Up in the Air: Can an Industry Compete on Costs Without Destroying its Workforce?

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Context for Study

- Structural shift in the U.S. industry since 2000
  - Successful entry and growth of LCCs
  - Over $30 billion losses and more than 10 bankruptcies—4 in large airlines
  - 100,000 job losses; $15 billion wage/benefit losses
  - Plummeting employee morale
  - Mounting service quality problems
- Other parts of the world have seen even more rapid rise of LCCs in recent years

Growth of low cost sector around the world from 2001-2003

	Flights/week (August 2001)	Flights/week (August 2003)	Percent change
North America	23,800	30,100	27%
Europe	4,150	10,060	140%
Asia	555	990	78%
Australia/ New Zealand	136	1,340	885%
Total	28,641	42,490	48%

Source: Drew Magill, Low Cost Carrier Market, Boeing, April 2004

This Study

- Within the MIT Global Airline Industry Program, Gittell, Kochan, McKersie and von Nordenflycht responsible for labor/HR component

- Put together a team of researchers from around the world through Labor and Employment Relations Association's Airline Industry Council

- Question: *Can we build a sustainable industry that balances the interests of investors, employees, customers and the communities/nations they serve?*

- Method: Draw on case studies and other research of team members from around the world and our research in the U.S.

Analytic Framework

- Competitive Position
  - Legacy vs. LCC
- Employment Relations Strategy
  - Control vs. Commitment
  - Avoid, Accommodate or Partner with Unions

Legacies vs. LCCs

- *Legacies* are airlines that were founded prior to deregulation and were designed to compete in a regulated environment
  - developed hubs to serve small markets more efficiently and to defend their turf
  - tend to have older employees and older aircraft
- *LCCs* are airlines that were founded after deregulation (or just before) and were designed to compete in a deregulated environment
  - rely less on hubs and serving small markets
  - tend to have younger employees and younger aircraft
- Both sectors increasingly compete on costs due to price-sensitive consumers

2004 snapshot:
LCC costs were 63-75% of legacy costs – U.S. costs lower than Europe, higher than Asia

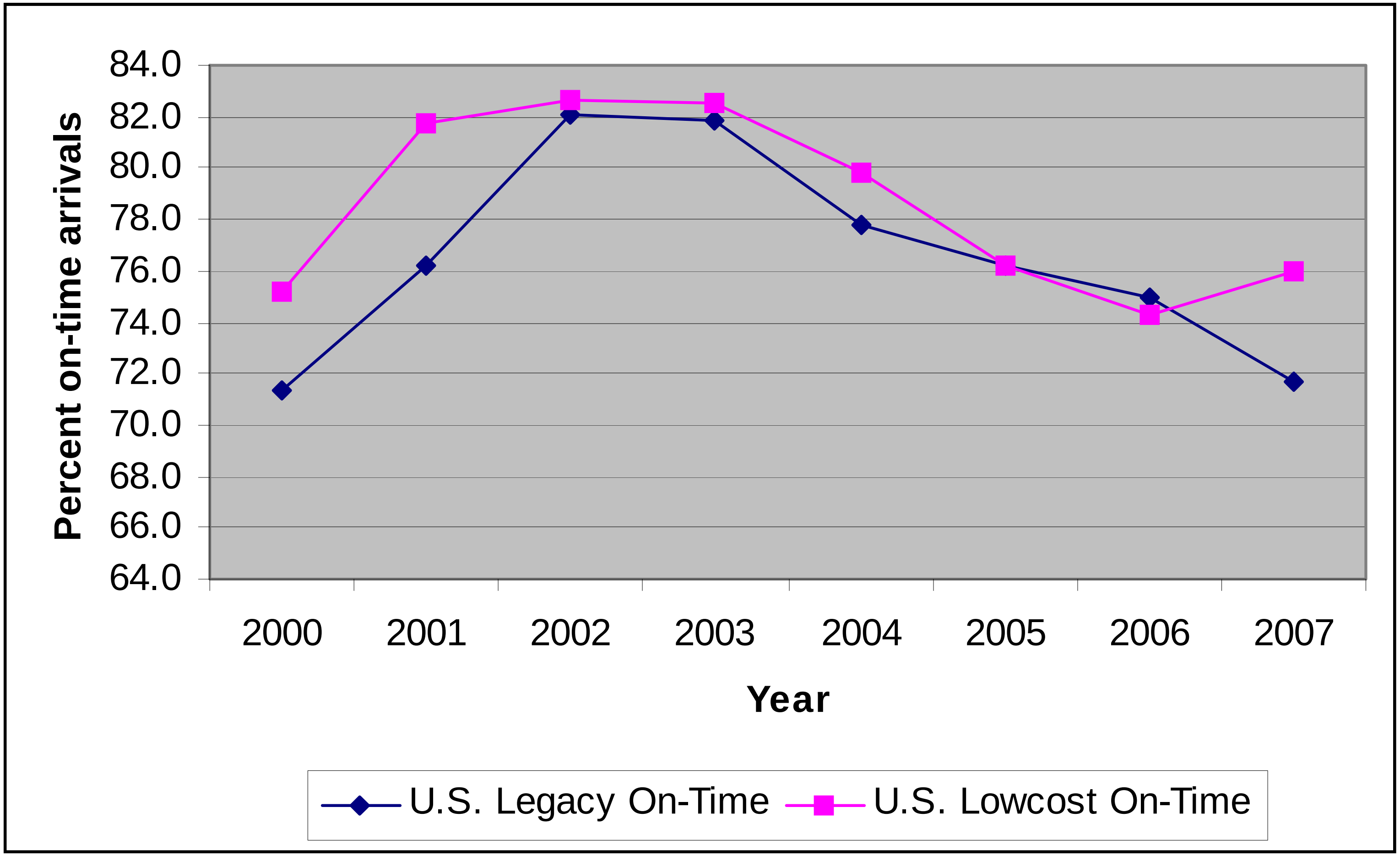
	Total unit costs ($/available seat mile)		
	Legacy Airlines	**Low Cost Airlines**	**Low Cost / Legacy**
Europe	.138	.103	75%
U.S.	.111	.080	72%
Asia/ Pacific	.102	.064	63%

