



## AIRLINE SURVIVAL IN A TOUGH WORLD

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WASHINGTON, D.C.

JULY 29, 2008

Thank you very much for inviting me and for interrupting what might normally be “those lazy days of summer” to hear what I have to say. I say “normally” because these are not normal times in the airline world and frantic efforts to survive rather than lazy days at the shore or in the mountains are the order of the day.

When I say that these are not normal times, I am not speaking casually. While there is much uncertainty about the price of oil and the near and medium term future of the economy, the range of possible situations for the U.S. industry over the next couple of years goes from “extremely stressed, requiring urgent action” at the *optimistic* end to “unprecedented crisis that will produce a radical change in industry structure” at the pessimistic end, with the likely range of outcomes pointing toward pretty radical change and a lot of pain. Only if you believe that oil prices will drop into the \$80-90 range within the near term can we expect things to go back more or less to where they were a year or so ago, albeit with somewhat less service, somewhat higher fares and a fair amount of stress from possible persistent economic weakness to keep things interesting. Even in this scenario, an airline or two might fail.

Don't get me wrong: I don't know what the price of oil will be next year, let alone in the next five or fifteen years. We may be witnessing a short-term oil price bubble. Or maybe we are witnessing a long-cycle wave of a kind we have seen before, with oil prices going high enough for long enough to call forth the investments in production, conservation and substitute technology that will begin to bring the price down, probably at the point where everyone agrees that high prices are here to stay. Of course, if such a cycle plays out, we will still have a significant period of high priced oil. Even the very successful contrarian restructuring shark who has just bought into Spicejet of India has done so on the theory that the oil price bubble will break relatively soon and bring prices down to a mere \$100/barrel!

Suppose he's right. At an actual realized price of \$100 a barrel complicated by an economic slowdown, nobody in the U.S. industry will make money without significant changes in their business model and some won't be able to manage the transition. At higher prices than that, the changes will have to be much more drastic indeed. We will then be looking at a domestic industry situation worse than that following 9/11 or even the Depression era that engendered regulation in the first place and facing challenges greater than that posed by deregulation thirty years ago.

Why such a sensational characterization?

Well, 9/11 was an external event that didn't change the economics of the industry but imposed a halt in output and a temporary reduction in demand, causing a liquidity crisis. Once the liquidity crisis was over and output resumed, demand came back and the structure of the industry wasn't much affected. It's true that 9/11 imposed very substantial and continuing security costs on the industry, but those costs, even broadly calculated, amounted to no more than a couple of per cent of total operating costs.

The Great Depression occurred in the industry's childhood and, from the industry's perspective, was replaced in quick succession by a four-year period of 100% load factors, followed in turn by a postwar explosion in demand accommodated by government-funded technological advance and an interim supply of very cheap capital. Deregulation imposed new competitive stresses and forced the industry to rearrange contractual commitments and change the way it did business, but it did so in the context of unprecedented growth in demand that continued over twenty-eight years with only a few interruptions.

In each case, after the initial shock the industry entered a virtuous cycle of rising demand, reduced costs and system expansion broadening the availability and convenience of the air transport product.

This looks different.

For thirty-two years, people paid less and less for air transportation that became more available and more convenient, a process that buoyed the industry even as it put unprecedented stress on individual managements and firms. Before that, technology lowered costs and made air transportation more valuable. Now, for the first time in the industry's history, travelers face rising fares reflecting dramatically rising costs, suppressing demand. In an effort to accommodate itself to reduced demand, the industry is engaged in reducing

capacity and rearranging route systems in ways that impair the convenience of the service it has to offer, making air transportation less valuable to those who use it at the same moment that they are being asked to pay more for it.

Since the advent of jets, the U.S. industry has produced seats for price-sensitive leisure passengers and schedules for convenience-sensitive business customers in the same “factory”, using the price-elastic leisure demand to help support network and frequency expansion that, in turn, made air service more valuable to customers willing to pay more for convenience. As service expanded, still more seats were available for sale at low prices to leisure travelers. As more of them showed up, they supported still more schedules that could attract even more business revenue, to the point where you could go from anywhere in the U.S. to anywhere else in the U.S. and to many places in the world with no more than one stop on the same airline, usually more than once a day.

