

# International Aviation Club

**Keynote Address by  
Leo F. Mullin  
Chairman and Chief Executive Officer of Delta Air Lines  
March 19, 2002 – Washington D.C.**

**\*\*\*\*\*AS PREPARED, NOT NECESSARILY AS DELIVERED\*\*\*\*\***

## **“Living on the Edge”**

How are airlines doing six months past September 11? What does the future look like for our nation’s air transportation system?

First, the good news: Despite losses near \$8 billion in 01, all U.S. airlines likely to survive, despite the Draconian measures required to achieve this result:

- Huge employee cuts have been made – approximately 95,000.
- Huge reductions in capital expenditure -- for the top 4 airlines (American, Continental, Delta, and United), capital expenditures in 2002 will fall 26% year over year.
- And, huge increases in debt

And, while airlines have taken dramatic internal steps, travel demand is slowly returning, though FAA forecast indicates return to pre-September 11 level won’t occur before 2003.

Congress and the Administration have been important allies in helping airlines work through the immediate crisis.

- The Airline Stabilization Act supplied a crucial \$5 billion to keep industry intact following an attack which employed aviation as its weapon.
- And the landmark Aviation Security Act was vital in restoring public confidence in air travel.

But there's discouraging news, too: While demand is increasing, it is driven by dramatic price cuts. As a result, the industry's rebound in revenue is lagging significantly behind the return in passenger demand. While the number of passengers traveling in January were down 15% year over year, revenue was down by 27%.

Cost of capital – measured by increased interest charges to the industry – has increased enormously Significant new debt incurred post-9/11 means higher interest costs

- Total cost for the majors in 2000 was \$1.1 billion
- Because of the need to borrow to fund losses, interest cost for 2002 will likely reach \$2.1 billion – a staggering 90% increase.

On average, the industry's investment grade rating fell 3 notches. Now, except for Southwest Airlines, the whole industry is rated at "junk bond" status. By comparison:

- Aerospace and defense contract industry fell one notch
- Hotel and gaming industry fell between 1-2 notches

At the same time, industry costs due to additional security and rising insurance premiums are escalating sharply. At Delta alone, the net incremental increase in security costs for 2002 – including offsets by the government -- is estimated at \$50 million.

In the arena of war risk insurance, U.S. carriers were paying premiums of \$20MM pre-9/11, but that amount has now risen to \$930MM. If the FAA's current program for war risk coverage does not continue to provide affordable insurance, costs could rise as high as \$1.7 billion.

The most troubling development, however, is this: We're driving customers away by making air travel onerous.

One positive point: The traveling public appears to have grasped the fact – and it is a fact – that air travel is now more safe and secure than it has ever been – *dramatically* more safe and secure.

But the price in terms of passenger disruption has been high. Here's how *USA Today* recently described the airport experience: "*Creep through serpentine security lines. Dump laptops, cell phones, the tiniest metal bits of anything into the X-ray machine belt. Bite your lip as guards thumb through your wallet or dig into your neatly packed undies. Hop around in stocking feet for the shoe inspection. Get frisked.*"

In the same article, the response from a business traveler is: "I am looking at how I can avoid future air travel."

To summarize: Though airline survival seems assured, the potential for the industry to grow and thrive, and to serve as the strong heart of a healthy economy, is seriously threatened. The reality is that we are an industry living on the edge.

My remarks this afternoon will cover:

- What are the repercussions of living on the edge?
- How did airlines end up in this position?
- What must be done to strength the industry – and to ultimately enable the industry to thrive?

To begin: What are the repercussions of living on the edge?

We eke by – able to finance day-to-day operations, but we invest inadequately in tomorrow. We're surviving, but we're not positioned to thrive. A thriving, growing, healthy business, by contrast, is one that serves its constituencies well, both today and tomorrow.