Source: ICAO data

More detailed U.S. data suggest

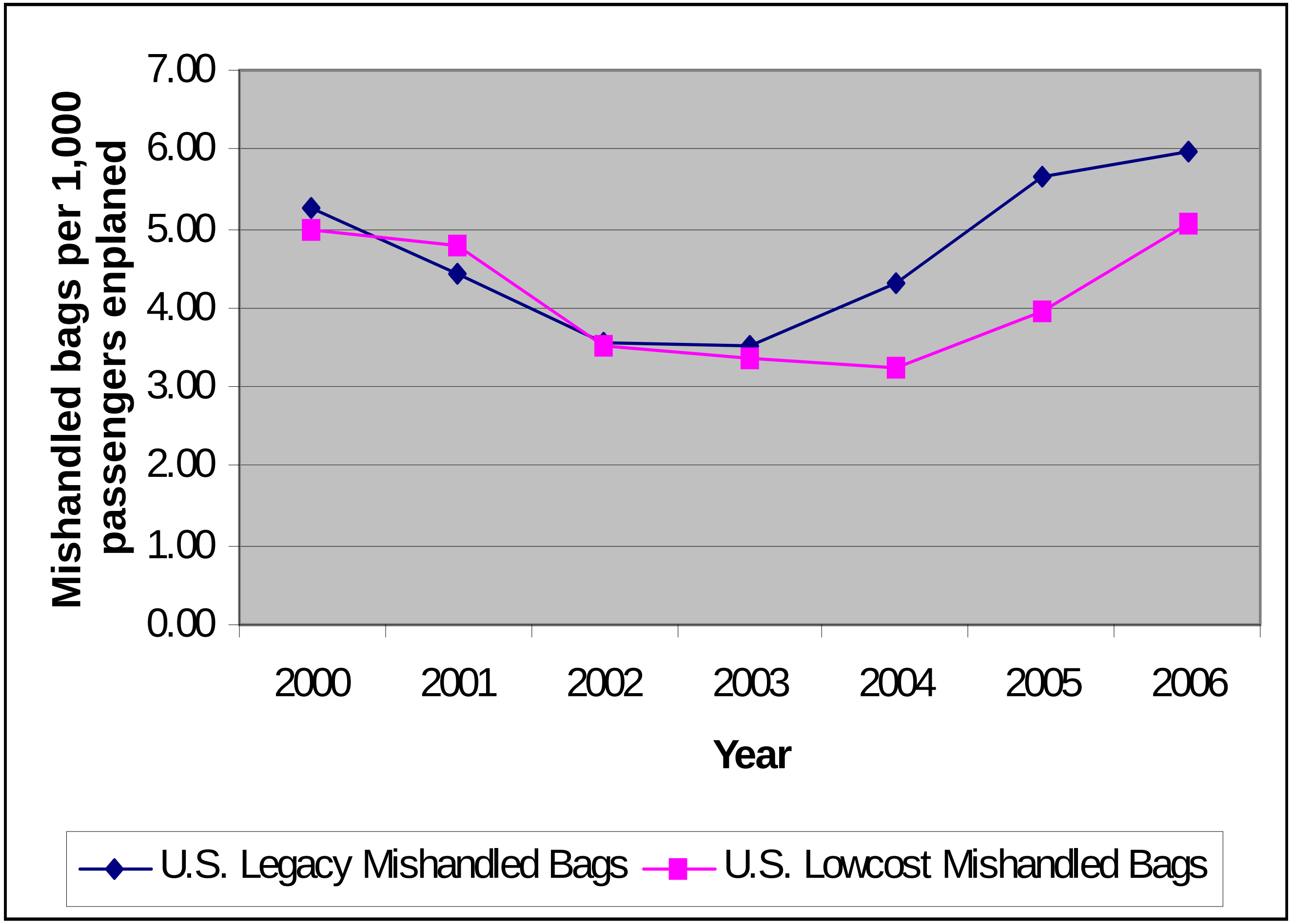
- Legacies have reduced the labor cost gap dramatically
  - But other costs are growing for them faster than for the LCCs (fuel, transport-related costs)
- Productivity has grown dramatically for both sectors
  - But low cost airlines are retaining their advantage on most measures
- Service quality is an increasing challenge for both sectors