The present process is a cycle running in reverse: As fuel has gone from \$30 per barrel to near \$150, fuel costs have gone from around 10% of network expenses to more than 40%. This has forced prices up in an effort to cover costs. As prices go up, price-sensitive travelers leave the system. Flights are consolidated into larger aircraft to get CASM down to where RASM has a prayer of covering it. As aircraft size rises and total passenger volume falls, the system shrinks. As the system shrinks, it becomes less attractive to convenience-oriented travelers and they resist paying more for less, hitting the road or taking fewer trips, causing the system to shrink some more. We have started down that road. Where will it end?

Well, we don't really know. What will oil prices be? Will technological innovation or process improvements lower the components of CASM other than fuel? Will leisure transportation continue to be produced jointly with business transportation? Will airlines become more specialized and how much cost can be saved or convenience increased by specialization? How rapidly and pervasively will households and businesses find substitutes for air travel? And we haven't even reached the question of what the macroeconomic environment will be as all this plays out. It will have a big influence on the magnitude and rate of change.

But we do know this: If oil prices stay up, the system is likely to look very different than before simply because there won't be enough business to sustain the old system. And we know that the transition to whatever is the new structure will cause a lot of pain to customers, airlines, labor, financiers and

civic parties. Some will guess right about where they fit into the new universe and how to get there; many will guess wrong.

We are beginning to get calls to stop this movie and to write a new script, with the stopping and writing done by government. We have heard calls for “planning”, for freezing capacity and then shrinking it proportionately by existing firms. We have heard suggestions that the government should enforce pricing on a sum-of-segment basis, without regard for the true economic cost of seats that are more valuable when produced together with those serving other itineraries or that might otherwise go to waste. We are told that without this kind of intervention, there will be a continued and inexorable tendency toward overinvestment, overcapacity and losses, ending in a cataclysm that will leave the country without air service. (I call this the Yogi Berra argument: “nobody goes there anymore; it’s too crowded”). Since airlines are a vital public service, they should be regulated like public utilities. While we are at it, we are told to overhaul the bankruptcy laws to prevent bankrupts from competing. And finally, we are told that the same government that we are counting on to do all this planning and implementing is the government that has been unable for twenty-five years to modernize the ATC system and that we need to ignore the paradox and tell *that* government to get on the stick.

We are also told that we can accomplish all this without eliminating healthy competition, although we are not told how. And we are told that despite the fact that we will move the industry to a competition-restricted cost-plus model, we can we can break the “stranglehold” of labor on the industry by imposing compulsory arbitration, somehow wishing away the effect of labor leverage on a diminished industry that the arbitrator knows is protected from the competitive consequences of its settlements.

Those who offer these arguments have been skeptical from the outset that a liberal market economy can be made to work in the airline industry. Their theoretical argument is an old one: that an industry with substantial fixed or common costs will be unsustainable as competition drives prices to levels that don’t allow the common costs to be recovered. This argument proves much too much: If we really believed it, we’d have to regulate virtually every industry, because virtually every industry has some fixed and common costs. If it were true, the only difference among industries would be a difference in the rate at which they disappear. But every supermarket pays rent; every company has overhead and capital equipment and yet costs are recovered.

Of course, drastic reductions in demand always leave an excess of capital and overhead that can't be supported. During the Great Depression it looked like market capitalism was dying or dead and nobody would ever recover those costs. Many thought virtually every business needed economic regulation but, even though the economy as a whole remained unregulated, when the demand that had dropped dramatically recovered common costs were recovered again and firms and market capitalism survived.

We shouldn't really be surprised at the calls for reregulation. While airline assets are moveable, they are long-lived, and the skills of those who work with them can be highly specialized. People who own and manage those assets, people who work with them, and people who depend on them, such as cities that have grown in conjunction with air transport (for example, as passenger or cargo hubs or the home for companies that depend on air transportation) find that the business can change faster than they can find replacement uses, jobs, and service. That causes pain. A lot of pain.

What makes it worse is that the airline business is very cyclical, depending as it does on both disposable income and business activity. When a structural shift in costs is combined with a slowing of the business cycle, a bigger transition is imposed. At the moment, we are in a cyclical double whammy: business activity and disposable income (some of it fueled by consumer debt) has gone from boom to near-bust in just two years and fuel costs have exploded, going from between 10-15% of total costs to 40-50% in the same period.

