly recall, as some of aviation's proudest moments.

For TWA, the end took another decade and was more orderly, but the result was similar. TWA grew some in the 1980's. A few corporate raiders recognized its potential. Mr. Carl Icahn ultimately acquired the company in 1986. TWA soon became a privately-owned company and became enmeshed in internal politics and the need for its owner to actually see his investment produce. This, as we know, is a considerable if not impossible feat in the airline business in the best of times, let alone when a company is enmeshed in market share wars, flying an old fleet operated by a high-seniority workforce and led by an owner determined to extract value from the enterprise by whatever means possible.

With the onset of the Gulf War, TWA was left with no access to capital and a need to adjust its size to fit its diminished capability. Its owner sold TWA's London Heathrow routes to American Airlines for sums of money that more than a decade ago were quite high -- almost a half billion dollars. But, like Pan Am, TWA quickly burned through that money. Worse, the airline continued to operate with its old inefficient fleet upon its remaining and far less profitable European routes, which continued to generate huge losses. TWA entered its first round of Chapter XI

proceedings in 1992. It emerged debt laden in 1993 without Mr. Icahn as owner. Worse, he was now a lender to the company. The resulting financial structure was not conducive to profitable operations so TWA entered its second round of Chapter XI in 1995 -- the so - called "Chapter XXII." This was a 'pre-packaged' deal that exchanged debt for equity and ultimately further entrenched Mr. Icahn as a lender and - worse still -- a purveyor of TWA tickets at prices lower than TWA itself could sell them!

The economic boom of the 90's gave TWA its last breath of life. It was able to accomplish several financings, acquire new planes and eventually had the newest fleet in the USA. But it was not enough. The issues of revenue generation, as in the case of Pan Am, continued to plague the company as business travelers did not see their way clear to spend their money on TWA. It was when they were leisure travelers that they did so. Thus TWA's revenue gap vis a vis its competitors continued while its organized labor groups tried to reconcile their reduced position vis a vis their counterparts at other US airlines.

Ultimately in January 2001 TWA entered the forbidden zone with the first-ever "Chapter XXXIII" bankruptcy filing. This was one with a different flavor. American Airlines had agreed to buy a majority of TWA's assets as well as take on most of the workforce. American had observed the great strides TWA had made after the mid-90's with a determined fleet renewal program and the winning of various customer service awards. Alas, while these efforts were enough to attract the interest of American, they were not enough to save TWA. With no access to funding and all the issues attendant to an older company with high costs there was no other choice. Thus TWA is now part of American Airlines. A year after celebrating its 75th anniversary, the oldest continuously-operated U.S. airline ceased to exist.

Obviously, there are many sobering lessons to be learned from the stories of Pan Am and TWA in the past decade, and from airlines like US Airways, United and perhaps even others in the decade to come. Airline operators in Europe and elsewhere still have some time to contemplate these lessons and hopefully learn from them. The environment of unfettered free-market economic competition -- to which TWA and Pan Am ultimately could not adapt -- has not yet fully arrived on this continent.

But it will arrive some day, and that day is likely not very far off. The proliferation of "open skies" agreements, the refusal of the European Union to allow individual governments to continue bailing out their ailing flag carriers and the rapid expansion of low-cost, cut-price carriers such as Ryanair are signs of an accelerating trend. Experience in America shows that once this trend takes hold, it cannot be reversed - if for no other reason than the politicians' quick realization that this is a genie the voters want left out of the bottle.

So the day will come. And when it does, here is the lesson you *must* remember:

Once regulatory control of pricing and scheduling is exchanged for free market determination you are no longer in charge. Your customers are.

That may seem simplistic and obvious - but the best lessons usually are.

When customers are truly free to choose among airlines, they will dictate the terms of your business.

The customers - not the bureaucrats and not the airlines - will decide where and when you fly and how much they will pay you.

The customers - not the governments - will decide who is allowed to compete, and who survives the competition.

The customers - not the labor unions and not the airlines - will decide how many people you employ, how they do their work and how much they are paid.

And if you think you can succeed doing things in ways other than how your customers want you to do it, you are about to be painfully re-educated.

Thus, in the future, if you hear airline managers say, "we will design a pricing scheme that suits our needs, and the passengers will just have to accept it," you will be listening to managers of a doomed enterprise.

If you hear union leaders say, "we will decide how the airline will be staffed and what facilities will be opened or closed," you will be listening to leaders whose members are on their way to losing their livelihoods.

If you hear government regulators say, "we will protect our flag carriers and shore up prices," you will be listening to regulators who soon will have far fewer airlines to regulate and will themselves be looking for new careers

Give the customers what they demand at the lowest cost of production, and you will succeed. Heed any other master and you will fail. That's the key difference between the old, regulated airline world and the brave new world that has arrived in the United States and is coming soon to an airport near you.

The airline industry continues to evolve, its shape and composition an ongoing work in process. Ultimately, some of the better-positioned and managed legacy carriers will survive and prosper along with a few of the new operators. For the carriers and their constituencies that cannot adapt, bankruptcy and liquidation are in the future, with the resources they control ultimately destined to be placed in the hands of those who can operate them in a manner that will produce a reasonable economic return.

I wish each of you all the best in accomplishing that.

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