On-time performance way down after rising amidst low traffic post 9/11



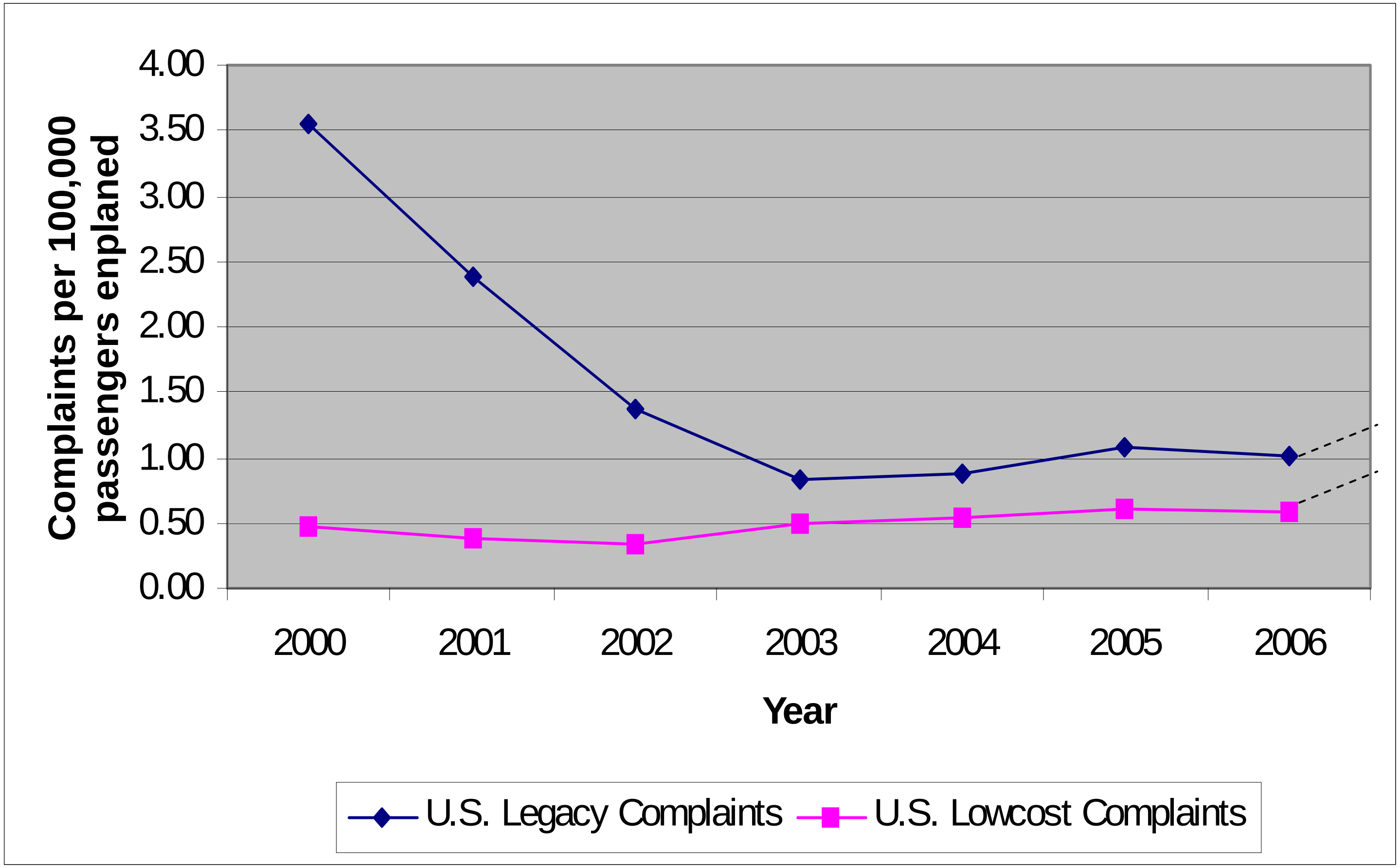
Source: U.S. Federal Aviation Administration, Air Travel Consumer Report