As costs have risen, airlines are pursuing domestic supply adjustments in an attempt to raise load factors and support price increases. Seasonal changes, rising prices and an economy that has softened further, will finally force significant domestic capacity reduction this autumn to chase declining demand. We are seeing airports drop off networks and small cities lose air service. But what has already occurred is miniscule. And while some airlines plan substantial cuts for this fall, most have cut only slightly. The planned domestic cuts in aggregate only take us from the record supply levels of this spring and summer back approximately to levels seen last year. They are still a small fraction of the cuts that will be required to produce a profitable new equilibrium if oil prices stay high.

Reregulation wouldn't affect the price of oil or the fragility of the economy. Those fundamentals will take time, perhaps a lot of time, to fix. In the meantime, to adapt to these realities the industry will need just the kind of innovation and flexibility that regulation is designed to impede. We can't make

changes necessary to achieve economic profit while preserving social utility, whatever the cost environment, without answering some important questions:

What is the minimum level of frequency that business travelers will find useful and keep networks commercially viable?

Precisely how do business travelers trade off ground travel and schedule frequency? Will they use more remote airports that have lower costs and prices? Will they drive farther for schedule frequency? How much farther? For how much more frequency?

What is the smallest aircraft that can be used profitably to provide that level of network convenience?

What kind of an aircraft might that be, a jet or turboprop or some hybrid like the geared fan? If it is something new, how long will it take to get it and what do we do in the meantime?

How much is it worth paying in capital costs to economize on fuel costs? Can the flexibility of low capital costs be used to position aircraft for network convenience, mitigating loss of business demand?

To what extent is the optimum size, extent and specialization of an airline “factory” (a single firm) different from the optimum size of an airline “product line” (the network it and its subcontractors and alliance partners sell to the public)? Is there an efficiency limit to airline firm size?

Can hubs be made operationally more efficient and less wasteful of aircraft time, facilities and labor?

Should leisure travel for price-sensitive customers be produced separately from business travel networks, as in much of Europe, or together, as in the U.S. up until now?

What features of air travel do customers insist on? What service features should be bundled and what offered a la carte? What features will they buy?

What will people spend their money on if airline travel becomes more expensive, making individual vacations and distant second homes less attractive ways to spend discretionary funds? Will they still visit their friends and relatives or will they post pictures on the web and send them fruitcakes at

Christmas? To what extent will demand dry up and to what extent will it shift to cheap charter-like airlines that put air and ground arrangements together?

There are so many variables and contingencies that we don't now know the answers to these questions. Certainly, no government effort to find and implement a planned answer can be conducted free of intense interest-group politics and crippling complexity. Nor can it be conducted quickly (consider the FAA's struggle with sectional and labor interests in its efforts to restructure ATC). There would be no magic in outsourcing this decision to a private monopoly, either. Any single management will be limited by its own history, talent, circumstances, prejudices and incentives. In short, neither an all-seeing government nor any single private management can be relied on to predict the shape of the industry as we move through what may well be a terrible and rapidly-changing period.

What is essential is that we generate multiple competing predictions, along with the freedom for firms to innovate using them and see which innovations flourish and which ones die. Only a deregulated market can do that.

Time puts a golden haze over our memories. We have forgotten how different the world that CAB regulation made was from the world that was waiting to emerge after deregulation. It's important to remember that the route system that the CAB made didn't survive even the early years of deregulation. Deregulation has brought the public enormous benefits in price and service and offered the business world tremendous opportunities that the CAB didn't invent, and some that it suppressed. Some examples:

It didn't create semi-ubiquitous hub and spoke networks. Even Delta's Atlanta hub was an unintended accident of the way its route certificates were written.

It didn't create low-cost point-to-point PSA and Southwest.

It didn't create cheap and stylish JetBlue or its niche ancestor, New York Air.

It didn't create leisure-focused, small-market Allegiant, although it hoped to do something like that with Supplemental Carriers and failed, partly because of the restrictions it imposed on them to keep them from competing with trunklines.

It didn't create route systems that linked dozens of international cities with interior U.S. gateways..

It didn't create alliances.

We could go on, but you get the point.

It was the freedom to experiment and innovate provided by deregulation that created these, along with the dozens of mistakes that emerged and disappeared. Some were ideas created and suppressed while the CAB had the power to suppress them. Some were not even thought up until there was some prospect of putting them into practice. Some were born of the desperation produced by competition.

Not only didn't regulation create the modern industry, it couldn't protect the industry that it did create from the outside world or from itself.

Regulation couldn't prevent overcapacity. The industry operated at load factors around 50%, lower in many markets. Despite a five-year CAB effort, including an illegal route moratorium, widebody load factors declined to 30% or so in transcontinental markets in the early 1970's and the industry was still losing money in 1973 and experienced only weak earnings in 1975.