For an airline that means:

- Providing customers with high levels of service, including excellent access to the world. Requires investments in employees, facilities, technology, and aircraft, plus alliances and partnerships.
- Providing a level of return on investment to our investors that ensures an adequate stream of future investment funds
- Attracting, training, rewarding, and retaining a highly qualified and highly motivated team of employees.

The common requirement for these constituencies and commitments is adequate cash resources to fund investment in the future – and cash resources are a scarce commodity in today's airline industry. The shortfall will affect all these constituencies:

One example: Recall months prior to 9/11 and the focus on the Airline Customer Service Commitment, which provided 12 guidelines forming basic service pledge. All airlines were working on improvements in:

- Information flow to customers
- Expanded use of Internet resources to offer lower fares.
- More efficient baggage handling
- Faster refunds
- Better processes for assisting disabled passengers
- And so on.

At Delta, our plans were to exceed many requirements, primarily through technology. We're working to find new, innovative ways to continue improving service – but hard reality is that without investment capital, many plans will be slowed, some may be shelved, at least temporarily. Delta's technology spend in 2000 was \$700 million, which now appears to be a high-water mark. In 2002, that amount is expected to fall to \$579 million, a drop of almost 20%. A significant diversion of those funds will be to security – which had not even been anticipated prior to 9/11 as a necessary part of the Customer Commitment. Candidly, security was a "given."

Postponed capital investments in technology will delay efforts to improve the travel experience, from reservations and ticketing to check-in, gate service, and baggage claim. As a result, our industry is poised to lose a generation of technology and innovation. While the current low-fare environment provides a short-term benefit to consumers, the longer-term loss in technology-based customer service improvements benefits no one.

Another key impact on customers is the cuts in schedules reduce frequency of flights, a highly valued component of customer service.

Next question: How did airlines end up on the edge?

For context, recall that the profitable mid-90'- 2000 were small part of the 100 years of air travel. From Wright Brothers flight through 1994, sum of airline profits was zero. While 9/11 precipitated financial crisis, the industry's vulnerability runs deeper.

Here's the sequence:

The Industry incurs huge losses:

- So cash flow from operations is non-existent
- Airlines, as previously mentioned, have to borrow simply to fund day-to-day operations – not for capital expenditures, which is the legitimate use of financing.

As a result the industry cuts back on service:

- Capacity, i.e. destinations and frequency of service
- Staffing
- Non-essential – e.g. in-flight entertainment, even – yes -- even FOOD
- Who would have thought the public would ever bemoan the loss of airline food?

The cutbacks even extend to core aviation system expenditures – planes, terminals, technology.

Prices can't be raised, because – despite all that has occurred – overcapacity still prevails. And because government taxes have absorbed any hope of realizing more revenues through pricing increases

Cost adjustments, particularly as they involve personnel, cannot be accomplished because of difficult labor contracts.

And finally, one of the normal method used by other industries to respond to these kinds of crises – i.e. mergers or acquisitions – has not been available to the airline industry to this point. Witness government reasoning on the United/USAir/American acquisition proposal.

The competing, imbalanced forces of costs, revenue, capital, capacity, demand, airline management and labor within our industry are all contributors to life on the edge. During the high tide of good economic times, enough cash flows through the airlines so that these jagged rocks which are endemic to our industry don't break the surface. But when good times and high waters

recede, as they now have done, the need for fundamental change in our industry is revealed once more.

So here we are, facing the same airline industry problems that periodically come to light. Why not seize this opportunity to fix the problems once and for all rather than wait for them to be covered up again?

I propose a four-step program to bring our industry back from the edge:

1. Put customers in first place.

I'm Immensely proud of improvements in security since 9/11. We can't and won't lose focus on security, but must simultaneously reduce hassle factor – it's possible and necessary to do both. The most promising tool on the horizon is a computerized system which would use data-mining and predictive software to profile passengers and look for potential threats – also known as the Trusted Passenger Program or, more simply, profiling.

We must, of course, distinguish between profiling based on bias and profiling based on information.