Similar pattern with baggage handling



Source: U.S. Federal Aviation Administration, Air Travel Consumer Report

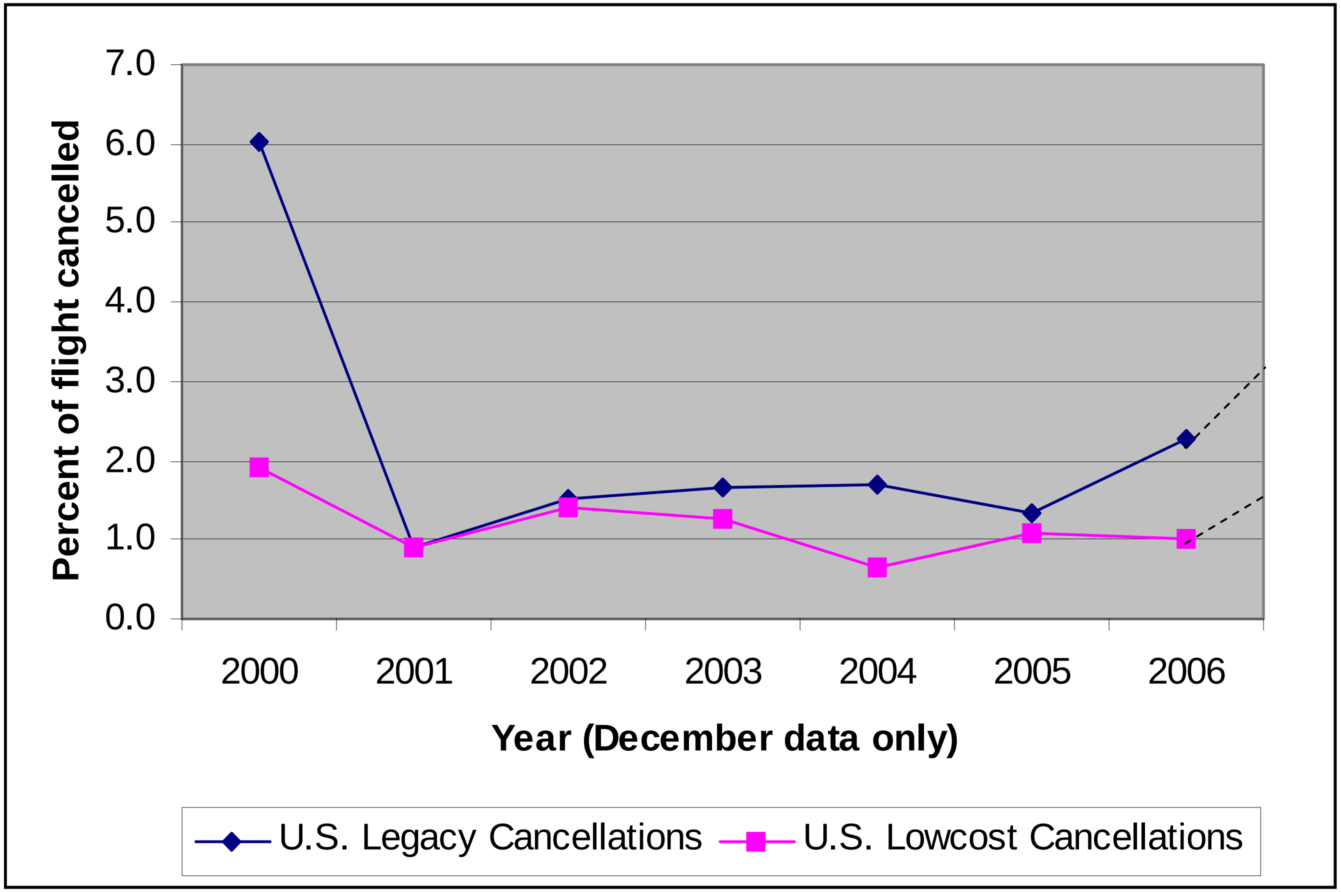
Legacy complaints way down since debacle of 2000, though rising again in 2007