It couldn't prevent oil shocks or their effects on profits (remember 1973).

It couldn't make all airlines profitable because it could never find a rate level or even a prescriptive formula (the aged among you will remember the DPFI) that allowed weak or poorly managed airlines to make a profit in competition with stronger airlines.

Regulation made airlines vulnerable to labor by imposing industry-wide rate structures and preventing bankruptcies, insuring that airline labor couldn't kill the goose that laid golden eggs by squeezing it too hard.

So reregulation will get us the worst of both worlds. It will not be able to "stop the movie", even if it slows it for a while. And trying to do so will simply postpone the inevitable adjustment and is a prescription for waste:

Waste from dysfunctional patterns and practices that will be preserved.

Waste from opportunities that won't be pursued.

Waste from seats that could be sold but will go empty.

And waste from inefficient wealth transfers to politically powerful interests at the expense of the traveling public and the economy as a whole.

The airline industry is not unique in its vulnerability to transition. Consider the railroad industry: It went through nearly 100 years of agony as a result of government-imposed obstacles to adaptation to the effects of 19<sup>th</sup> century overbuilding and of 20<sup>th</sup> century technological changes like the rise of trucks and pipelines. Regulation responsive to the complaints of labor, sectional interests and competitors blocked mergers and route realignments, as well as the new rates, high and low, that would make it possible to implement labor-saving technological innovations like unit trains and centralized, automated controls. Only deregulation allowed forging today's system of large networks and specialized carriers that is viable and economically competitive.

Consider the airline industry's current siblings-in-agony, the domestic auto manufacturers. The openness of the industry to foreign competition and foreign capital has resulted in the U.S. production of millions of vehicles a year adapted to the new prices of oil, while forcing the producers of products that consumers no longer want to engage in a forced march toward innovation in the hope of survival. Does anyone think that we'd be better off as a country trying to impose industry-wide output cuts and to force consumers to buy proportionate numbers of Expeditions, Suburbans and Ram trucks, rather than more efficient vehicles? Ford has just announced a complete makeover in its lines of cars and the relationship of its U.S. and world products. Does anyone think we'll get to a sustainable automobile industry faster if we regulate and dictate its adaptation?

Adaptation is occurring. The vehicles we need are being built and sold in the United States. Not many of them are being built in Michigan and St. Louis and St. Paul and many don't have U.S. brand names on them. But the industry is hurrying to adapt and U.S.-based companies have been forced to join the race. As a patriotic sentimentalist, I hope that they will succeed, but I don't think we'll hasten the day that that will occur by trying to preserve the industry as it was in 2005, let alone in 1978.

Michigan and Indiana and Missouri are reeling from the changes in the auto industry. And in the same way, if it turns out that we need radical changes in the airline network, there will be plenty more agony to go around in those places and elsewhere. (Why fly to Las Vegas if you can take a bus to Connecticut, New Jersey and their analogs around the country in less time and at a fraction of the cost?) Anticipated pain is already producing rumblings in Congress that there might be a public duty to halt or slow service changes as airlines respond to oil prices. It's not to our moral credit to ignore the pain that industrial adjustment creates and, being practical, we ignore that pain at

our political peril. So if airline-adjustment pain continues or intensifies, what should the government do?

First of all, like doctors, it should do no harm. This means not standing in the way of adaptation and not trying to guess up front what will work. Picking winners and shaping industries (sometimes known as “industrial policy”) hasn’t worked here in the past. It hasn’t worked in Europe, it hasn’t worked in India or China or Japan and there is no reason to believe it will work here this time.

In fact dynamic growth has occurred in just those countries and industries that have moved or stayed away from industrial policy. The problems with it are obvious: First, the policy always somehow protects the interests of everyone already in the game, usually at the expense of others not represented. The decisions made are hostage to political pressures and interest groups of all sorts. Second, by the time you get everyone to agree on what should be done, the circumstances have changed again so that the policy is outmoded. Finally, it’s bad enough that the outcome is often inefficient; but even worse is the irresistible pressure to validate the decision by suppressing alternatives that might compete with the plan or prove it wrong.

What we need instead is the combined product of many firms with a great deal at stake striving to survive and prosper in the environment that is emerging.