Regardless of the solution, It is increasingly clear that random screenings are ineffective. *Newsweek* columnist Anna Quindlen recently noted: “*My objection isn't that having strangers frisk you is creepy, although it is, or that it makes you angry when it happens three times in one day, although it does. It's that its a waste of scare resources. Who knows who could be sliding by while security personnel are checking my lipstick for Plasticine?*”

In addition, we owe it to customers to halt and reverse the growing burden of passenger taxes and fees. Taxes on \$200 airplane ticket are currently 26% of total price – up from 15% five years ago.

For comparison sake, consider other consumption taxes:

- 11% on a bottle of rum
- 9% on pack of cigarettes
- and 0% on bus and rail tickets.

If we could do security well – eliminating the hassle -- and also return passengers to flying while simultaneously gaining some pricing power, then we could add back customer services and conveniences. And hopefully, we can make flying a pleasant experience once more.

2. Allow airlines to use normal range of business tools, including restructuring

Airline industry needs access to the methods other industries use to address overcapacity and achieve cost benefits, including mergers and acquisitions. Airlines also need Congress' assistance in ensuring failing carriers don't drag healthy carriers down, too.

3. Refine the collective bargaining process so it encourages resolutions without inconveniencing customers.

Airlines have virtually no ability to control largest cost category – salary and benefits – in the face of a highly unionized industry. From both a customer service and a financial perspective, no airline today can weather a strike. Our industry must find a way to arrive at labor agreements that ceases to hold the customer hostage in the process.

The current process pushes parties to an impasse. We need to define a new procedure that respects the collective bargaining process and also respects the customers we serve. Our industry would strongly advocate some form of mandatory arbitration – perhaps even the “last best offer” approach, widely

used now by firefighters and police officers. In such a scenario, both management and labor would provide a last best offer to arbitrators. Arbitrators would only choose one or the other, not bargain between offers.

This would force both sides to the center, and would re-introduce true collective bargaining to airlines – and avoid a situation where all the power lies on the side of the party with the capacity to impose a strike the public and the company cannot afford.

#### 4. Provide the infrastructure required to accommodate future travel demand

The latest FAA forecast shows 1 billion passengers expected now in 2013 rather than 2010 – but they are still on the way. – They are all born. We must provide ATC and airport infrastructure that not only accommodates future customers but also welcomes them aboard with the level of service they deserve.

The list of tasks I've laid out is clearly challenging. Pulling an industry back from the edge won't be easy – and no success is possible without cooperation within the industry – and just as importantly, without support from Congress and the Administration.

But the stakes are high, and the goal we seek is worthy of the effort. We all recall the FAA announcement on September 11 grounding all air service. Implementation sped rapidly throughout the country. Business seemed suspended and unsure, and travel -- the lubricant of business – was simply missing. The nation's 2<sup>nd</sup> largest industry – travel and tourism - ground to a fast halt – and has not yet recovered.

It was in this context that the government provided aid to the airline industry. Not because airlines are more deserving than anyone else, but because the public interest of the nation so depends on a vibrant aviation sector.

Going back to earlier times, economic gloom has often pervaded the industry – but this time was clearly different. The proof of the interdependence of a strong aviation sector and the public interest of the country was plainly there for all to see – clearer than ever before.

As Jane Garvey described the September 11 shutdown of the industry in remarks to the Aero Club: *“Nothing – nothing – spoke more powerfully or eloquently to me than aviation's silence the afternoon of September 11. That blank screen. No civil aircraft aloft. It was as if the heart of the nation ceased to beat.”*

So now we know – we need, as a country, an aviation sector that thrives, not just survives. And it needs to thrive because it is in the public interest that it thrive. The industry and government have got to cooperate on an urgent agenda to ensure this happens – because things are heading too much in the wrong way.

The program I've outlined today would immensely help. I only hope we can collectively get at it quickly.

Thank you.