----- Anticipated 2007 increases based on recent data

Source: U.S. Federal Aviation Administration, Air Travel Consumer Report

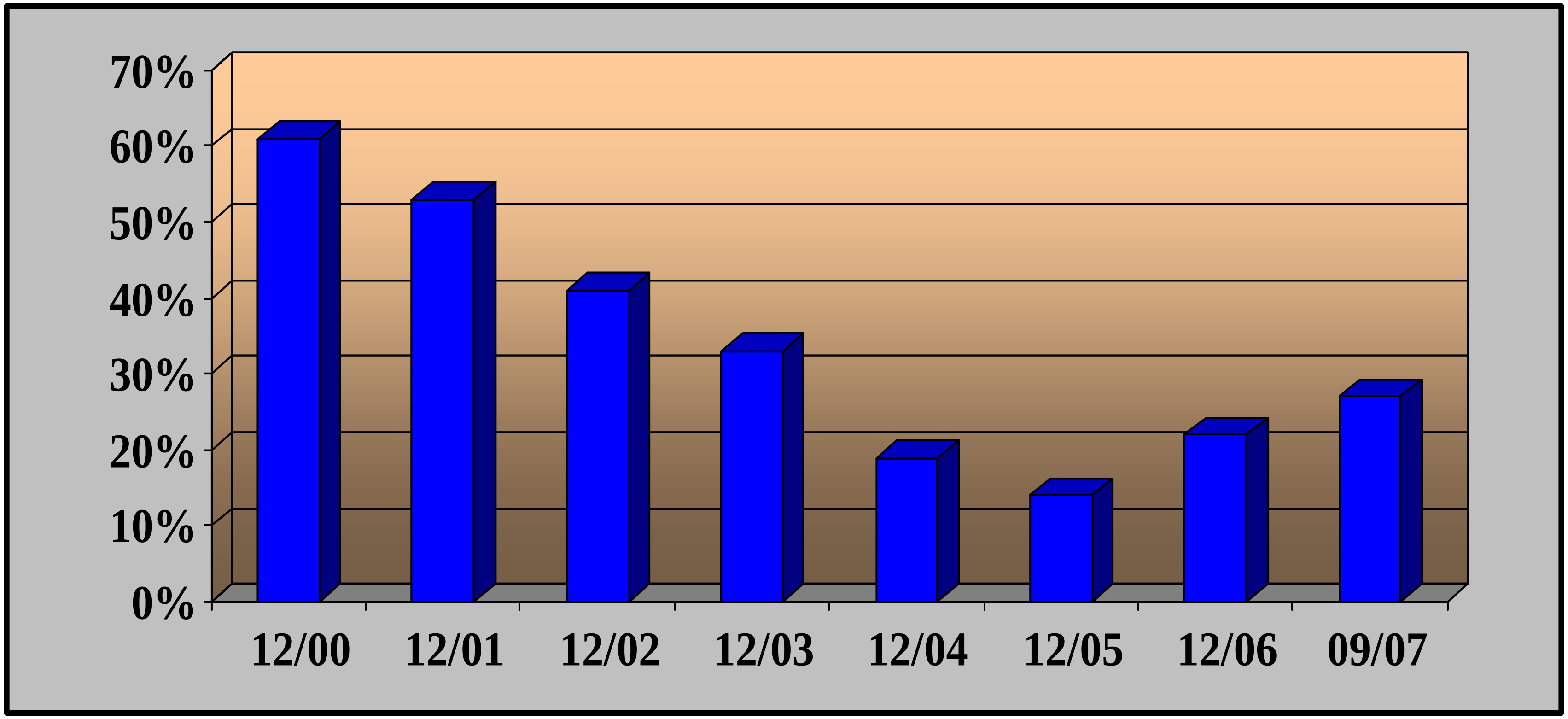
Cancellations dropped after 2000, but are beginning to rise again