Second, the FAA should build an ATC system that reduces costs by using airspace efficiently, reducing or eliminating holds and circuitry. It should also promote its efficient use by letting users face the costs of serving them and letting them decide how much they value it. That might best be done by removing the system from appropriations and labor politics, but I don’t kid myself about the political difficulty of doing that. Even without that step, something has to be done to overhaul the present process or we will never get the system back into phase with the demands the real world places on it.

Third, whether or not oil prices fall, the bankruptcy laws should be revised to reduce even further management’s exclusive right to propose a reorganization. I am not suggesting forced liquidation here and certainly not suggesting that we restrict the right of firms in reorganization to make the most efficient economic use of the assets they have by competing where advantageous. What I am suggesting is that managements that have failed to adapt to a changing environment be subject to being pushed aside for a competing plan of reorganization, with liquidation a real alternative if no reorganization plan seems likely to succeed. This will promote innovation and adaptation and

minimize distortions to competition while preserving intangible value where it exists.

In Australia, filing for bankruptcy ousts management. A new temporary management weighs possible reorganization against liquidation and proceeds accordingly. This may throw away specialized knowledge unnecessarily and probably goes too far in the opposite direction from where we are, but forcing existing management into a real race on neutral ground to salvage efficient use of remaining assets is the right balance to strike between using firm-specialized knowledge and perpetuating the jobs of incumbent executives at the expense of creditors and competitors.

Fourth, it means stepping up to what preserving air service to ease political pain really costs. If we want an Essential Air Service Program to perpetuate air service to smaller and medium-size communities, we need to recognize that it will become a lot more expensive at \$4.00 per gallon than at \$1.00 and if service cuts expand the number of protected points. Whether there is the political will to subsidize more expensive service to more airports, many of which are a relatively short drive from other airports that have service, will be tested as the number of such airports goes up. But whatever the level of service we really want, we should step up to paying for it directly and not hold the industry hostage or provide special regulatory carve-outs to provide it.

Fifth, it means trying to assist industrial development alternatives for communities trying to find alternative uses for abandoned facilities like airline hubs and maintenance centers.

Sixth, it may mean being freer with unemployment insurance in industries especially hard hit by changing economic conditions, but tying it to job retraining for younger workers and carefully designing it so that it doesn't destroy incentives to adapt. We should ease the transition to other forms of specialized job knowledge, but make sure not to create more rooms full of idle auto workers with no incentive to find other employment.

Seventh, it means continuing to move to protect pensions from underfunding and ultimate abandonment in bankruptcy and perhaps strengthening the PBGC system still further so that the failure of airlines doesn't leave individuals who have earned pensions stranded at retirement.

And finally, it means moving to some sort of health care system not tied to employment, so that loss of an airline job (or an auto company job) doesn't

mean loss of health insurance and potential financial catastrophe to workers and so that shrinking airlines are not burdened by legacy health costs.

I am aware that the better ATC system paid for by users that we've been long waiting for is not likely to come soon. And I am aware that my other suggestions address problems that are very complicated as well and risk mistakes. But allowing the economy to adapt to a comprehensive set of new energy prices and policies seems increasingly important now, and I'd rather see mistakes made in measures designed to lubricate change and anesthetize those who experience pain from change than mistakes made by efforts to keep change from occurring.

So to sum up:

We don't know what's going to happen to the price of oil. If it stays above \$100, the industry will change a lot and if it stays above, say, \$125, the industry will change radically. In either case, I don't know exactly what will emerge, but I don't think anyone else does either. I know it is very unlikely to be an 80% scale model of what exists today and we shouldn't try to build one. We will see less total service at higher prices, and both business and leisure travelers will find other ways to spend their money to achieve their goals. The leisure and business ends of the market may separate, perhaps becoming something more like what exists in Europe and is emerging in Asia. In that world, we may see fewer hubs and more turboprops connecting to them but more jet service twice a week from Appleton, Wisconsin to Orlando, tied to a hotel package and tickets to see the Mouse.

No one really knows how the public will react to a dramatic shift in the relative price of air transportation and other uses for their money. Let's not try to outguess demand with a planning process designed to enforce a new order, but rather let's allow as many players as possible to make their own guesses about where we should go, putting their money where their mouths are.

"Depend upon it, sir, when a man knows he is to be *hanged in a fortnight*, it concentrates his mind wonderfully", Dr. Johnson is reported to have said. Let's not break the concentration of airline managements by saving them from grisly contemplation. Let's focus instead on minimizing the damage to those who depend on the potential victims.

Thank you for listening.