----- Anticipated 2007 increases based on recent data

Source: U.S. Federal Aviation Administration, Air Travel Consumer Report

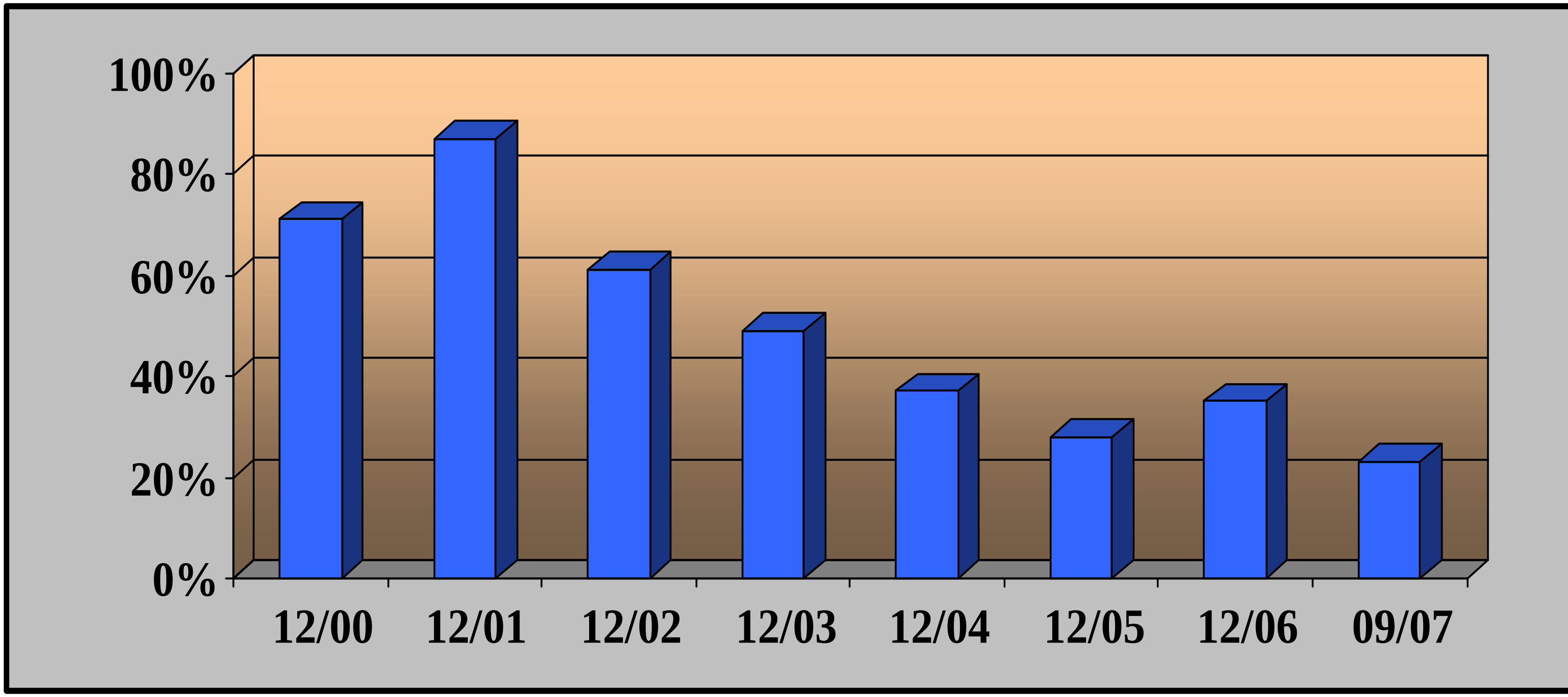
Employee morale has declined since 2000



Positive views of employee morale

Source: The Wilson Center for Public Research, Inc. – based on 165,203 interviews conducted with pilots or flight attendants from 1/1/2001 to 9/12/07. The specific question read as follows: "How would you describe, in your own words, the pilot [flight attendant] group's morale?"

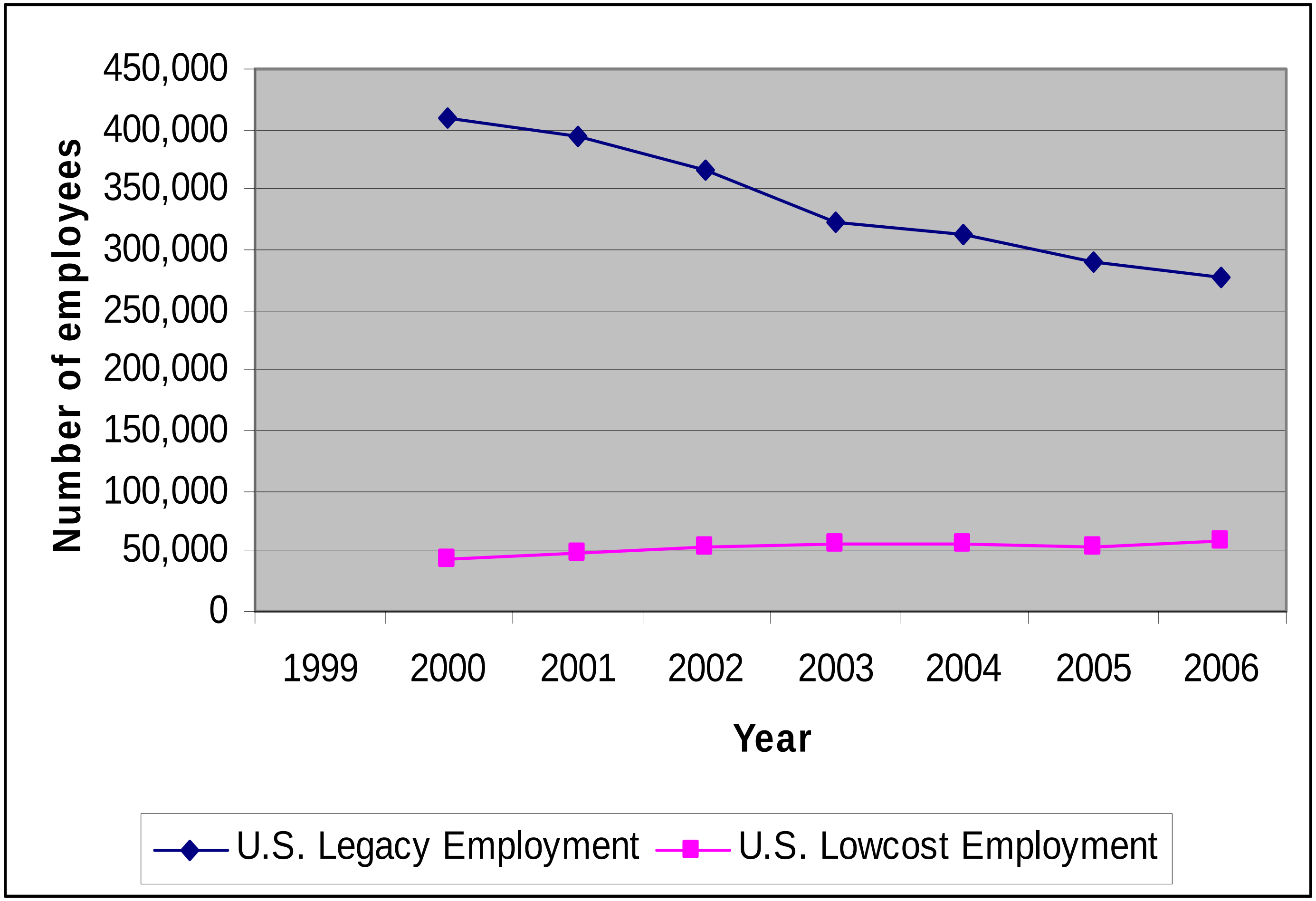
Along with support for management



Positive views of how management is running the airline

Source: The Wilson Center for Public Research, Inc. – based on 165,203 interviews conducted with pilots or flight attendants from 1/1/2001 to 9/12/07. The specific question reads as follows: How would you describe, in your own view, how [company name's] management is running the company."

Perhaps related to downsizing (and perceived focus on labor costs rather than broader costs)



Source: U.S. Department of Transportation, Form 41

Analytic Framework

- Competitive Position
  - LCC vs. Legacy
- Employment Relations Strategy
  - Control vs. Commitment
  - Avoid, Accommodate or Partner with Unions

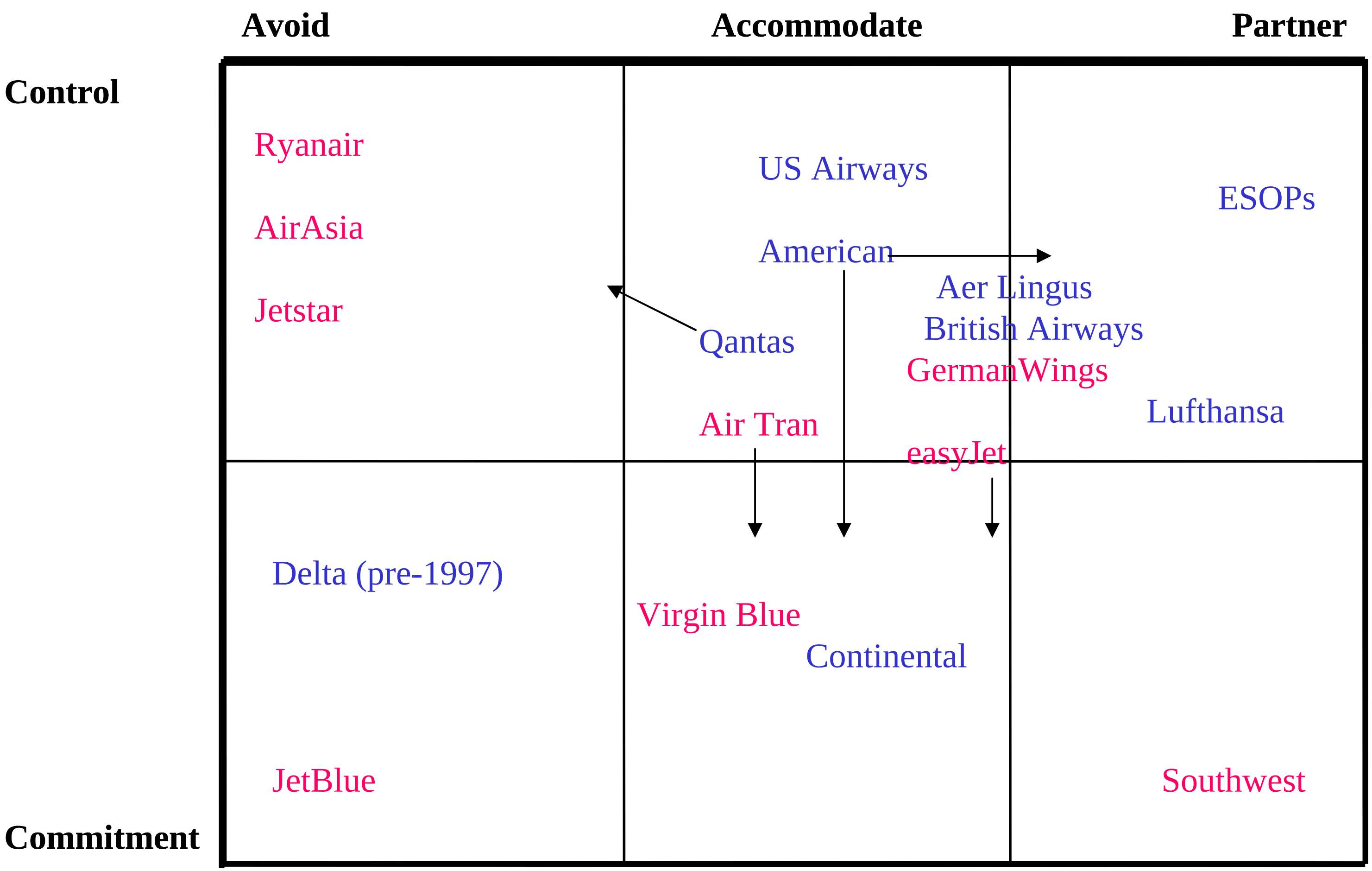
Control vs. commitment

- *Control* is the traditional approach to managing people
  - specifying what needs to be done and requesting that employees *comply* with those needs
  - sometimes called compliance approach
- *Commitment* is an alternative approach to managing people
  - engaging employees to *understand the interests* of the organization and its customers and *act accordingly*

Avoid, accommodate or partner with unions

- *Avoid* means to actively discourage employees from unionization
- *Accommodate* means to ‘put up with’ unions and negotiate with them as required, maintaining an arms length relationship
- *Partner* means to develop a closer relationship with unions, sharing more information and more often than required, seeking mutual gains solutions

Employment Relations Strategy



Note: Competitive position indicated by color – legacy (blue) and LCC (pink)

Observations regarding control vs. commitment

- *Control* more common than *commitment* in this industry for both LCCs and legacies
- Some airlines are moving toward *commitment* approach
  - Continental successfully achieved change in the mid-1990s
  - American, Air Tran and EasyJet trying more recently
- *Commitment* approach can work with different union strategies
  - avoid unions (JetBlue, Delta)
  - accommodate unions (Continental, VirginBlue)
  - partner with unions (Southwest)

Observations regarding avoid, accommodate or partner with unions

- *Accommodate* has been most common strategy toward unions in this industry, for legacies and LCCs
- Some have moved from *accommodate* to *avoid*
  - Continental/Eastern in past
  - Qantas moving in this direction with JetStar?
- Some have tried moving toward *partnership*
  - American, British Air, EasyJet, Aer Lingus
  - varying degrees of success
  - airlines have often sought union support for lowering costs but it's a difficult path to negotiate
  - requires a *desire to partner* by employees and their unions

RYANAIR vs. SOUTHWEST AIRLINES

- Two of the most successful LCCs are following *opposite* employment relations strategies
  - Ryanair – control/avoid unions
  - Southwest – commitment/partner with unions
- Our interviews revealed that these two LCCs are serving as competing role models for start-ups
- Sometimes internal battles are evident
- Many are opting for hybrid approaches
  - JetBlue – commitment/avoid unions
  - VirginBlue – commitment/accommodate unions

Under pressure, Southwest maintains high commitment/partnership approach

- Now largest carrier in U.S. domestic market
- Nearly highest *labor* unit costs – but nearly lowest *total* unit costs
- Baggage handling has lagged – but top performer on complaints and delays
- Wall Street analysts questioned SWA's high wages – response?
- "It's true, our employees are well-paid. **They've produced the most efficient, most profitable airline with the best customer service and they deserve to share the wealth** .. Our people know what the airline industry environment is like. I am confident they will do what it takes to keep SWA on top. I would consider it a failure if we have to go to our employees and tell them to take a pay cut." (CEO Gary Kelly, *Wall Street Journal*, 12/19/05)

Conclusions

- Multiple approaches to the employment relationship—within and across legacy and LCC segments
  - Several of these approaches can work well for investors
  - We predict that the best outcomes for employees (and perhaps for customers too) will follow from a high commitment, partnership approach
  - More challenging to achieve than other approaches

- Answer to the title question: **Can an Industry Compete on Costs Without Destroying its Workforce?**
  - Yes, but achieving a better balance in outcomes will take continued changes

- Alternative scenarios
  - Option 1: Building toward the "perfect storm"
  - Option 2: Learning and change: Airline by airline; union by union
  - Option 3: Airlines, government and unions join to build a sustainable industry